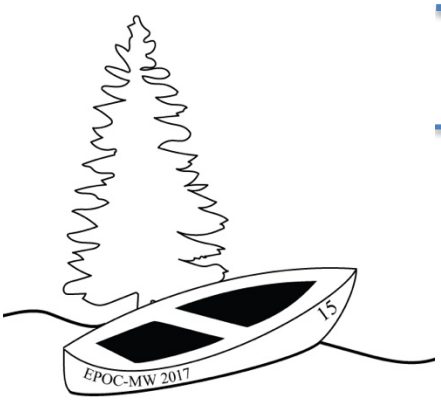

Working Paper Proceedings

15th Engineering Project Organization Conference
with
5th International Megaprojects Workshop
Stanford Sierra Camp, California
June 5-7, 2017

Application of Relational Governance in Infrastructure Privatization

Soh Young In, Stanford University, USA

Rajiv Sharma, Stanford University, USA

Ashby Monk, Stanford University, USA

Proceedings Editors
Ashwin Mahalingam, IIT Madras, Tripp Shealy, Virginia Tech, and Nuno Gil, University of Manchester

APPLICATION OF RELATIONAL GOVERNANCE IN INFRASTRUCTURE PRIVATIZATION

Abstract

Infrastructure privatization is expected to bring operational efficiency gains and diversified, greater financial access. But due to the heterogeneous and politically salient nature of infrastructure, performance of privatized infrastructure firms is often hindered by misaligned stakeholder interests and frequent government intervention. This study takes a new approach in examining infrastructure privatization challenges by applying traditional relational governance analysis to the privatized firm. Although relational governance can encompass economic, legal, sociological and psychological governance perspectives, we borrow MacNeil (2000)'s two distinct definitions of "relational"; one is socio-political influences on the exchange and the other is the continuing nature of contracts. These two aspects are correlated to each other in an inverse relationship; when socio-political understanding breaks down, the need of contract enforcement rises, and vice versa. This inverse relationship is illustrated in two contrasting airport privatization cases—British Airport Authority (BAA) and Auckland International Airport Ltd. (AIAL). For instance, the regulatory backlash that followed the acquisition of BAA reveals the need for socio-political understanding to manage interpersonal and inter-organizational dynamics among investors, management bodies, airport users, and local community. In contrast, the AIAL case shows how the government can play a central role in building strategic and nationwide consensus, leading to favorable investment and economic impact. Consequently, the New Zealand government can maintain a relational form of light-handed regulatory contract. Thus, we suggest that understanding socio-political interactions and wider political economic contexts can overcome the shortfalls of the governance structure created by formal contracts.

Keywords: infrastructure privatization, corporate governance, relational governance, stakeholder management, light-handed regulation, airport privatization

INTRODUCTION

The global demand for infrastructure investment is estimated at about US $3.7 trillion annually. However, only about US $2.7 trillion is being invested each year (World Economic Forum 2014). This infrastructure funding gap has led to the growth of a global infrastructure market for private investors. As governments face the dual problem of unprecedented levels of debt on their balance sheets and the desperate need to stimulate their economies, the presence of private infrastructure investment is greater than ever. During the 42-month period between January 2012 and August 2015, governments around the world raised over US $812 billion through privatization, and this amount is the highest among any comparable previous period (Megginson 2015).

Yet the rise of private investors and global trend of infrastructure privatization brings governance challenges. Performance of privatized firms is often hindered by misaligned stakeholder interests and frequent government interventions. These governance problems are accentuated in the infrastructure sector due to its distinct properties; large scaled and long-term infrastructure projects inherently involve multiple stakeholders, and public infrastructure assets and services are closely related to the public's interest. Profit-seeking behaviors of outside investors may exploit the monopolistic nature of public infrastructure, and underserve public interest. Government, on the other hand, must minimize restrictions to encourage the private sector to participate but still exercise enough control to safeguard public infrastructure from abusive monopolistic power. Consequentially the following question arises: how can public or private organizations best manage these new governance problems throughout the privatization process.

Empirical studies aimed at determining which privatization contract arrangement is most effective and yields the best results have failed to do so. The same privatization arrangements implemented in different countries give completely different results depending on the context in which privatization takes place (Drakić 2007). In this paper, we provide evidence of a relative governance failure from the British Airport Authority (BAA)'s private acquisition case—key management personnel departing, outside investors making opportunistic decisions, and the government intervening to protect the public interest. In contrast, the Auckland International Airport Ltd. (AIAL) in New Zealand has exhibited stable management and financials since

privatization, and less need for government intervention because new shareholders are in line with the country's long-term growth plans.

Contemporary organization studies recognize the limitations of traditional explanations of contract within law and economics, which frame a firm's governance, and adopt broadly socio-political perspectives that can complement these shortcomings. MacNeil (2000) emphasizes that contracts must have a relational aspect in order to have proper legal and economic analysis. He uses the term "relational" in two ways: The first refers to the fact that "all contracts occur in the context of a social matrix" and consideration must be given to societal and political influences on the exchange. The second, which is more relevant to relational contract theory, refers to the fact that "many contracts involve a continuing relationship between the parties, which will affect the way in which their contract operates" (Stone 2005). The socio-political understanding and contract enforcement are inversely correlated in relational governance, which means that when socio-political understanding breaks down, the need of contract enforcement rises, and vice versa.

In this paper, we argue that the heterogeneous and politically salient nature of infrastructure privatization requires a relational governance mechanism, which can facilitate transitional governance and performance in infrastructure privatization. This is achieved by using a socio-political approach, studying the interaction between investors and the government, while simultaneously being aware that these decisions are made within a larger political economic context. Our position is supported by two comparative case studies: the private acquisition of BAA and the privatization of AIAL.

This paper takes a new approach in understanding and addressing infrastructure privatization challenges by applying traditional relational governance studies to privatized firms. Firstly, we focus on socio-political perspectives in the infrastructure sector when applying works of traditional corporate governance and relational governance. Secondly, we provide concrete examples of how a socio-political understanding can alter the performance and impact of infrastructure privatization, and thereby achieve flexible government regulation enforcement. Lastly, we examine the dynamics among various stakeholders, including investors, managers, users, and governments, who are not only affected by but also influence firm's management. Previous discussions focus on bilateral exchange relationships in infrastructure management,

such as public vs private sector, but multilateral relationships have not been much discussed (Levitt et al. 2009).

The rest of the paper is structured as follows. Section 2 assesses governance challenges caused by organizational change resulting from infrastructure privatization. Section 3 reviews major contracts that frame the basic governance of a privatized firm, and their limitation in the absence of a socio-political understanding. Section 4 analyzes two airport privatization cases, and discusses how relational governance can be applied in practice. Section 5 concludes our findings.

GOVERNANCE CHALLENGE IN INFRASTRUCTURE PRIVATIZATION

A voluminous corporate finance literature identifies governance challenges in newly privatized firms. At the most basic level, a corporate governance problem arises whenever an outside investor wishes to exercise control differently from the manager in charge of the firm (Becht et al. 2003). Dispersed ownership magnifies the problem by giving rise to conflicts of interest between the various corporate claimholders and by creating a collective action problem among investors (Bolton 1995). Moreover, government tends to interfere with firm's management too much, which undermines fair market competition during privatization (Schmidt 1996; Shapiro and Willig 1990).

Levitt et al. (2009) expand the discussion to the area of infrastructure project development and delivery. He demonstrates that two distinct governance challenges in infrastructure projects are opportunistic behaviors of displaced agencies due to misaligned incentives, and political and regulatory intervention. These challenges systematically occur during the project shaping, implementation and operation of these projects, and even in magnified degrees because these infrastructure projects are long-term and large scale and often involve multiple stakeholders.

This section reviews leading works of Becht et al. (2003), Bolton (1995), and Levitt et al. (2009) on corporate governance problems and relates them to the challenges particular to infrastructure privatization.

Shareholder vs Stakeholder Debate

The classic public debate between Adolf A. Berle, Jr. and E. Merrick Dodd, Jr. over the basic role and function of corporates has not yet drawn comprehensive agreement. Berle (1931) argues that a corporation should only represent its shareholders' interests in their actions.[1] Dodd (1932), however, argues that a corporation is accountable to both the society in which they operate and their shareholders (Macintosh, 1999). Building on Dodd's original argument, Edwards Freeman developed the stakeholder theory track, which ensues that corporations are organizations that are accountable to their stakeholders and balance shareholders' financial interests against the interests of other stakeholders, such as customers, employees, suppliers and the local community, even if it reduces shareholder returns. Milton Friedman (1970) disagrees that responsibility to multiple stakeholders would exacerbate the separation of ownership and control and make management even less accountable to shareholders.

Traditionally, the law has not given a voice to non-shareholder stakeholders in the strategic direction of corporations such as employees and local residents. Unlike shareholders, these stakeholders do not have rights to trigger derivative actions against directors for breach of duty; also they do not have voting rights. As a result, these marginalized stakeholders have little influence even if they have a vested interest in the operation and management of the corporation.

The debate on whether a privatized corporation should only represent benefits to its shareholders or take account of other constituencies is rekindled during infrastructure privatization. Since infrastructure as public goods often exhibit natural monopolies and market failure, the government is responsible to provide access to the society.[2] In infrastructure projects, the non-shareholder stakeholders without legal influence over a corporation's management are often citizens and the local community. Thus, without government involvement, public infrastructure and its services are unlikely to be provided at all or are unlikely to be provided at

[1] "All powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears", Berle (1931).

[2] Public infrastructure and its service often exhibit market failure although they are beneficial to the public. They generate positive externalities by stimulating economic activities but it is difficult to internalize them. Given the size of the capital invested over a long time horizon, it is difficult for the private sector to realize an adequate return on their investment within the desirable period. Thus the government used to have a primary responsibility to manage and operate them. (In et al. 2017)

levels that are socially optimal. If these new shareholders from the private sector seek to maximize profits, the business of the newly privatized infrastructure firm may go against the original stakeholders' (or public's) interest.

Dispersed Ownership and Displaced Agency

Along with the global wave of privatization and a growing importance of large institutional investors, the issue of how the newly privatized corporations should be owned and controlled has emerged (Becht et al. 2003). Retrenched governments are now offering infrastructure investment opportunities to private actors in the form of sales of shares, sales of assets or various public-private partnership arrangements. Infrastructure privatization is expected to provide not only new sources of financing, but also efficiency gains compared to public procurement.

However, Bolton (1995) argues that the state-owned firms' inefficiency problem might not be completely resolved through privatization because it also involves corporate governance issues. He identifies that the main source of state-owned firms' inefficiency is the extreme dispersion of ownership among all the citizens in the country, and the absence of adequate incentive schemes for managers as well as for their supervisors, who are often politicians. But these barriers also exist in private medium-sized and large firms.

Dispersed ownership and control might not mitigate the inefficiencies of state-owned firms if privatized firms fail to align incentives within multiple counterparties, especially heterogeneous shareholders, managers and government who represents citizens. Bolton (1995) identifies three features that exacerbate the corporate governance problem in the newly privatized firms. Firstly share-ownership is widely dispersed among individual shareholders, whose wealth is relatively little. And, there is threat from concentration of share-ownership through financial intermediation that it can take advantage from small and ill-informed small investors. Secondly, the management body of privatized firms are inherited from the former state-owned firms, and their informational monopoly makes it more difficult to monitor the management. Lastly, newly privatized firms tend to depend on firm's monopolistic market power. The firms face no competition and no threat of bankruptcy.

In infrastructure projects, these problems become more evident as large-scale capital requirements involve more individual and institutional investment and the government has a stronger influence on the business. For instance, certain private investors with short-term

investment goals may conflict with pension funds' long-term investment return horizons. In addition, key domestic management personnel may have a strong loyalty to public interests whereas a foreign board of directors may care or empathize less about this. Some of the costs and benefits are often misaligned with the privatization project's optimal outcomes.

Levitt et al. (2009) introduce the phenomenon of "displaced agency" that results from this problem of misaligned incentives. Displaced agency occurs when a stakeholder's interests from shifting costs or responsibilities are not fully represented in the current transaction. This may lead to the new management to pursue their self-interests and choose sub-optimal decisions for the infrastructure project. For example, the domestic management teams at BAA who decided to exit the firm due to their conflict with the Spanish-led investment consortium and the investors leveraging short-term debt with a view to selling non-core assets.

Regulatory Interference

Infrastructure plays a critical role in the process of development and a nation's security and well-being, and thus infrastructure privatization is a high priority public policy agenda item (Levitt 2009; Vickers and Yarrow 1988). Consequentially, the governance of infrastructure projects inherently bears high political and regulatory risks. Corporate governance challenges are often exacerbated because political or regulatory actors try to intervene in operational and managerial decisions ex post to alter results from ex ante decisions. Schmidt (1996) and Shapiro and Willig (1990) find that under state ownership the government has better information about the firm's management (the benefit), but the government also tends to interfere too much (the cost). The issues of excessive political intervention ties back to Bolton's argument on why privatized firms do not necessarily bring expected performance from fair market competition and new management.

CONTRACTS OF INFRASTRUCTURE PRIVATIZATION

A spectrum of contracts frames the governance mechanism of privatized firms. In state-owned firms, contracts (mostly employment contracts) serve as an instrument of authority and hierarchies. Contracts in privatized firms, on the other hand, serve as instruments of market exchange. They define divisions between the firm and the market, and between the public and

private sectors, and how these boundaries are drawn (or are influenced) by government economic and industry policies. Contracts are also increasingly being deployed as instruments to social relations between the state and citizens in infrastructure privatization (Vincent-Jones 2000).

When contracts are designed properly, private investors have an incentive to see that an infrastructure project is executed efficiently, and the government can allocate the risks and returns in an incentive-compatible way (Ehlers 2014). However, contracts are necessary but not always sufficient to ensure optimal outcomes—especially in infrastructure privatization, which inherently involves multiple stakeholders potentially with misaligned interests. The relationship defined at the point of contract continues over the long life-cycle of the infrastructure asset, and affects how the contract operates. We propose that these interpersonal and inter-organizational relationships in infrastructure management can be better examined and explained using a relational perspective.

In this section, we review how contracts frame capital structure, privatization method and regulation throughout the infrastructure privatization process and relational theory may affect the governance of privatized infrastructure companies.

Capital Structure

Investors determine the level of financial leverage and method of financing (such as debt vs equity financing), which can have a significant impact on the capital structure of privatized infrastructure and its subsequent performance. Most investors try to leverage debt financing for investments expecting to earn a rate of return greater than the cost of interest because the repayment of loan principal and its accrued interest is pre-determined regardless of the subsequent outcome of investments.[3]

But investors' profit maximizing actions may dominate the corporation's capital structure and exploit its stakeholders' interest. Some opportunistic investors may abuse the financial leverage and replace equity in infrastructure companies with high volume of debts. For instance, a short-term financial engineering strategy employed by private equity-type investors was badly exposed during the GFC because of debt repayment issues, which severely compromised their

[3] The infrastructure sector tends to have high financial leverage; for instance, the average debt to enterprise value ratio by sector is estimated around 40-80% in toll roads, 60-90% in water infrastructure, and 50-80% in gas and electric power distribution and transmission (Beeferman 2008).

ability to make capital investments into the assets. These short-term profit seeking strategies have little or no regard for the long-term quality and robustness of the infrastructure networks, and have come under heavy scrutiny from other stakeholders (Helm and Tindall 2009). The BAA case study specifies the detrimental effects of using excessive financial leverage for the financing of privatized infrastructure investments; the credit crunch during 2007-2008 impacted BAA's new owners' financial capacity to pay highly-leveraged debt for privatization, and thus dried up potential capital expenditure for service improvement.

In order to prevent the aggressive profit-seeking behaviors, regulators in the infrastructure sector usually limit allowable rates of return based on the weighted average cost of capital (WACC). By extracting a return from the difference between the WACC and the marginal cost of debt, the resulting gain represents a transfer of wealth from customers to shareholders. A marginal cost of debt below the WACC would enable an arbitrage opportunity to be exploited (Helm and Tindall 2009).

Mode of Privatization

The mode of privatization can determine the degree of ownership dispersion. Public sector firms can be sold to the private sector through public offerings of shares (and floating shares thereafter) or private trade sales of assets. The notable difference between the two options is whether the ownership is held widely or tightly (Gillen 2011). The different modes of privatization entail different risk and responsibility allocations, financing and control of revenues, and the firm's management structure.

With share floatation, the company listed on the stock market through an IPO and its shares are to be traded later on. The government can tap a wide range of investors and expedite the capital raising process. It can also enhance the transparency of the firm's decision-making process by listing the company on the public market. However, it can be challenging to satisfy widely dispersed shareholders' expectations and to supervise managerial activities. And public dissemination of information can be undesirably used by market competitors.

The trade sale is a private sale where an individual or group of investors bid to purchase the shares of the airport corporation. In this case, the investment consortium takes over the management body. However, discordance within the investment consortia or dominance of certain participants may cause stumbling blocks. For example, in cases when the investment

consortia have a conflict with pre-existing management bodies and/or the public interest, the government should regulate its management. The BAA case is an example where the Spanish-led new investment consortia and original UK-based management body failed to communicate appropriately causing a severe management exodus.

Regulations

Infrastructure privatization is accompanied by a certain level of regulatory control in order to restrict the private sector with monopolistic market power. Empirical evidence shows that countries that devise regulatory frameworks up front and develop reasonable capacity to implement and enforce regulations have better success with privatization (Alexander and Estache 2000). Modern regulatory experiences have shown, however, that promoting efficiency conflicts with government price controls (Forsyth et al. 2004). This provides a considerable challenge in setting the minimal but necessary regulatory control for a particular situation. The government must balance between two long-term objectives— firstly, the investors should get a reasonable rate of return so as to ensure that investment actually takes place, and, secondly, the investors should not abuse its monopoly power to have excessive returns.

Regulators often use direct regulation mechanisms such as rate of return control and price cap regulation, with a number of hybrid variations developing that combine elements of the two. Regulations also intervene the tendering process in order to enhance market competition and control possible abuse of monopolistic market power. When a natural monopoly is sold outright and no or limited competition is expected, the privatization process should be accompanied with regulation. A further approach relates to the situation where deregulation takes place in order to provide new competitors in the market, such as airline or bus services where the monopoly is thought to be largely the result of regulatory control of entry rather than cost characteristics (Nash 2005).

Rate of return regulation is a traditional form of utility regulation, which constrains the rate of return on a certain-allowed rate base. Here, the regulator's primary task is to ensure that the airport operator can achieve financial equilibrium whereby the total allowed revenue must equal its total costs. The regulator requires detailed information on operational costs and the value of assets, and needs to ensure that the cost of capital would enable minimum profit to private investment.

The drawback of this regulation is a lack of incentive for outside investors to cut costs and to provide detailed information on costs, assets, and investments for regulators to assess the required price adjustment (Estache and de Rus 2000). There is an incentive to overinvest or to overstate the value of the assets when the correct value is difficult to assess precisely as this would have the effect of increasing the value of allowed benefits although prices would also increase. Thus, structural separation and unbundling are employed to control the rate of return while promoting competition. When structural separation is applied to facilitate competition, the rate of return depends on traditional rates of return on capital investments. Where no separation occurs, the rate of return depends on the growing value of the asset; in other words, asset-pricing inflation can be exploited (Estache and de Rus 2000; O'Neill 2009). In cases where fair market competition is not possible, regulatory tools have been used to control the consumer prices.

Price cap regulation is to protect the interests of infrastructure users and promote its economic efficiency. The price cap enables an operator to increase its prices with inflation, while subtracting potential cost savings by the firm due to either increased efficiency or technological progress. Price cap regulation is becoming more common worldwide over rate of return regulation because of the incentives to cut costs and invest appropriately. The key issue in price cap regulation is which business activities should be regulated. In the airport sector, there are single-till and dual-till revenue control systems; the difference is whether the regulator treats aeronautical business (all airline related services) and non-aeronautical business (non airline related services) separately or not. With the dual-till system, only aeronautical revenues are used to set airline charges as opposed to a single till model where both non-aeronautical and aeronautical revenues are used in the determination of the price caps (Gillen 2007).

Some regulators use light-handed regulations that allow the government, firm and its users to negotiate over price formulas and provision of investment (Helm 1998). Governments of New Zealand and Australia, for example, have adopted a light-handed regulatory framework for their airports with no formal pricing control but provision in the legislation for airports to consult with airlines over charges. Thus, governments are able to influence pricing regulation through legislative provisions. The light-handed regulatory environment can be seen as an implied relational contract between the firm and its relevant stakeholders (e.g. customer and the local community), highlighting the relationship between the parties and the need for a deeper

understanding of each respective party's requirements in order to achieve a mutually beneficial outcome. The light-handed regulatory framework facilitated the development of strong commercial relationships between airports and their airline customers, which in turn enhanced investment and value for money for airport users (Schuster 2009).

RELATIONAL APPROACHES AND CASE ANALYSIS

In this section, we cite specific examples of how relational understanding can complement contracts in infrastructure privatization but may undermine corporate governance when disregarded. Cases include the private acquisition of UK airport operating company BAA, and privatization of New Zealand's main international airport operator AIAL. The BAA case demonstrates the consequence of disregarding interpersonal and inter-organizational dynamics among investors, management bodies, airport users, and local community. Its poor governance enforced the UK government to exercise strict regulatory interventions. On the other hand, the governance model employed by AIAL reveals how infrastructure privatization can achieve both financial and wider economic goals. Strong community bonds and aligned incentives among shareholders enabled a long-term perspective for the AIAL business. The government, in turn, is able to keep its light-handed regulation, which it uses to oversee its privatized airport business but with provisional regulatory intervention.

Acquisition of British Airport Authority (BAA)

BAA was established in 1966 as the owner of Heathrow, Gatwick and Stansted airports, and the company floated on the London Stock Exchange in 1987. In 2006, BAA was acquired by ADI, an investment consortium led by Ferrovial, a Spanish construction company. The transaction was through a 'club' deal, where three large institutional investors, Ferrovial, Caisse de Dépot et Placement du Québec (CDPQ) and Singapore's Government Investment Corporation (GIC), partnered to form a consortium bid.[4] The ADI consortium offered to value BAA equity at

[4] CDPQ is an institutional investor that manages several public and parapublic pension plans and insurance programs in Quebec.

£10.11 billion and to give an enterprise value of £16.4 billion.[5] The acquisition was the largest infrastructure private transaction at the time. The final share breakdown was Ferrovial 62%, CDPQ 28% and GIC 10%.

Lack of Cross-cultural Understanding

As the largest shareholder, Ferrovial had a stronghold on the board of directors (the board), and excessively influenced the executive decision-making process. Prior to its acquisition by ADI, the board consisted of 12 members, with 6 independent non-executive directors and 6 executive directors in compliance with the UK Corporate Governance Code (the Code). All non-executive directors of the company had experience in managing or directing other large publicly listed companies in the UK, with specific infrastructure and regulated industry experience (BAA 2011). The Code is to ensure that the board should include a balance of executive and non-executive directors such that no individual or small group of individuals can dominate the board's decision making (FRC 2010). After the acquisition, however, the board expanded to 14 members, with 12 existing members replaced by 7 new members from Ferrovial, 3 from CDPQ and 2 from GIC (BAA 2011).

The new board installed by a majority of Ferrovial members undermined cultural differences between Ferrovial and BAA, and highlighted a disjointed governance structure. Decisions for the firm were made only in Madrid, and certainly not in the UK at BAA headquarters (Interview F, Former BAA employee, London). The chairman of Ferrovial announced that the company was clearly operating as a "UK business but with headquarters based in Madrid" (Mulligan 2007). The cultural tension and disjointed governance structure caused a subsequent management exodus, detrimental impact on operational and financial performance, and public outcry.

The new board and its decision making process seemed to create a level of anxiety amongst pre-existing senior managers, and a large number of experienced and talented senior management left the firm. BAA employees at the time complained about an absence of a clear communication channel and a loss of loyalty. They said their contribution to the business was not allowed because Ferrovial managers wanted to do things their way. Moreover, they claimed that

[5] Enterprise value is a measure of a company's value that includes the company's debt, preferred shares as well as the equity value (Brealey et al 2006).

ADI controlled BAA by putting their own people and pre-existing managers felt relegated to being an operating subsidiary of a Madrid-based company (Interview F, Former BAA employee, London).

The loss of key personnel with specific experience of dealing with stakeholders affected its operational performance. The managing director of American Airlines described the situation since ADI acquired the company as follows: "In the last two years BAA has been less responsive over operational issues and access to senior management has deteriorated" (House of Commons Transport Committee 2008). BAA used to invest a large amount of intellectual capital and monetary resources to manage the relationships with regulators. However, the ADI consortium underestimated the size of the task to gain a favorable regulatory outcome and did not invest adequate resources to do so.

Highly Leveraged Capital Structure

ADI's BAA acquisition was heavily leveraged to drive shareholders' wealth. However, this financial engineering driven strategy caused significant financial pressure. The BAA acquisition was funded with short-term debt with the view of selling non-core assets to pay down principal and refinancing with longer-term debt. At the time of the acquisition, cheap credit with minimal security or covenant restrictions was abundant and high leveraged investments were surging. The average leveraged loan in 2006, for example, was about 5.9 times the borrower's EBITDA whereas the same figure in 2001 was 4.7 (Larsen 2006). However, due to the collapse of the credit markets in 2007-2008, the consortium struggled to sell off assets to refinance its debts.

This pushed the company to a state of severe financial pressure because of the imminent maturity of the debt (Osborne 2008). Although ADI had intended to refinance its debt through an asset-backed securitization, the credit squeeze of 2007 delayed the plan and the market raised doubts about ADI's ability to refinance existing debt. The GFC had forced interest payments on BAA loans to unsustainable levels with the consortium having to pay annual interest of €2 billion, significantly eating into its EBITDA of €3.04 billion (Gordon and Mulligan 2008). The capital expenditure set aside at the time of the acquisition was being used to pay off debt, rather than being invested in the new buildings and improvements required to drive future revenue growth (McNeil 2010). ADI was forced by the Competition Commission to sell Gatwick Airport

in 2009. Ferrovial was forced put its controlling stake in BAA for sale in 2010 as part of its strategy to regain control of its own finances.

The deterioration of the company's value drivers destructed its equity value. BAA's equity was valued at £4.6 billion at the time of the transaction. The general brokers' consensus value of BAA's equity, at the time that Ferrovial announced its partial sale in 2010, was £729 million, an 87% decrease in value from the investment put into the company by the consortium[6]. Given the consortium's improved handling of its debt situation and recovery in passenger growth forecasts, this consensus value subsequently rose to £2.3 billion as of June 2011, but still represented a 58% or £3.2 billion destruction in equity value (Interview G, Investment Bank Financial Advisor to Ferrovial, London).

Such financial distress narrowed the focus of management, adversely affecting other areas of the business. Because ADI focused more heavily on its commercial developments in retail and duty-free, it compromised the basic servicing needs of customers in terminals and allowed further deterioration of its buildings. As a result, public outcry plagued the company since the acquisition in 2006. British economist John Kay highlighted the short-sighted shareholder perspective that ADI employed for its governance of BAA, "the activities that generate customer satisfaction—providing seats, enough security guards, clean toilets and elevators that work—are a cost, not a source of revenue." Consequently, insufficient capital investment led to maintenance shortfalls, stalled redevelopment projects and subsequent overcrowding and delays.

Outside Investors and Regulatory Backlash

A lack of appreciation toward domestic regulation escalated public indignation towards the company. Prior to the acquisition, there had been little opposition by the UK government to the foreign ownership of BAA; however once it appeared that the tension surrounding foreign ownership came to the fore, the Competition Commission enforced subsequent rules to break up BAA's monopoly position of UK airports.

The UK Office of Fair Trading (OFT) launched an investigation in to the market structure of UK airports and its impact on users. In their report, the OFT had referred BAA to the

[6] Values were obtained from interviews with the financial advisors to Ferrovial, reflecting the general broker consensus at the time.

Competition Commission inquiry for a possible break up of the airports group stating that "there was evidence of poor quality and high charges raising significant concerns among customers." The Competition Commission subsequently undertook a comprehensive two year inquiry into the supply of airport services by BAA to determine if any features of the market 'prevents, restricts or distorts competition' and, if so, what action might be taken to remedy these (House of Commons Transport Committee 2008). The provisional, preliminary findings of the inquiry found that there were competition problems at each of BAA's seven UK airports with adverse consequences for passengers and airlines. The principal cause of these problems was considered to be their common ownership by BAA. The proposed remedies upon which further consultation would take place included ordering BAA to sell two of its three London airports and also, either Edinburgh or Glasgow airport (Done et al., 2006).

Privatization of New Zealand Auckland Airport

The New Zealand government first signaled its intention to sell its 50% stake in the airport a few months after the corporatization of AIAL in 1988. Privatization did not actually happen until 1998 when the government announced that it would sell 51.6% of its shares and publicly list the company on the stock market through an IPO. The government announced that such a decision was made because AIAL was considering the development of a second runway and the government was reluctant to shoulder the burden of funding major development projects and related contingent liabilities (Clements and Thompson 2003).

Privatization was through an open price book-build share float as opposed to the more traditional fixed-price share float. This involved inviting selected institutional investors to bid for shares through a tendering process with competing bids to determine the final share price. The New Zealand general public were also invited to apply to purchase shares by dollar value rather than by number of shares. The IPO was five times oversubscribed with 65,837 New Zealanders becoming shareholders, and AIAL ranked among the top ten companies on the NZ Stock Exchange (AIAL Annual Report).

Community Support and Strategic Planning

The AIAL privatization was executed alongside a strategic plan and with nationwide consensus. The disciplined transition was a key driver for achieving positive outcomes (Interview B, Senior Management, AIAL). As a first step, the AIAL corporatization enabled a

shift in management thinking towards financial incentives and improving profitability in order to alleviate a wide internal disagreement on capital expenditure projects between the local and central governments. After the privatization, the management was subject to the scrutiny of public markets. This enabled AIAL to further shift towards a commercial focus with the approach of a business aligned with growing revenues, margins, innovating on product offerings and competing for market share.

There is a strong emotional connection to airports, particularly in smaller countries, and this was evident in the case of AIAL (Interview C, Board Member, AIAL). The public share offering was patriotically promoted with All Black rugby players as an opportunity for New Zealanders to own a piece of "their" airport. A lot of the investors that joined the company at the time of the float have continued to hold their investments to this day.

The solid community bonding among domestic shareholders has had a positive impact on the AIAL privatization. 80% of AIAL shares are owned by New Zealanders, and the government ministers who oversaw the sale agreed that it met their initial objectives (Interview A, Senior Management, AIAL). The domestic shareholder base largely consists of domestic pension funds, local schools and residents, local indigenous people, and local and central government officials. This community bonding has contributed to not only efficiency improvements in running the airport but also in ensuring growth opportunities are identified and acted upon (Interview B, Senior Management, AIAL). It enabled the airport to achieve favorable outcomes when entering into the bond and capital markets for financing purposes as well as from rating agencies; as of November 2016, AIAL's Long-Term Credit Rating by S&P is A- (Interview C, Board Member, AIAL).

Capital Structure and Incentive Alignment

AIAL has maintained a conservative approach to leveraging its capital structure and relatively lower levels of debt. AIAL has a broad shareholder base, and shareholders have traditionally been attracted by the conservative nature of the asset. Thus, the company has adopted a capital structure that is appropriate to its ownership structure with a long-term perspective.

A conservative capital structure reflects the aspirations of its shareholders and its firm commitment towards long-term development; it shows that AIAL is in a strong financial position

to make investments in physical capital to meet forecasted passenger growth and to provide high-quality services. It also provides a positive signal to the government and other stakeholders that the new owner is not abusing its monopolistic position. This capital structure has enabled AIAL's strong credit rating and provided flexible access to capital. For instance, a NZ$130 million retail bond issuance in 2008 and subsequent NZ$50 million bond issue were both oversubscribed. The company also has access to a syndicate of bank facilities that encompass nearly 50% of its source of borrowings (AIAL Annual Report).

Light-handed Regulation

New Zealand airports, including AIAL, are subjected to light-handed regulation by the Airport Authorities Act, which states that "airports must consult with major airline customers when setting aeronautical charges or undertaking major capital expenditure." The key aspect of this regulation is the lack of explicit regulatory control for the setting of airline charges. The legislation calls for consultation, as opposed to negotiation, of aeronautical charges, after which, airports are able to implement charges as they see fit. The consultation process for setting airline charges continued with the airports ultimately able to price as they saw fit. In addition, AIAL is required to consult with its substantial airline customers before embarking on any capital expenditure where the amount of the expenditure is equal to, at least the value of 20% of the assets (AIAL Annual Report).

The consultation process usually takes about a year, with the airport publicizing three or four proposals for its charges. Each time a proposal is put out, the airlines and representative bodies conduct their own analysis with expert advisers before responding. Through this process, airlines have had an effect in reducing the initial pricing proposals set out by the airports, but have not achieved a result that they believe is fair or in line with the findings of the initial Commerce Commission inquiry in 2002. The airlines express their frustration at the consultation process by comparing it to the inquisition of price control that the Commerce Commission undertakes. The situation can be likened to a Commerce Commission review where one of the submitters to the process actually has the final say in the discussion.

As a result, it appears that the consultation process of aeronautical charges favors the stance of airports, with limited threat of regulatory control. The airport is a lot more wary of the threat of a Commerce Commission pricing inquiry. However, the fact that the Commerce

Commission's recommendation following an inquiry, requires the support of the Minister in charge, means that an inquiry is unlikely to take place if it is believed that there is a small political will for pricing control. Unless AIAL acted in a radical way, the threat of pricing control under the current regulatory environment is quite small.

The light-handed regulation allows the government to have influence on how airport prices are regulated while ensuring the performance of the company that manages the airport. Since privatization, AIAL has set airline charges four times, in 2000, 2002, 2006 and 2009 (Interview B, Senior Management, AIAL). AIAL can earn substantial revenues from its aeronautical activities and thus contribute to its successful financial performance (Mackenzie-Williams, 2004). The management needs to balance this with the threat of regulatory intervention if they overstep the mark too much. The light handed approach illustrates how a more relational arrangement with lower formal contract enforcement can discipline the regulation process.

CONCLUSION

These two cases illustrate how relational factors, such as cultural understanding, community support and local commitment, have integral impacts on the outcome of privatization and subsequent regulatory controls. The BAA case shows that a shareholder's wealth-maximization approach should be accompanied by a properly considered relationship-based governance model. The decision-making process dominated by a Spanish-based board caused internal frustrations and the exit of key personnel, particularly those with experience in handling crucial stakeholder issues. Secondly, excessive financial leverage put the consortium under immense financial pressure and caused a sharp decline in value for the company.

In the AIAL case, on the other hand, the use of light handed regulation as a form of relational contract, enabled the government to play a central role in contributing to the company's performance and providing wider economic benefits for the regional and national economies. The governance strategies of AIAL are influenced by politicians through the threat of intervention if market power is exploited. The government's inclusive IPO privatization process and resulting ownership structure for the company have contributed to a robust policy on capital structure. The government minimized the restrictions on airport pricing in order to make the AIAL share sale appeal as an attractive investment opportunity to private investors.

So what could ADI have done differently to achieve a better private acquisition outcome in the BAA case? We suggest that a socio-political understanding could have averted the regulatory backlash. Firstly, a cohesive board of directors that was closer to the everyday activities of company's UK headquarters would have enabled decisions to be made in harmony with stakeholders' expectations and internal employees. Secondly, developing local relationships and communication channels with regulators may have reduced the adverse impacts of the regulatory backlash. With infrastructure companies perceived as having monopolistic characteristics, it is especially important to demonstrate the value that the company brings to the community. Governance strategies must be employed to avoid appearing as a "tax on people's lifestyles" (Interview B, Senior Management, AIAL). Lastly, an intensive capital investment program to improve the standard of the terminals and general customer services around BAA's airports should have been in place. This however was compromised by the excessive amount of financial leverage that was used to fund the acquisition.

To sum, this study demonstrates that relational governance mechanisms can help to address governance challenges in privatized infrastructure—heterogeneous stakeholder interests and high political risk. The cases in this paper highlight how a relational approach can be adopted in multiple areas of privately owned infrastructure. This includes a more inclusive privatization process (as used by the NZ government in the case of AIAL), a more flexible corporate governance strategy that balances shareholder and stakeholder interests and a regulatory framework that disciplines itself and provides flexibility through relationships without being constrained by the formality of contract. We acknowledge that each case will have unique characteristics and the government must balance between a relational approach and flexible and light form of regulatory control. As evidenced in the AIAL case, privatizing infrastructure can improve the quality of public services, provide a larger pool of capital, and stimulate economic activity. These desired outcomes depend on how decision makers consider societal, political and economic factors, including cultural understanding, political consensus, capacity of the private sector, market conditions, type of asset and service, and quality of service prior to private sector involvement.

Reference:

Alexander, I., and Estache, A. (2000). "Infrastructure Restructuring and Regulation: Building a Base for Sustainable Growth." *Policy Research Working Paper Series,* No. 2415. World Bank. Washington, DC.

Auckland International Airport Limited Annual Report (1989-2009)

BAA (2011). Retrieved Feb 20, 2012 from www.baa.com.

Becht, M., Bolton, P., & Röell, A. (2003). "Corporate Governance and Control". *Handbook of the Economics of Finance,* 1, 1-109.

Beeferman, L. (2008). "Pension Fund Investment in Infrastructure: A Resource Paper". *Occasional paper*, 3. Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School, Cambridge, MA.

Berle, A. A. (1931). "Corporate Powers as Powers in Trust". *Harvard Law Review*, 44(7), 1049-1074.

Bolton, P. (1995). "Privatization and the Separation of Ownership and Control: Lessons from Chinese Enterprise Reform". *Economics of Transition*, 3(1), 1-11.

Brealey, R., Myers, S. C., and Allen, F. (2006). *Principle of Corporate Finance*. McGraw Hill.

Clements, A., and Thompson, M. (2003). *Where New Zealand Touches the World from Farm Paddock to South Pacific Hub a History of Auckland International Airport*. Auckland, NZ.

Dodd, E. M. (1932). "For Whom Are Corporate Managers Trustees?". *Harvard Law Review*, 45(7), 1145-1163.

Done, K., and Mulligan, M. (2006). "Articles tracking the BAA Takeover between February and July 2006" *Financial Times*. www.ft.com

Drakić, M. (2007). "Privatization in Economic Theory". *Panoeconomicus,* 54(1), 103-118.

Ehlers, T. (2014). "Understanding the Challenges for Infrastructure Finance." *BIS Working Papers*, No. 454. Bank for International Settlements (BIS), Basel.

Estache, A., and de Rus, G. (2000). "Privatization and Regulation of Transport Infrastructure : Guidelines for Policymakers and Regulators." *World Bank Institute (WBI) Development Study*. World Bank. Washington DC.

Forsyth, P., D.W. Gillen, A. Knorr, O.G. Mayer, H.-M. Niemeier, D. Starkie. (2004). *The Economic Regulation of Airports—Recent Developments in Australasia, North America and Europe*. Gower Publishing, Ltd., Aldershot, UK

Friedman, M. (1970). "The Social Responsibility of Business Is To Increase Its Profits". *New York Times Magazine*, pp. 122-126.

Financial Reporting Council (FRC). (2010). UK Corporate Governance Code. Retrieved Dec 16, 2016 from http://www.frc.org.uk/corporate/ukcgcode.cfm

Gillen, D. (2011). "The Evolution of Airport Ownership and Governance." *Journal of Air Transport Management*, 17(1): 3-13.

Gillen, D. (2007). "The Regulation of Airports." *Working Papers,* No. 2007-5. Centre for Transportation Studies. Vancouver, BC.

Gordon, S., and M. Mulligan. (2008). "Fears for Ferrovial over Burden of Debt at BAA." *Financial Times*. Mar 25, 2008. Retrieved Dec 16, 2016 from https://www.ft.com/content/e9f142a4-faa0-11dc-aa46-000077b07658

Helm, D. (2009). "Infrastructure Investment, the Cost of Capital, and Regulation: an Assessment." *Oxford Review of Economic Policy*, 25(3): 307-326.

Helm, D. and T. Tindall. (2009). "The Evolution of Infrastructure and Utility Ownership and Its Implications." *Oxford Review of Economic Policy*, 25: 411-434.

House of Commons Transport Committee. (2008). "The Future of BAA: Fourth Report of Session 2007-8". London: The Stationery Office.

In, SY., Luiza C., and Kim, M. J. (2016). "Decision Framework for Private Participation in Airport Sector: The Case of Incheon International Airport in South Korea." *Stanford Global Project Center Working Paper*. Stanford University.

Larsen, P.T. (2006). "Money is as Cheap as Chips But Day of Reckoning Nears." *Financial Times*. Sep 26, 2006. Retrieved Dec 16, 2016 from http://www.ft.com/cms/s/0/ef4b5072-4dc3-11db-8704-0000779e2340.html?ft_site=falcon&desktop=true#axzz4SytxjPBv

Levitt, R. E., Henisz, W. J., and Settel, D. (2009). "Defining and Mitigating the Governance Challenges of Infrastructure Project Development and Delivery". In *Submitted to the Conference on Leadership and Management of Construction, Lake Tahoe, CA*, November 5-8, 2009.

Macintosh, J. C. (1999). "The Issues, Effects and Consequences of the Berle–Dodd Debate, 1931–1932". *Accounting, Organizations and Society*, 24(2), 139-153.

MacNeil, I.R. (2000). "Relational Contract Theory: Challenges and Queries." *Northwestern University Law Review*, 94(3): 877–907.

McNeill, D. (2010). "Behind the 'Heathrow Hassle': a Political and Cultural Economy of the Privatized Airport." *Environment and Planning A*, 42(12): 2859-2873.

McKenzie-Williams, P. (2004). "A Shift Towards Regulation? The Case of New Zealand." In P. Forsyth, D. Gillen, A. Knorr, O. Mayer, H-M. Niemeier, D. Starkie (eds.) *The Economic Regulation of Airports—Recent Developments in Australasia, North America and Europe*. Gower Publishing, Ltd., Aldershot, UK

Megginson, W. L. (2015). "Privatization Trends and Major Deals in 2014 and Two-Thirds 2015." *The PB Report 2014/2015*. Retrieved Dec 16, 2016 from http://www.privatizationbarometer.net/PUB/NL/5/5/PB_AR2014-2015.pdf.

Mulligan, M. (2007). "Heathrow Operator Admits to Its Many Failings." *Financial Times*. Jun 30, 2007. Retrieved Dec 16, 2016 from http://www.ft.com/cms/s/0/b3ebc1f4-26a5-11dc-8e18-000b5df10621.html?ft_site=falcon&desktop=true#axzz4SytxjPBv

Nash, C.A. (2005). "Privatization in Transport." *Handbook of Transport Strategy, Policy and Institutions.* eds Button, K., Hensher, D.A. Elsevier, Amsterdam: 97–113.

O'Neill, P. M. (2009). "Infrastructure Financing and Operation in the Contemporary City". *Geographical Research,* 48(1): 3-12.

Osborne, A. (2008). "Is it terminal for BAA and Ferrovial financing?" *The Daily Telegraph.* Feb, 17, 2008. Retrieved Dec 16, 2016 from http://www.telegraph.co.uk/finance/markets/2784496/Is-itterminal-for-BAA-and-Ferrovial-financing.html.

Sharma, R., (2012). Infrastructure: an emerging asset class for institutional investors. In *The Societal Function of Investment Asset Classes: Implications for Responsible Investment Conference*.

Schmidt, K. M. (1996). "Incomplete Contracts and Privatization". *European Economic Review*, 40(3), 569-579.

Schuster, D. (2009). "Australia's Approach to Airport Charges: the Sydney Airport Experience." *Journal of Air Transport Management*, 15: 121-126.

Shapiro, C., and Willig, R. D. (1990). "Economic Rationales for the Scope of Privatization". *The Political Economy of Public Sector Reform and Privatization*, Westview Press, London, 55-87.

Stone, R. (2005). *The Modern Law of Contract*. Psychology Press.

Vickers, J., and Yarrow, G. K. (1988). *Privatization: An Economic Analysis*. MIT Press. Vol. 18.

Vincent-Jones, P. (2000). "Contractual Governance: Institutional and Organizational Analysis". *Oxford Journal of Legal Studies*, 20(3), 317-351.

World Economic Forum. (2014). *Strategic Infrastructure: Steps to Operate and Maintain Infrastructure Efficiently and Effectively*. World Economic Forum, Cologny/Geneva, Switzerland. Retrieved Dec 16, 2016 from http://reports.weforum.org/strategic-infrastructure-2014/.

Application of Relational Governance in Infrastructure Privatization

April 2017

Abstract

Infrastructure privatization is expected to bring operational efficiency gains and diversified, greater financial access. But due to the heterogeneous and politically salient nature of infrastructure, performance of privatized infrastructure firms is often hindered by misaligned stakeholder interests and frequent government intervention. This study takes a new approach in examining infrastructure privatization challenges by applying traditional relational governance analysis to the privatized firm. Although relational governance can encompass economic, legal, sociological and psychological governance perspectives, we borrow MacNeil (2000)'s two distinct definitions of "relational"; one is socio-political influences on the exchange and the other is the continuing nature of contracts. These two aspects are correlated to each other in an inverse relationship; when socio-political understanding breaks down, the need of contract enforcement rises, and vice versa. This inverse relationship is illustrated in two contrasting airport privatization cases—British Airport Authority (BAA) and Auckland International Airport Ltd. (AIAL). For instance, the regulatory backlash that followed the acquisition of BAA reveals the need for socio-political understanding to manage interpersonal and inter-organizational dynamics among investors, management bodies, airport users, and local community. In contrast, the AIAL case shows how the government can play a central role in building strategic and nationwide consensus, leading to favorable investment and economic impact. Consequently, the New Zealand government can maintain a relational form of light-handed regulatory contract. Thus, we suggest that understanding socio-political interactions and wider political economic contexts can overcome the shortfalls of the governance structure created by formal contracts.

Keywords: infrastructure privatization, corporate governance, relational governance, stakeholder management, light-handed regulation, airport privatization

INTRODUCTION

The global demand for infrastructure investment is estimated at about US $3.7 trillion annually. However, only about US $2.7 trillion is being invested each year (World Economic Forum 2014). This infrastructure funding gap has led to the growth of a global infrastructure market for private investors. As governments face the dual problem of unprecedented levels of debt on their balance sheets and the desperate need to stimulate their economies, the presence of private infrastructure investment is greater than ever. During the 42-month period between January 2012 and August 2015, governments around the world raised over US $812 billion through privatization, and this amount is the highest among any comparable previous period (Megginson 2015).

Yet the rise of private investors and global trend of infrastructure privatization brings governance challenges. Performance of privatized firms is often hindered by misaligned stakeholder interests and frequent government interventions. These governance problems are accentuated in the infrastructure sector due to its distinct properties; large scaled and long-term infrastructure projects inherently involve multiple stakeholders, and public infrastructure assets and services are closely related to the public's interest. Profit-seeking behaviors of outside investors may exploit the monopolistic nature of public infrastructure, and underserve public interest. Government, on the other hand, must minimize restrictions to encourage the private sector to participate but still exercise enough control to safeguard public infrastructure from abusive monopolistic power. Consequentially the following question arises: how can public or private organizations best manage these new governance problems throughout the privatization process.

Empirical studies aimed at determining which privatization contract arrangement is most effective and yields the best results have failed to do so. The same privatization arrangements implemented in different countries give completely different results depending on the context in which privatization takes place (Drakić 2007). In this paper, we provide evidence of a relative governance failure from the British Airport Authority (BAA)'s private acquisition case—key management personnel departing, outside investors making opportunistic decisions, and the government intervening to protect the public interest. In contrast, the Auckland International Airport Ltd. (AIAL) in New Zealand has exhibited stable management and financials since

privatization, and less need for government intervention because new shareholders are in line with the country's long-term growth plans.

Contemporary organization studies recognize the limitations of traditional explanations of contract within law and economics, which frame a firm's governance, and adopt broadly socio-political perspectives that can complement these shortcomings. MacNeil (2000) emphasizes that contracts must have a relational aspect in order to have proper legal and economic analysis. He uses the term "relational" in two ways: The first refers to the fact that "all contracts occur in the context of a social matrix" and consideration must be given to societal and political influences on the exchange. The second, which is more relevant to relational contract theory, refers to the fact that "many contracts involve a continuing relationship between the parties, which will affect the way in which their contract operates" (Stone 2005). The socio-political understanding and contract enforcement are inversely correlated in relational governance, which means that when socio-political understanding breaks down, the need of contract enforcement rises, and vice versa.

In this paper, we argue that the heterogeneous and politically salient nature of infrastructure privatization requires a relational governance mechanism, which can facilitate transitional governance and performance in infrastructure privatization. This is achieved by using a socio-political approach, studying the interaction between investors and the government, while simultaneously being aware that these decisions are made within a larger political economic context. Our position is supported by two comparative case studies: the private acquisition of BAA and the privatization of AIAL.

This paper takes a new approach in understanding and addressing infrastructure privatization challenges by applying traditional relational governance studies to privatized firms. Firstly, we focus on socio-political perspectives in the infrastructure sector when applying works of traditional corporate governance and relational governance. Secondly, we provide concrete examples of how a socio-political understanding can alter the performance and impact of infrastructure privatization, and thereby achieve flexible government regulation enforcement. Lastly, we examine the dynamics among various stakeholders, including investors, managers, users, and governments, who are not only affected by but also influence firm's management. Previous discussions focus on bilateral exchange relationships in infrastructure management,

such as public vs private sector, but multilateral relationships have not been much discussed (Levitt et al. 2009).

The rest of the paper is structured as follows. Section 2 assesses governance challenges caused by organizational change resulting from infrastructure privatization. Section 3 reviews major contracts that frame the basic governance of a privatized firm, and their limitation in the absence of a socio-political understanding. Section 4 analyzes two airport privatization cases, and discusses how relational governance can be applied in practice. Section 5 concludes our findings.

GOVERNANCE CHALLENGE IN INFRASTRUCTURE PRIVATIZATION

A voluminous corporate finance literature identifies governance challenges in newly privatized firms. At the most basic level, a corporate governance problem arises whenever an outside investor wishes to exercise control differently from the manager in charge of the firm (Becht et al. 2003). Dispersed ownership magnifies the problem by giving rise to conflicts of interest between the various corporate claimholders and by creating a collective action problem among investors (Bolton 1995). Moreover, government tends to interfere with firm's management too much, which undermines fair market competition during privatization (Schmidt 1996; Shapiro and Willig 1990).

Levitt et al. (2009) expand the discussion to the area of infrastructure project development and delivery. He demonstrates that two distinct governance challenges in infrastructure projects are opportunistic behaviors of displaced agencies due to misaligned incentives, and political and regulatory intervention. These challenges systematically occur during the project shaping, implementation and operation of these projects, and even in magnified degrees because these infrastructure projects are long-term and large scale and often involve multiple stakeholders.

This section reviews leading works of Becht et al. (2003), Bolton (1995), and Levitt et al. (2009) on corporate governance problems and relates them to the challenges particular to infrastructure privatization.

Shareholder vs Stakeholder Debate

The classic public debate between Adolf A. Berle, Jr. and E. Merrick Dodd, Jr. over the basic role and function of corporates has not yet drawn comprehensive agreement. Berle (1931) argues that a corporation should only represent its shareholders' interests in their actions.[1] Dodd (1932), however, argues that a corporation is accountable to both the society in which they operate and their shareholders (Macintosh, 1999). Building on Dodd's original argument, Edwards Freeman developed the stakeholder theory track, which ensues that corporations are organizations that are accountable to their stakeholders and balance shareholders' financial interests against the interests of other stakeholders, such as customers, employees, suppliers and the local community, even if it reduces shareholder returns. Milton Friedman (1970) disagrees that responsibility to multiple stakeholders would exacerbate the separation of ownership and control and make management even less accountable to shareholders.

Traditionally, the law has not given a voice to non-shareholder stakeholders in the strategic direction of corporations such as employees and local residents. Unlike shareholders, these stakeholders do not have rights to trigger derivative actions against directors for breach of duty; also they do not have voting rights. As a result, these marginalized stakeholders have little influence even if they have a vested interest in the operation and management of the corporation.

The debate on whether a privatized corporation should only represent benefits to its shareholders or take account of other constituencies is rekindled during infrastructure privatization. Since infrastructure as public goods often exhibit natural monopolies and market failure, the government is responsible to provide access to the society.[2] In infrastructure projects, the non-shareholder stakeholders without legal influence over a corporation's management are often citizens and the local community. Thus, without government involvement, public infrastructure and its services are unlikely to be provided at all or are unlikely to be provided at levels that are socially optimal. If these new shareholders from the private sector seek to

[1] "All powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears", Berle (1931).

[2] Public infrastructure and its service often exhibit market failure although they are beneficial to the public. They generate positive externalities by stimulating economic activities but it is difficult to internalize them. Given the size of the capital invested over a long time horizon, it is difficult for the private sector to realize an adequate return on their investment within the desirable period. Thus the government used to have a primary responsibility to manage and operate them. (In et al. 2017)

maximize profits, the business of the newly privatized infrastructure firm may go against the original stakeholders' (or public's) interest.

Dispersed Ownership and Displaced Agency

Along with the global wave of privatization and a growing importance of large institutional investors, the issue of how the newly privatized corporations should be owned and controlled has emerged (Becht et al. 2003). Retrenched governments are now offering infrastructure investment opportunities to private actors in the form of sales of shares, sales of assets or various public-private partnership arrangements. Infrastructure privatization is expected to provide not only new sources of financing, but also efficiency gains compared to public procurement.

However, Bolton (1995) argues that the state-owned firms' inefficiency problem might not be completely resolved through privatization because it also involves corporate governance issues. He identifies that the main source of state-owned firms' inefficiency is the extreme dispersion of ownership among all the citizens in the country, and the absence of adequate incentive schemes for managers as well as for their supervisors, who are often politicians. But these barriers also exist in private medium-sized and large firms.

Dispersed ownership and control might not mitigate the inefficiencies of state-owned firms if privatized firms fail to align incentives within multiple counterparties, especially heterogeneous shareholders, managers and government who represents citizens. Bolton (1995) identifies three features that exacerbate the corporate governance problem in the newly privatized firms. Firstly share-ownership is widely dispersed among individual shareholders, whose wealth is relatively little. And, there is threat from concentration of share-ownership through financial intermediation that it can take advantage from small and ill-informed small investors. Secondly, the management body of privatized firms are inherited from the former state-owned firms, and their informational monopoly makes it more difficult to monitor the management. Lastly, newly privatized firms tend to depend on firm's monopolistic market power. The firms face no competition and no threat of bankruptcy.

In infrastructure projects, these problems become more evident as large-scale capital requirements involve more individual and institutional investment and the government has a stronger influence on the business. For instance, certain private investors with short-term investment goals may conflict with pension funds' long-term investment return horizons. In

addition, key domestic management personnel may have a strong loyalty to public interests whereas a foreign board of directors may care or empathize less about this. Some of the costs and benefits are often misaligned with the privatization project's optimal outcomes.

Levitt et al. (2009) introduce the phenomenon of "displaced agency" that results from this problem of misaligned incentives. Displaced agency occurs when a stakeholder's interests from shifting costs or responsibilities are not fully represented in the current transaction. This may lead to the new management to pursue their self-interests and choose sub-optimal decisions for the infrastructure project. For example, the domestic management teams at BAA who decided to exit the firm due to their conflict with the Spanish-led investment consortium and the investors leveraging short-term debt with a view to selling non-core assets.

Regulatory Interference

Infrastructure plays a critical role in the process of development and a nation's security and well-being, and thus infrastructure privatization is a high priority public policy agenda item (Levitt 2009; Vickers and Yarrow 1988). Consequentially, the governance of infrastructure projects inherently bears high political and regulatory risks. Corporate governance challenges are often exacerbated because political or regulatory actors try to intervene in operational and managerial decisions ex post to alter results from ex ante decisions. Schmidt (1996) and Shapiro and Willig (1990) find that under state ownership the government has better information about the firm's management (the benefit), but the government also tends to interfere too much (the cost). The issues of excessive political intervention ties back to Bolton's argument on why privatized firms do not necessarily bring expected performance from fair market competition and new management.

CONTRACTS OF INFRASTRUCTURE PRIVATIZATION

A spectrum of contracts frames the governance mechanism of privatized firms. In state-owned firms, contracts (mostly employment contracts) serve as an instrument of authority and hierarchies. Contracts in privatized firms, on the other hand, serve as instruments of market exchange. They define divisions between the firm and the market, and between the public and private sectors, and how these boundaries are drawn (or are influenced) by government economic

and industry policies. Contracts are also increasingly being deployed as instruments to social relations between the state and citizens in infrastructure privatization (Vincent-Jones 2000).

When contracts are designed properly, private investors have an incentive to see that an infrastructure project is executed efficiently, and the government can allocate the risks and returns in an incentive-compatible way (Ehlers 2014). However, contracts are necessary but not always sufficient to ensure optimal outcomes—especially in infrastructure privatization, which inherently involves multiple stakeholders potentially with misaligned interests. The relationship defined at the point of contract continues over the long life-cycle of the infrastructure asset, and affects how the contract operates. We propose that these interpersonal and inter-organizational relationships in infrastructure management can be better examined and explained using a relational perspective.

In this section, we review how contracts frame capital structure, privatization method and regulation throughout the infrastructure privatization process and relational theory may affect the governance of privatized infrastructure companies.

Capital Structure

Investors determine the level of financial leverage and method of financing (such as debt vs equity financing), which can have a significant impact on the capital structure of privatized infrastructure and its subsequent performance. Most investors try to leverage debt financing for investments expecting to earn a rate of return greater than the cost of interest because the repayment of loan principal and its accrued interest is pre-determined regardless of the subsequent outcome of investments.[3]

But investors' profit maximizing actions may dominate the corporation's capital structure and exploit its stakeholders' interest. Some opportunistic investors may abuse the financial leverage and replace equity in infrastructure companies with high volume of debts. For instance, a short-term financial engineering strategy employed by private equity-type investors was badly exposed during the GFC because of debt repayment issues, which severely compromised their ability to make capital investments into the assets. These short-term profit seeking strategies

[3] The infrastructure sector tends to have high financial leverage; for instance, the average debt to enterprise value ratio by sector is estimated around 40-80% in toll roads, 60-90% in water infrastructure, and 50-80% in gas and electric power distribution and transmission (Beeferman 2008).

have little or no regard for the long-term quality and robustness of the infrastructure networks, and have come under heavy scrutiny from other stakeholders (Helm and Tindall 2009). The BAA case study specifies the detrimental effects of using excessive financial leverage for the financing of privatized infrastructure investments; the credit crunch during 2007-2008 impacted BAA's new owners' financial capacity to pay highly-leveraged debt for privatization, and thus dried up potential capital expenditure for service improvement.

In order to prevent the aggressive profit-seeking behaviors, regulators in the infrastructure sector usually limit allowable rates of return based on the weighted average cost of capital (WACC). By extracting a return from the difference between the WACC and the marginal cost of debt, the resulting gain represents a transfer of wealth from customers to shareholders. A marginal cost of debt below the WACC would enable an arbitrage opportunity to be exploited (Helm and Tindall 2009).

Mode of Privatization

The mode of privatization can determine the degree of ownership dispersion. Public sector firms can be sold to the private sector through public offerings of shares (and floating shares thereafter) or private trade sales of assets. The notable difference between the two options is whether the ownership is held widely or tightly (Gillen 2011). The different modes of privatization entail different risk and responsibility allocations, financing and control of revenues, and the firm's management structure.

With share floatation, the company listed on the stock market through an IPO and its shares are to be traded later on. The government can tap a wide range of investors and expedite the capital raising process. It can also enhance the transparency of the firm's decision-making process by listing the company on the public market. However, it can be challenging to satisfy widely dispersed shareholders' expectations and to supervise managerial activities. And public dissemination of information can be undesirably used by market competitors.

The trade sale is a private sale where an individual or group of investors bid to purchase the shares of the airport corporation. In this case, the investment consortium takes over the management body. However, discordance within the investment consortia or dominance of certain participants may cause stumbling blocks. For example, in cases when the investment consortia have a conflict with pre-existing management bodies and/or the public interest, the

government should regulate its management. The BAA case is an example where the Spanish-led new investment consortia and original UK-based management body failed to communicate appropriately causing a severe management exodus.

Regulations

Infrastructure privatization is accompanied by a certain level of regulatory control in order to restrict the private sector with monopolistic market power. Empirical evidence shows that countries that devise regulatory frameworks up front and develop reasonable capacity to implement and enforce regulations have better success with privatization (Alexander and Estache 2000). Modern regulatory experiences have shown, however, that promoting efficiency conflicts with government price controls (Forsyth et al. 2004). This provides a considerable challenge in setting the minimal but necessary regulatory control for a particular situation. The government must balance between two long-term objectives— firstly, the investors should get a reasonable rate of return so as to ensure that investment actually takes place, and, secondly, the investors should not abuse its monopoly power to have excessive returns.

Regulators often use direct regulation mechanisms such as rate of return control and price cap regulation, with a number of hybrid variations developing that combine elements of the two. Regulations also intervene the tendering process in order to enhance market competition and control possible abuse of monopolistic market power. When a natural monopoly is sold outright and no or limited competition is expected, the privatization process should be accompanied with regulation. A further approach relates to the situation where deregulation takes place in order to provide new competitors in the market, such as airline or bus services where the monopoly is thought to be largely the result of regulatory control of entry rather than cost characteristics (Nash 2005).

Rate of return regulation is a traditional form of utility regulation, which constrains the rate of return on a certain-allowed rate base. Here, the regulator's primary task is to ensure that the airport operator can achieve financial equilibrium whereby the total allowed revenue must equal its total costs. The regulator requires detailed information on operational costs and the value of assets, and needs to ensure that the cost of capital would enable minimum profit to private investment.

The drawback of this regulation is a lack of incentive for outside investors to cut costs and to provide detailed information on costs, assets, and investments for regulators to assess the required price adjustment (Estache and de Rus 2000). There is an incentive to overinvest or to overstate the value of the assets when the correct value is difficult to assess precisely as this would have the effect of increasing the value of allowed benefits although prices would also increase. Thus, structural separation and unbundling are employed to control the rate of return while promoting competition. When structural separation is applied to facilitate competition, the rate of return depends on traditional rates of return on capital investments. Where no separation occurs, the rate of return depends on the growing value of the asset; in other words, asset-pricing inflation can be exploited (Estache and de Rus 2000; O'Neill 2009). In cases where fair market competition is not possible, regulatory tools have been used to control the consumer prices.

Price cap regulation is to protect the interests of infrastructure users and promote its economic efficiency. The price cap enables an operator to increase its prices with inflation, while subtracting potential cost savings by the firm due to either increased efficiency or technological progress. Price cap regulation is becoming more common worldwide over rate of return regulation because of the incentives to cut costs and invest appropriately. The key issue in price cap regulation is which business activities should be regulated. In the airport sector, there are single-till and dual-till revenue control systems; the difference is whether the regulator treats aeronautical business (all airline related services) and non-aeronautical business (non airline related services) separately or not. With the dual-till system, only aeronautical revenues are used to set airline charges as opposed to a single till model where both non-aeronautical and aeronautical revenues are used in the determination of the price caps (Gillen 2007).

Some regulators use light-handed regulations that allow the government, firm and its users to negotiate over price formulas and provision of investment (Helm 1998). Governments of New Zealand and Australia, for example, have adopted a light-handed regulatory framework for their airports with no formal pricing control but provision in the legislation for airports to consult with airlines over charges. Thus, governments are able to influence pricing regulation through legislative provisions. The light-handed regulatory environment can be seen as an implied relational contract between the firm and its relevant stakeholders (e.g. customer and the local community), highlighting the relationship between the parties and the need for a deeper

understanding of each respective party's requirements in order to achieve a mutually beneficial outcome. The light-handed regulatory framework facilitated the development of strong commercial relationships between airports and their airline customers, which in turn enhanced investment and value for money for airport users (Schuster 2009).

RELATIONAL APPROACHES AND CASE ANALYSIS

In this section, we cite specific examples of how relational understanding can complement contracts in infrastructure privatization but may undermine corporate governance when disregarded. Cases include the private acquisition of UK airport operating company BAA, and privatization of New Zealand's main international airport operator AIAL. The BAA case demonstrates the consequence of disregarding interpersonal and inter-organizational dynamics among investors, management bodies, airport users, and local community. Its poor governance enforced the UK government to exercise strict regulatory interventions. On the other hand, the governance model employed by AIAL reveals how infrastructure privatization can achieve both financial and wider economic goals. Strong community bonds and aligned incentives among shareholders enabled a long-term perspective for the AIAL business. The government, in turn, is able to keep its light-handed regulation, which it uses to oversee its privatized airport business but with provisional regulatory intervention.

Acquisition of British Airport Authority (BAA)

BAA was established in 1966 as the owner of Heathrow, Gatwick and Stansted airports, and the company floated on the London Stock Exchange in 1987. In 2006, BAA was acquired by ADI, an investment consortium led by Ferrovial, a Spanish construction company. The transaction was through a 'club' deal, where three large institutional investors, Ferrovial, Caisse de Dépot et Placement du Québec (CDPQ) and Singapore's Government Investment Corporation (GIC), partnered to form a consortium bid.[4] The ADI consortium offered to value BAA equity at £10.11 billion and to give an enterprise value of £16.4 billion.[5] The acquisition was the largest

[4] CDPQ is an institutional investor that manages several public and parapublic pension plans and insurance programs in Quebec.

[5] Enterprise value is a measure of a company's value that includes the company's debt, preferred shares as well as the equity value (Brealey et al 2006).

infrastructure private transaction at the time. The final share breakdown was Ferrovial 62%, CDPQ 28% and GIC 10%.

Lack of Cross-cultural Understanding

As the largest shareholder, Ferrovial had a stronghold on the board of directors (the board), and excessively influenced the executive decision-making process. Prior to its acquisition by ADI, the board consisted of 12 members, with 6 independent non-executive directors and 6 executive directors in compliance with the UK Corporate Governance Code (the Code). All non-executive directors of the company had experience in managing or directing other large publicly listed companies in the UK, with specific infrastructure and regulated industry experience (BAA 2011). The Code is to ensure that the board should include a balance of executive and non-executive directors such that no individual or small group of individuals can dominate the board's decision making (FRC 2010). After the acquisition, however, the board expanded to 14 members, with 12 existing members replaced by 7 new members from Ferrovial, 3 from CDPQ and 2 from GIC (BAA 2011).

The new board installed by a majority of Ferrovial members undermined cultural differences between Ferrovial and BAA, and highlighted a disjointed governance structure. Decisions for the firm were made only in Madrid, and certainly not in the UK at BAA headquarters (Interview F, Former BAA employee, London). The chairman of Ferrovial announced that the company was clearly operating as a "UK business but with headquarters based in Madrid" (Mulligan 2007). The cultural tension and disjointed governance structure caused a subsequent management exodus, detrimental impact on operational and financial performance, and public outcry.

The new board and its decision making process seemed to create a level of anxiety amongst pre-existing senior managers, and a large number of experienced and talented senior management left the firm. BAA employees at the time complained about an absence of a clear communication channel and a loss of loyalty. They said their contribution to the business was not allowed because Ferrovial managers wanted to do things their way. Moreover, they claimed that ADI controlled BAA by putting their own people and pre-existing managers felt relegated to being an operating subsidiary of a Madrid-based company (Interview F, Former BAA employee, London).

The loss of key personnel with specific experience of dealing with stakeholders affected its operational performance. The managing director of American Airlines described the situation since ADI acquired the company as follows: "In the last two years BAA has been less responsive over operational issues and access to senior management has deteriorated" (House of Commons Transport Committee 2008). BAA used to invest a large amount of intellectual capital and monetary resources to manage the relationships with regulators. However, the ADI consortium underestimated the size of the task to gain a favorable regulatory outcome and did not invest adequate resources to do so.

Highly Leveraged Capital Structure

ADI's BAA acquisition was heavily leveraged to drive shareholders' wealth. However, this financial engineering driven strategy caused significant financial pressure. The BAA acquisition was funded with short-term debt with the view of selling non-core assets to pay down principal and refinancing with longer-term debt. At the time of the acquisition, cheap credit with minimal security or covenant restrictions was abundant and high leveraged investments were surging. The average leveraged loan in 2006, for example, was about 5.9 times the borrower's EBITDA whereas the same figure in 2001 was 4.7 (Larsen 2006). However, due to the collapse of the credit markets in 2007-2008, the consortium struggled to sell off assets to refinance its debts.

This pushed the company to a state of severe financial pressure because of the imminent maturity of the debt (Osborne 2008). Although ADI had intended to refinance its debt through an asset-backed securitization, the credit squeeze of 2007 delayed the plan and the market raised doubts about ADI's ability to refinance existing debt. The GFC had forced interest payments on BAA loans to unsustainable levels with the consortium having to pay annual interest of €2 billion, significantly eating into its EBITDA of €3.04 billion (Gordon and Mulligan 2008). The capital expenditure set aside at the time of the acquisition was being used to pay off debt, rather than being invested in the new buildings and improvements required to drive future revenue growth (McNeil 2010). ADI was forced by the Competition Commission to sell Gatwick Airport in 2009. Ferrovial was forced put its controlling stake in BAA for sale in 2010 as part of its strategy to regain control of its own finances.

The deterioration of the company's value drivers destructed its equity value. BAA's equity was valued at £4.6 billion at the time of the transaction. The general brokers' consensus value of

BAA's equity, at the time that Ferrovial announced its partial sale in 2010, was £729 million, an 87% decrease in value from the investment put into the company by the consortium[6]. Given the consortium's improved handling of its debt situation and recovery in passenger growth forecasts, this consensus value subsequently rose to £2.3 billion as of June 2011, but still represented a 58% or £3.2 billion destruction in equity value (Interview G, Investment Bank Financial Advisor to Ferrovial, London).

Such financial distress narrowed the focus of management, adversely affecting other areas of the business. Because ADI focused more heavily on its commercial developments in retail and duty-free, it compromised the basic servicing needs of customers in terminals and allowed further deterioration of its buildings. As a result, public outcry plagued the company since the acquisition in 2006. British economist John Kay highlighted the short-sighted shareholder perspective that ADI employed for its governance of BAA, "the activities that generate customer satisfaction—providing seats, enough security guards, clean toilets and elevators that work—are a cost, not a source of revenue." Consequently, insufficient capital investment led to maintenance shortfalls, stalled redevelopment projects and subsequent overcrowding and delays.

Outside Investors and Regulatory Backlash

A lack of appreciation toward domestic regulation escalated public indignation towards the company. Prior to the acquisition, there had been little opposition by the UK government to the foreign ownership of BAA; however once it appeared that the tension surrounding foreign ownership came to the fore, the Competition Commission enforced subsequent rules to break up BAA's monopoly position of UK airports.

The UK Office of Fair Trading (OFT) launched an investigation in to the market structure of UK airports and its impact on users. In their report, the OFT had referred BAA to the Competition Commission inquiry for a possible break up of the airports group stating that "there was evidence of poor quality and high charges raising significant concerns among customers." The Competition Commission subsequently undertook a comprehensive two year inquiry into the supply of airport services by BAA to determine if any features of the market 'prevents, restricts or distorts competition' and, if so, what action might be taken to remedy these (House of

[6] Values were obtained from interviews with the financial advisors to Ferrovial, reflecting the general broker consensus at the time.

Commons Transport Committee 2008). The provisional, preliminary findings of the inquiry found that there were competition problems at each of BAA's seven UK airports with adverse consequences for passengers and airlines. The principal cause of these problems was considered to be their common ownership by BAA. The proposed remedies upon which further consultation would take place included ordering BAA to sell two of its three London airports and also, either Edinburgh or Glasgow airport (Done et al., 2006).

Privatization of New Zealand Auckland Airport

The New Zealand government first signaled its intention to sell its 50% stake in the airport a few months after the corporatization of AIAL in 1988. Privatization did not actually happen until 1998 when the government announced that it would sell 51.6% of its shares and publicly list the company on the stock market through an IPO. The government announced that such a decision was made because AIAL was considering the development of a second runway and the government was reluctant to shoulder the burden of funding major development projects and related contingent liabilities (Clements and Thompson 2003).

Privatization was through an open price book-build share float as opposed to the more traditional fixed-price share float. This involved inviting selected institutional investors to bid for shares through a tendering process with competing bids to determine the final share price. The New Zealand general public were also invited to apply to purchase shares by dollar value rather than by number of shares. The IPO was five times oversubscribed with 65,837 New Zealanders becoming shareholders, and AIAL ranked among the top ten companies on the NZ Stock Exchange (AIAL Annual Report).

Community Support and Strategic Planning

The AIAL privatization was executed alongside a strategic plan and with nationwide consensus. The disciplined transition was a key driver for achieving positive outcomes (Interview B, Senior Management, AIAL). As a first step, the AIAL corporatization enabled a shift in management thinking towards financial incentives and improving profitability in order to alleviate a wide internal disagreement on capital expenditure projects between the local and central governments. After the privatization, the management was subject to the scrutiny of public markets. This enabled AIAL to further shift towards a commercial focus with the

approach of a business aligned with growing revenues, margins, innovating on product offerings and competing for market share.

There is a strong emotional connection to airports, particularly in smaller countries, and this was evident in the case of AIAL (Interview C, Board Member, AIAL). The public share offering was patriotically promoted with All Black rugby players as an opportunity for New Zealanders to own a piece of "their" airport. A lot of the investors that joined the company at the time of the float have continued to hold their investments to this day.

The solid community bonding among domestic shareholders has had a positive impact on the AIAL privatization. 80% of AIAL shares are owned by New Zealanders, and the government ministers who oversaw the sale agreed that it met their initial objectives (Interview A, Senior Management, AIAL). The domestic shareholder base largely consists of domestic pension funds, local schools and residents, local indigenous people, and local and central government officials. This community bonding has contributed to not only efficiency improvements in running the airport but also in ensuring growth opportunities are identified and acted upon (Interview B, Senior Management, AIAL). It enabled the airport to achieve favorable outcomes when entering into the bond and capital markets for financing purposes as well as from rating agencies; as of November 2016, AIAL's Long-Term Credit Rating by S&P is A- (Interview C, Board Member, AIAL).

Capital Structure and Incentive Alignment

AIAL has maintained a conservative approach to leveraging its capital structure and relatively lower levels of debt. AIAL has a broad shareholder base, and shareholders have traditionally been attracted by the conservative nature of the asset. Thus, the company has adopted a capital structure that is appropriate to its ownership structure with a long-term perspective.

A conservative capital structure reflects the aspirations of its shareholders and its firm commitment towards long-term development; it shows that AIAL is in a strong financial position to make investments in physical capital to meet forecasted passenger growth and to provide high-quality services. It also provides a positive signal to the government and other stakeholders that the new owner is not abusing its monopolistic position. This capital structure has enabled AIAL's strong credit rating and provided flexible access to capital. For instance, a NZ$130

million retail bond issuance in 2008 and subsequent NZ$50 million bond issue were both oversubscribed. The company also has access to a syndicate of bank facilities that encompass nearly 50% of its source of borrowings (AIAL Annual Report).

Light-handed Regulation

New Zealand airports, including AIAL, are subjected to light-handed regulation by the Airport Authorities Act, which states that "airports must consult with major airline customers when setting aeronautical charges or undertaking major capital expenditure." The key aspect of this regulation is the lack of explicit regulatory control for the setting of airline charges. The legislation calls for consultation, as opposed to negotiation, of aeronautical charges, after which, airports are able to implement charges as they see fit. The consultation process for setting airline charges continued with the airports ultimately able to price as they saw fit. In addition, AIAL is required to consult with its substantial airline customers before embarking on any capital expenditure where the amount of the expenditure is equal to, at least the value of 20% of the assets (AIAL Annual Report).

The consultation process usually takes about a year, with the airport publicizing three or four proposals for its charges. Each time a proposal is put out, the airlines and representative bodies conduct their own analysis with expert advisers before responding. Through this process, airlines have had an effect in reducing the initial pricing proposals set out by the airports, but have not achieved a result that they believe is fair or in line with the findings of the initial Commerce Commission inquiry in 2002. The airlines express their frustration at the consultation process by comparing it to the inquisition of price control that the Commerce Commission undertakes. The situation can be likened to a Commerce Commission review where one of the submitters to the process actually has the final say in the discussion.

As a result, it appears that the consultation process of aeronautical charges favors the stance of airports, with limited threat of regulatory control. The airport is a lot more wary of the threat of a Commerce Commission pricing inquiry. However, the fact that the Commerce Commission's recommendation following an inquiry, requires the support of the Minister in charge, means that an inquiry is unlikely to take place if it is believed that there is a small political will for pricing control. Unless AIAL acted in a radical way, the threat of pricing control under the current regulatory environment is quite small.

The light-handed regulation allows the government to have influence on how airport prices are regulated while ensuring the performance of the company that manages the airport. Since privatization, AIAL has set airline charges four times, in 2000, 2002, 2006 and 2009 (Interview B, Senior Management, AIAL). AIAL can earn substantial revenues from its aeronautical activities and thus contribute to its successful financial performance (Mackenzie-Williams, 2004). The management needs to balance this with the threat of regulatory intervention if they overstep the mark too much. The light handed approach illustrates how a more relational arrangement with lower formal contract enforcement can discipline the regulation process.

CONCLUSION

These two cases illustrate how relational factors, such as cultural understanding, community support and local commitment, have integral impacts on the outcome of privatization and subsequent regulatory controls. The BAA case shows that a shareholder's wealth-maximization approach should be accompanied by a properly considered relationship-based governance model. The decision-making process dominated by a Spanish-based board caused internal frustrations and the exit of key personnel, particularly those with experience in handling crucial stakeholder issues. Secondly, excessive financial leverage put the consortium under immense financial pressure and caused a sharp decline in value for the company.

In the AIAL case, on the other hand, the use of light handed regulation as a form of relational contract, enabled the government to play a central role in contributing to the company's performance and providing wider economic benefits for the regional and national economies. The governance strategies of AIAL are influenced by politicians through the threat of intervention if market power is exploited. The government's inclusive IPO privatization process and resulting ownership structure for the company have contributed to a robust policy on capital structure. The government minimized the restrictions on airport pricing in order to make the AIAL share sale appeal as an attractive investment opportunity to private investors.

So what could ADI have done differently to achieve a better private acquisition outcome in the BAA case? We suggest that a socio-political understanding could have averted the regulatory backlash. Firstly, a cohesive board of directors that was closer to the everyday activities of company's UK headquarters would have enabled decisions to be made in harmony with

stakeholders' expectations and internal employees. Secondly, developing local relationships and communication channels with regulators may have reduced the adverse impacts of the regulatory backlash. With infrastructure companies perceived as having monopolistic characteristics, it is especially important to demonstrate the value that the company brings to the community. Governance strategies must be employed to avoid appearing as a "tax on people's lifestyles" (Interview B, Senior Management, AIAL). Lastly, an intensive capital investment program to improve the standard of the terminals and general customer services around BAA's airports should have been in place. This however was compromised by the excessive amount of financial leverage that was used to fund the acquisition.

To sum, this study demonstrates that relational governance mechanisms can help to address governance challenges in privatized infrastructure—heterogeneous stakeholder interests and high political risk. The cases in this paper highlight how a relational approach can be adopted in multiple areas of privately owned infrastructure. This includes a more inclusive privatization process (as used by the NZ government in the case of AIAL), a more flexible corporate governance strategy that balances shareholder and stakeholder interests and a regulatory framework that disciplines itself and provides flexibility through relationships without being constrained by the formality of contract. We acknowledge that each case will have unique characteristics and the government must balance between a relational approach and flexible and light form of regulatory control. As evidenced in the AIAL case, privatizing infrastructure can improve the quality of public services, provide a larger pool of capital, and stimulate economic activity. These desired outcomes depend on how decision makers consider societal, political and economic factors, including cultural understanding, political consensus, capacity of the private sector, market conditions, type of asset and service, and quality of service prior to private sector involvement.

Reference:

Alexander, I., and Estache, A. (2000). "Infrastructure Restructuring and Regulation: Building a Base for Sustainable Growth." *Policy Research Working Paper Series,* No. 2415. World Bank. Washington, DC.

Auckland International Airport Limited Annual Report (1989-2009)

BAA (2011). Retrieved Feb 20, 2012 from www.baa.com.

Becht, M., Bolton, P., & Röell, A. (2003). "Corporate Governance and Control". *Handbook of the Economics of Finance*, 1, 1-109.

Beeferman, L. (2008). "Pension Fund Investment in Infrastructure: A Resource Paper". *Occasional paper*, 3. Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School, Cambridge, MA.

Berle, A. A. (1931). "Corporate Powers as Powers in Trust". *Harvard Law Review*, 44(7), 1049-1074.

Bolton, P. (1995). "Privatization and the Separation of Ownership and Control: Lessons from Chinese Enterprise Reform". *Economics of Transition*, 3(1), 1-11.

Brealey, R., Myers, S. C., and Allen, F. (2006). *Principle of Corporate Finance*. McGraw Hill.

Clements, A., and Thompson, M. (2003). *Where New Zealand Touches the World from Farm Paddock to South Pacific Hub a History of Auckland International Airport*. Auckland, NZ.

Dodd, E. M. (1932). "For Whom Are Corporate Managers Trustees?". *Harvard Law Review*, 45(7), 1145-1163.

Done, K., and Mulligan, M. (2006). "Articles tracking the BAA Takeover between February and July 2006" *Financial Times*. www.ft.com

Drakić, M. (2007). "Privatization in Economic Theory". *Panoeconomicus*, 54(1), 103-118.

Ehlers, T. (2014). "Understanding the Challenges for Infrastructure Finance." *BIS Working Papers*, No. 454. Bank for International Settlements (BIS), Basel.

Estache, A., and de Rus, G. (2000). "Privatization and Regulation of Transport Infrastructure : Guidelines for Policymakers and Regulators." *World Bank Institute (WBI) Development Study*. World Bank. Washington DC.

Forsyth, P., D.W. Gillen, A. Knorr, O.G. Mayer, H.-M. Niemeier, D. Starkie. (2004). *The Economic Regulation of Airports—Recent Developments in Australasia, North America and Europe*. Gower Publishing, Ltd., Aldershot, UK

Friedman, M. (1970). "The Social Responsibility of Business Is To Increase Its Profits". *New York Times Magazine*, pp. 122-126.

Financial Reporting Council (FRC). (2010). UK Corporate Governance Code. Retrieved Dec 16, 2016 from http://www.frc.org.uk/corporate/ukcgcode.cfm

Gillen, D. (2011). "The Evolution of Airport Ownership and Governance." *Journal of Air Transport Management*, 17(1): 3-13.

Gillen, D. (2007). "The Regulation of Airports." *Working Papers,* No. 2007-5. Centre for Transportation Studies. Vancouver, BC.

Gordon, S., and M. Mulligan. (2008). "Fears for Ferrovial over Burden of Debt at BAA." *Financial Times*. Mar 25, 2008. Retrieved Dec 16, 2016 from https://www.ft.com/content/e9f142a4-faa0-11dc-aa46-000077b07658

Helm, D. (2009). "Infrastructure Investment, the Cost of Capital, and Regulation: an Assessment." *Oxford Review of Economic Policy*, 25(3): 307-326.

Helm, D. and T. Tindall. (2009). "The Evolution of Infrastructure and Utility Ownership and Its Implications." *Oxford Review of Economic Policy,* 25: 411-434.

House of Commons Transport Committee. (2008). "The Future of BAA: Fourth Report of Session 2007-8". London: The Stationery Office.

In, SY., Luiza C., and Kim, M. J. (2016). "Decision Framework for Private Participation in Airport Sector: The Case of Incheon International Airport in South Korea." *Stanford Global Project Center Working Paper*. Stanford University.

Larsen, P.T. (2006). "Money is as Cheap as Chips But Day of Reckoning Nears." *Financial Times*. Sep 26, 2006. Retrieved Dec 16, 2016 from http://www.ft.com/cms/s/0/ef4b5072-4dc3-11db-8704-0000779e2340.html?ft_site=falcon&desktop=true#axzz4SytxjPBv

Levitt, R. E., Henisz, W. J., and Settel, D. (2009). "Defining and Mitigating the Governance Challenges of Infrastructure Project Development and Delivery". In *Submitted to the Conference on Leadership and Management of Construction, Lake Tahoe, CA*, November 5-8, 2009.

Macintosh, J. C. (1999). "The Issues, Effects and Consequences of the Berle–Dodd Debate, 1931–1932". *Accounting, Organizations and Society*, 24(2), 139-153.

MacNeil, I.R. (2000). "Relational Contract Theory: Challenges and Queries." *Northwestern University Law Review,* 94(3): 877–907.

McNeill, D. (2010). "Behind the 'Heathrow Hassle': a Political and Cultural Economy of the Privatized Airport." *Environment and Planning A*, 42(12): 2859-2873.

McKenzie-Williams, P. (2004). "A Shift Towards Regulation? The Case of New Zealand." In P. Forsyth, D. Gillen, A. Knorr, O. Mayer, H-M. Niemeier, D. Starkie (eds.) *The Economic Regulation of Airports—Recent Developments in Australasia, North America and Europe*. Gower Publishing, Ltd., Aldershot, UK

Megginson, W. L. (2015). "Privatization Trends and Major Deals in 2014 and Two-Thirds 2015." *The PB Report 2014/2015*. Retrieved Dec 16, 2016 from http://www.privatizationbarometer.net/PUB/NL/5/5/PB_AR2014-2015.pdf.

Mulligan, M. (2007). "Heathrow Operator Admits to Its Many Failings." *Financial Times*. Jun 30, 2007. Retrieved Dec 16, 2016 from http://www.ft.com/cms/s/0/b3ebc1f4-26a5-11dc-8e18-000b5df10621.html?ft_site=falcon&desktop=true#axzz4SytxjPBv

Nash, C.A. (2005). "Privatization in Transport." *Handbook of Transport Strategy, Policy and Institutions.* eds Button, K., Hensher, D.A. Elsevier, Amsterdam: 97–113.

O'Neill, P. M. (2009). "Infrastructure Financing and Operation in the Contemporary City". *Geographical Research,* 48(1): 3-12.

Osborne, A. (2008). "Is it terminal for BAA and Ferrovial financing?" *The Daily Telegraph.* Feb, 17, 2008. Retrieved Dec 16, 2016 from http://www.telegraph.co.uk/finance/markets/2784496/Is-itterminal-for-BAA-and-Ferrovial-financing.html.

Sharma, R., (2012). Infrastructure: an emerging asset class for institutional investors. In *The Societal Function of Investment Asset Classes: Implications for Responsible Investment Conference*.

Schmidt, K. M. (1996). "Incomplete Contracts and Privatization". *European Economic Review*, 40(3), 569-579.

Schuster, D. (2009). "Australia's Approach to Airport Charges: the Sydney Airport Experience." *Journal of Air Transport Management,* 15: 121-126.

Shapiro, C., and Willig, R. D. (1990). "Economic Rationales for the Scope of Privatization". *The Political Economy of Public Sector Reform and Privatization*, Westview Press, London, 55-87.

Stone, R. (2005). *The Modern Law of Contract*. Psychology Press.

Vickers, J., and Yarrow, G. K. (1988). *Privatization: An Economic Analysis*. MIT Press. Vol. 18.

Vincent-Jones, P. (2000). "Contractual Governance: Institutional and Organizational Analysis". *Oxford Journal of Legal Studies*, 20(3), 317-351.

World Economic Forum. (2014). *Strategic Infrastructure: Steps to Operate and Maintain Infrastructure Efficiently and Effectively*. World Economic Forum, Cologny/Geneva, Switzerland. Retrieved Dec 16, 2016 from http://reports.weforum.org/strategic-infrastructure-2014/.