



**INCOMPLETE CONTRACT IN PRIVATE FINANCE
INITIATIVE (PFI): IDENTIFICATION OF ITS
PRESENCE AND DEVELOPMENT OF PROPOSED
STRATEGIES**

BY

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ABSTRACT

The research concerns identifying the presence of incomplete contract (IC) in Private Finance Initiative (PFI) projects in Malaysia and the development of appropriate strategies. A contract can be incomplete due to its lengthy period, high risk and uncertainty, high transaction cost, and others. Theoretically, complete contract cannot be achieved and many contracts - including PFI contracts - remain inefficiently incomplete. Previous researchers claimed that IC in PFI projects caused problems such as delay, time and cost overruns, and disputes among the contracting parties. Consequently, these problems led to inefficiencies in the project's implementation and delivery. Malaysia has been using PFI as an alternative procurement route in delivering public infrastructure and services. However, there are criticisms surrounding PFI implementation, such as lopsided and the absence of a robust and clear agreement. Notwithstanding, there is lack of literature evidence on the presence of IC in PFI projects in Malaysia. With the aim to facilitate achieving effectiveness and efficiency in PFI contracts, this research was conducted 1) to establish the concept of IC; 2) to identify the presence of IC in PFI projects; 3) to assess its extent and implications; 4) to develop appropriate strategies to deal with implications caused by IC; and 5) to assess the appropriateness and acceptance by the PFI key players in Malaysia on the strategies proposed. The methodology adopted was extensive literature review, two rounds of modified Delphi questionnaire involving 18 panellists and 13 panellists in Round 1 and Round 2 respectively and interview survey approach involving 30 respondents. The findings from this research confirmed the presence of IC in PFI projects in Malaysia and identified the provisions that contribute to the incompleteness, areas in the contracts that are deemed incomplete, their extent and implications. Subsequently, appropriate strategies have been specifically designed, validated and herein proposed to address the implications arising from IC in PFI projects. In the course of doing this research, a robust methodology has been developed to identify the presence of IC in PFI projects. The methodology may be modified for it to be applicable to identify IC in other contract settings. The significance of the research and its findings may be viewed as follows; 1) key PFI stakeholders, policy makers and contract drafters may use this research and its findings as reference in their future endeavour in developing and managing PFI contracts; 2) the proposed strategies could assist contract drafters especially those who are involved in PFI projects in giving attention to aspects that contribute to contract incompleteness and its implications and consequently improve the provisions when drafting new contracts; and 3) the proposed strategies could provide basis in the preparation of guidelines and solutions in dealing with IC.

خلاصة البحث

هذا البحث يهتم بتحديد حضور العقد غير الكامل في مشروع مبادرة التمويل (الخاص في ماليزيا PFI) ونمو الإستراتيجية المناسبة. العقد غير الكامل موجود بسبب وقت طويل ومخاطرة عالية وشك وتكلفة المعاملات مرتفعة والآخرين. وفي النظرية، العقد الكامل لا يستطيع تحقيقه وكثير العقود-ضم العقد مبادرة التمويل الخاص - لا تزال غير كاملة. نظرا إلى الباحث السابق أن العقد غير الكامل في مشروع مبادرة التمويل الخاص سيصل آجلا وتجاوز التكاليف وخلاف بين الأطراف المتعاقدة. بعدئذ، هذه المشكلة تؤدي إلى فشل توصيل وتنفيذ المشروع. إن ماليزيا يستخدم مثل مسار الشراء البديل في توصيل البنية التحتية العامة والخدمات بيد أن هناك النقد حول تنفيذ مبادرة التمويل الخاص مثل غير متوازن وغياب قوي واتفق واضح. من جانب آخر، عدم وجود أدلة أدبية من وجود العقد غير الكامل في مشروع مبادرة التمويل الخاص في ماليزيا. بهدف تيسير لتحقيق الفعالية والكفاءة في العقد مبادرة التمويل الخاص ، تم إجراء هذا البحث لبناء مفهوم العقد غير الكامل، وتحديد وجود العقد غير الكامل ، وتقييم مدنها وتأثيرها ، وضع الإستراتيجية المناسبة للتعامل مع الآثار الناجمة عن عدم اكتمال العقد ، وتقييم مدى ملاءمتها وقبولها من اللعيبين الرئيسيين في ماليزيا بشأن الإستراتيجية المقترحة. هذه المنهجية المعتمدة استعراض الأدبيات واسعة النطاق، جولات من الاستبيان المعدل تضم 18 عضوا و13 عضوا في الجولة الأولى والجولة الثانية ومقابلة التي شملت 30 مشاركا. أكدت نتائج هذا البحث أن العقد غير الكامل موجود في مشروع مبادرة التمويل الخاص في ماليزيا وحددت الأحكام التي تسهم في عدم اكتمالها ومناطق العقد التي تعتبر ناقصة ونطاقها وآثارها. بعد ذلك، تم تصميم الإستراتيجيات المناسبة والمصادقة عليها والمقترحة هنا لمعالجة الآثار المترتبة على ذلك من العقد غير الكامل في مشروع مبادرة التمويل الخاص . وفي سياق القيام بهذا البحث، قد وضعت المنهجية القوية لتحديد وجود العقد غير الكامل في مشروع مبادرة التمويل الخاص . على هذا النحو يمكن أن تعديل المنهجية بحيث تكون قابلة للتطبيق لتحديد العقد غير الكامل في إعدادات العقود الأخرى. فضلا عن هذا يمكن النظر إلى أهمية البحث ونتائجه على النحو التالي (1) أصحاب المصلحة الرئيسيين، صناعات السياسات وصانعي العقود قد يستخدمون هذا البحث ونتائجه كمرجع في مساعدتهم المستقبل في تطوير وإدارة العقود المبرمة. (2) يمكن الإستراتيجيات المقترحة أن تساعد واضعي العقود لا سيما أولئك الذين يشاركون في مشروع مبادرة التمويل الخاص الذي يسهم في عدم اكتمال العقود وما يترتب عليها من آثار وبالتالي تحسين الأحكام عند صياغة العقود الجديدة. (3) يمكن أن توفر الإستراتيجيات المقترحة أساسا لإعداد المبادئ التوجيهية والحلول في التعامل مع العقد غير الكامل.

APPROVAL PAGE

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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This thesis is gratefully dedicated to...

My beloved father and mother who have tirelessly support me during good and bad times. Without your Doa and support, I might not be able to get through this journey smoothly. Thanks for always being there for me.

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LIST OF ABBREVIATIONS

| | |
|-------------|---|
| ADB | Asian Development Bank |
| AG | Auditor General |
| AIM | Agensi Inovasi Malaysia |
| BLT | Build-Lease-Transfer |
| BOO | Build-Own-Operate |
| BOT | Build-Operate-Transfer |
| BOOT | Build-Own-Operate-Transfer |
| BTO | Build-Transfer-Operate |
| BQ | Bill of quantities |
| CA | Certificate of Availability |
| CBI | Confederation of British Industry |
| CIPS | The Chartered Institute of Purchasing & Supply |
| CM | Construction management |
| DBFO | Design-Build-Finance-Operate |
| DBFOM | Design-Build-Finance-Operate-Maintain |
| DCMF | Design-Construct-Manage-Finance |
| GLC | Government-linked company |
| HM Treasury | Her Majesty's Treasury |
| IC | Incomplete Contract |
| IUM | International Islamic University Malaysia |
| JCT | The Joint Contracts Tribunal |
| JKR | Jabatan Kerja Raya |
| KAED | Kulliyah of Architecture and Environmental Design |
| KPI | Key performance indicator |
| MP | Malaysia Plan |
| EPF | Employee Provident Fund |
| FGD | Focus group discussion |
| FIDIC | International Federation of Consulting Engineers |
| LAD | Liquidated ascertained damages |
| NAO | National Audit Office |
| NHS | National Health Service |
| PAM | Pertubuhan Arkitek Malaysia |
| PDA | Preliminary detailed abstract |
| PFI | Private Finance Initiative |
| PF2 | Private Finance 2 |
| PM | Project management |
| PPIAF | Public-Private Infrastructure Advisory Facility |
| PPP | Public-Private Partnership |
| PTF | Pension Trust Fund |
| PWD | Public Work Department |
| RII | Relative importance index |
| RICS | Royal Institution of Chartered Surveyors |
| SD | Standard deviation |
| SIB | Strategic Investment Board |

| | |
|--------|--|
| SoPC | Standardisation of PFI contracts |
| SoPCNI | Standardization of PFI contracts, Northern Ireland |
| SPV | Special-purpose vehicle |
| UiTM | Universiti Teknologi MARA |
| UK | United Kingdom |
| UKAS | Unit Kerjasama Awam Swasta |
| UKM | Universiti Kebangsaan Malaysia |
| VfM | Value for money |

CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

This chapter introduces this research reports on the identification of incompleteness of Private Finance Initiative (PFI) contracts and development of proposed strategies. The chapter is presented as follows:

- i. Background of the research
- ii. Problem statement
- iii. Research questions
- iv. Research aim and objectives
- v. Scope of the research
- vi. Outline methodology
- vii. Organization of the thesis
- viii. Papers in support of the research

1.2 BACKGROUND OF THE RESEARCH

This research is about incomplete contract (IC) in Private Finance Initiative (PFI) in Malaysia. IC is defined as a contract that fails to clearly spell out ex-ante the parties' requirements, duties and obligations for every realised contingency and it has gaps, missing provisions, and ambiguities in its terms (Hart, 1995; Yates, 1998). Although the contract is considered complete and valid when all requirements to contract (i.e. free consent, competent to contract, lawful consideration and object, legality) is met (Malaysia & Legal Research Board, 2010), the concept of IC actually concerns on the

substance of the contract itself. In principle, a contract must state the parties' responsibilities and the required action in dealing with all anticipated incidents which may or may not happen in the future (Onishi, Omoto, & Kobayashi, 2002). In doing so, the parties need to address all uncertain situations which might occur in the agreements, where the potential future contingencies might be too numerous and/or too difficult to anticipate (Kim, 2012). Hence, failing to identify those future contingencies makes the contract incomplete (de Brux, 2010).

Contract is defined as “a set of promise or set of promises for the breach of which the law gives the remedy, or the performance of which the law in some way recognizes as a duty” (Beatson, Burrows, & Cartwright, 2010). The functions of contract are; to assist future planning of the transaction and to provide provision for potential uncertainties; to set out the respective responsibilities of the parties and the standard of performance that should be carried out; allocate potential economic risks involved in the transaction; and provide for what is to happen if things go wrong (Beatson et al., 2010).

A contract is a very important instrument for an economic transaction. Most economic transaction involve contract, from a simple consumer transactions (e.g. contract for transportation, sale of goods and for service provider) to commercial transaction which involve the exchange of land, goods, or services in return for money, for example, construction contracts, employment contracts, insurance policies, professional services and etc. (Beatson et al., 2010). In construction, a contract is fundamental. Not only it comprises traditional risk associated with a business transaction, but construction contracts usually involve a long-drawn process and a lot of uncertainty that cannot be reasonably be predicted in its entirety (Cheung & Yiu,

2006). Therefore, the construction contracts cannot avoid being incomplete (Ya-zhuo & Fan, 2011).

IC can be identified when the clauses are vague or ambiguous (Hart & Holmstrom, 1986), there are gaps and missing provisions (Hart, 1995; Quiggin, 2002), the contract require renegotiations (Schmidt, 2010a), and there are additional work and changes (Badenfelt, 2011). Some literatures have discussed why contracts are incomplete. Among the causes of IC are due to long-duration contract (Kostritsky, 2004; Baker & Krawiec, 2006; Iossa, Spagnolo, & Vellez, 2007;), high risk or uncertainty (Lonsdale, 2005; Ya-zhuo & Fan, 2011), high transaction cost (Hart, 1995; Tirole, 1999; Klein, 2000; Scott & Triantis, 2005), bounded rationality (Barnett, 1992; Brousseau & Glachant, 2004), and asymmetric information (Spier, 1992; Katz, 2005). Nonetheless, in some situation, contracting parties choose IC as they trust their counterpart (Herold, 2010; Miller, Denison, & Matuszewski, 2013).

There are positive and negative implications of IC. Positively, IC can provide the necessary flexibility to deal with complexity and uncertainty (Cruz & Marques, 2013; Miller et al., 2013). Not only that, Miller et al. (2013) and Ya-zhuo & Fan (2011) contended that the transaction cost for IC is lower compared to complete contract. Then, again, when the contract is incomplete, the parties need to renegotiate to fill in the gaps in the contract (Hart, 1995; Guasch, 2004). Renegotiation could be an opportunity to enhance project welfare (Guasch, 2004; Athias & Saussier, 2010). However, renegotiation could also expose the contracting parties to the risk of opportunistic behaviour (Baker & Krawiec, 2006; Iossa et al., 2007). In a worse situation, IC could lead to contractual dispute (Grant, Kline, & Quiggin, 2012) and breach of contract (Abdallah, Darayseh, & Waples, 2013; Chua, 2012).

IC can be present in any contract including in PFI contract. PFI is an alternative procurement method introduced to improve the efficiency and effectiveness in delivering public infrastructure and services (Abdul Quium, 2011). Conventionally, the task to procure public infrastructure and services is the public authority's responsibility where the process of designing, constructing, operating, and maintaining the assets is done separately. However, as the country is expanding and the public authorities have a hard time to cater for the increasing demand for new and better public infrastructure and services, a new alternative procurement called the Public-Private Partnership (PPP) is implemented (Abdul Quium, 2011; G. Winch, Gunawansa, Schmidt, & Onishi, 2012). In Malaysia, the implementation of PPP had formally started in 1983 when the government launched The Privatization Policy to support the Malaysia Incorporated Policy (Unit Kerjasama Awam Swasta [UKAS], 2015). However, despite its successful performances, there were many complaints and critiques surrounding this policy. Lopsided fixed contract (Khairuddin, 2009), corruption, favouritism, cronyism and 'bail-out'-ism (whereby losses suffered by the privatized project is being absorbed by the government) (Azmi & Associates, 2008) are some examples of criticisms from the public and the opposition parties. In 2006, PFI was introduced through the 9th Malaysia Plan (9th MP) and later it was grouped under the PPP umbrella together with Privatization. In practice, the terms PFI and PPP have often been used interchangeably (Khairuddin, 2012), and in this thesis a similar approach is adopted.

As Malaysia is targeting to become a high income and developed nation by the year 2020, the government is very committed in encouraging private participation in stimulating the country's economic growth (Nor Mohamed, 2010). This is reflected in the previous and current Malaysia Plan (MP), where billions of Ringgit were allocated as Facilitation Fund to encourage private sector participation in the economy especially