

Contracting in the Fog of War ... Private Security Providers in Iraq: A Principal-Agent Analysis

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1 Introduction

This paper will look at the phenomenon of outsourcing security tasks to private security providers/contractors (PSPs/PSCs) in Iraq after the invasion of coalition forces in March 2003. As a general premise it will be assumed that if something as highly important as providing security is privatized, it is the special interest of the outsourcing party to hold the executing party as close as possible to its own goals, leading partially to problems of accountability. The theory of Institutional Economics seeks to solve these problems putting the contractual relationships in the focus of interest. The principal-agent setting which is part of this approach will be used to examine the question what kind of contractual hazards could be expected in such a deeply destabilized environment as contemporary Iraq and what possibilities does the principal have to enforce the agent's compliance to the negotiated contract.

To answer the question the paper will (1) briefly outline the principal-agent setting and notions relevant to the examination; (2) introduce the Iraq-scenario in order to mark out the case study's background and its key players; before (3) applying the theoretical assumptions to the case of Iraq; and (4) drawing some conclusions. The examination period of time covers March 2003 to December 2005. Primary sources are official reports and documents of various US institutions and organizations. No less important has been information gathered by the author in background interviews with managers of Private Security Providers currently operating in Iraq. These interviews took place in London and Paris in spring 2005. As the selection of sources shows, the focus of this paper clearly lies on the American engagement in Iraq, as the United States took and takes the lion's share of actual fighting and reconstruction efforts.

2 Theoretical Framework

One of the main aims of Institutional Economics is to reduce different interactions to its common principles in order to enable general assumptions for effective collaboration between different parties (Jost 2001: 10, 34). The

theory's premises are bounded rationality,¹ saying that the human behavior is unintentionally rational but limited, due to incomplete information (Williamson 1990: 34). Furthermore, opportunism, meaning seeking one's self interest, including calculated efforts to mislead, is regarded as inherent of the human being (Williamson 1999: 377). The principal-agent setting is used as a method of displaying the relationship between an ordering party (principal) and a performing party (agent) in which both are assumed to act as rational actors and thus according to their self-interest. Due to the fact that incomplete information is assumed in this relationship, knowledge asymmetries are unavoidable. The problems and uncertainties arising from this fact can be classified on the basis of the temporal positioning of the underlying information asymmetries. 'Hidden information' describes, therefore, the hazards before the contract is made (*ex-ante*), whereas 'hidden actions' focus on the *ex-post* effects of information asymmetries (Arrow 1985: 37–51).

This paper deals primarily with the question of the hazards and the enforcement of already agreed-on contracts and thus *ex-post* considerations take wider space. However, in order to create a complete picture, it is also useful to look at the period before the actual conclusion of a contract, at least theoretically. In the case of hidden information, the principal can not observe all relevant facts *ex-ante* and can therefore not decide comprehensively what price would be appropriate for the needed goods or services. This causes an effect named adverse selection, which has been firstly described extensively by Akerlof (1970: 488–500). He showed that under circumstances where the principal is partly unable to distinguish and judge the quality of a service he will always stick to the cheapest offer. Therefore, the average price may sink extensively until high-value agents cannot compete anymore and are excluded. This finally leads to a partial market failure since in the end only low-quality agents will offer their services.

Ex-post, i.e. after principal and agent have signed a contract, the actions the principal wants the agent to perform are relatively costly for the latter (they require him time, effort or other resources) (Bergen/Dutta/Walker 1992: 4). Furthermore, the principal can control the agent's activities only incompletely and only under positive information costs, which may lead the agent to use his discretionary freedom to undertake "hidden actions" (Jost 2001: 27). Doing this, the agent has two basic choices to maximize his own utility, which both lead to inefficiencies for the principal. He can work with unnecessarily high budgets due to alleged unfavorable exogenous effects, and thus raising the price, or he can reduce his efforts again due to exogenous effects, but still demanding the same payment for his services, i.e. lower his costs.

1 This paper follows Herbert A. Simon's and Oliver E. Williamson's concept of bounded rationality.

Accepting that the principal has only incomplete information on the agent's action and that the agent's self-interest may lead him to use this information asymmetry for his own purpose, the principal has to search for possibilities to maximize the agent's compliance. On a large scale level, it is a general advantage for the principal if the realization of the contract takes place in relatively secure surroundings with functioning institutions of law enforcement. This will impede the agent from blaming exogenous circumstances when behaving non-compliantly. Moreover, it enables the principal to handle disputes under civil and criminal law more effectively (Kleine 1995: 23–26). Secondly, the principal can rely on market incentives in order to ensure the agent's compliance, which generally means offering the agent the opportunity to gain additional profit (Holmström/Roberts 1998: 80–83). Or more practically speaking, the agent will be much more willing to do his job properly if he is hoping to get a follow-up contract for which he will face competition.

On the single-contract level, the principal again has two main possibilities to achieve the agent's compliance. He can insist on drawing a highly specific contract which means formulating rules that limit the agent's operative or financial choices as far as possible, examples being coding guidelines, process definitions, project management rules and fixed fees. But this of course creates an inflexible framework which may not be appropriate to changing exogenous circumstances and would therefore increase the necessity to renegotiate contracts (Jost 2001: 46). Equally related to the single contract is the principal's possibility to monitor the agent. In this context, monitoring covers all means of control through which the principal intends to decrease his information disadvantage. These activities lead to monitoring-costs as the principal has to create monitoring structures and hire qualified personnel.

All this leads to the general working thesis that a principal has the best chance that an agent will comply with its contract when the following conditions are fulfilled (1) General binding rules and norms are guaranteed by functioning legal institutions; (2) There are effective market incentives, e.g., competition; (3) Contracts are specific without being inflexible; and (4) Functioning monitoring structures exist. However, in order to apply these theoretical assumptions to the use of private security contractors in a post-war scenario, it is necessary to take a closer look at the situation in Iraq itself. What are the general market conditions there? Who is principal and who is agent? And which kinds of services are being dealt with?

3 Iraq

3.1 *A Complex Battlefield*

When US forces reached the center of Baghdad on 9 April 2003, Department of Defense (DoD) senior officials expected that the Iraqi people would welcome the troops as liberators, that fully functioning government institutions could be overtaken and that the Iraqi police would remain on duty to provide civil order (GAO 2005a: 14). However, that was not the case. As most of the regular Iraqi troops did before, all police forces, as well as most of the public administration personnel, simply disappeared. When General (ret.) James Garner and his staff of the Pentagon's Office of Humanitarian and Reconstruction Affairs (ORHA) arrived in Baghdad 12 days later, most of the Iraqi governance structure had been looted or destroyed. In addition to the lack of the simplest communication infrastructure, like functioning phones or computer networks, it has to be added that the ORHA had no plans for dealing with this complete collapse of public order and bureaucracy (Perito 2005: 4). Due to this failure, Garners's plan to hold early elections and to create an Iraqi administration as fast as possible could not be realized. On 6 May 2003, US-Ambassador Paul Bremer was appointed head of the Central Provisional Authority (CPA), which would take over governing power and assist Iraqi interim authorities to plan future elections and to draft a constitution in the mid-term (Ward 2005: 4). However, facing growing violence by an insurgency movement getting stronger and stronger, it was decided to hand over power to the Iraqi people as soon as possible. Accordingly, the CPA dissolved on 28 June 2004, transferring some of its power to an Iraqi Interim Government (IIG) while reassigning most of its administrative capabilities to the US Embassy in Baghdad (NSDP 36 2004: 2). After elections for a constituent assembly in the beginning of 2005, a constitution was successfully drafted and became effective in December 2005. However, these developments towards Iraqi sovereignty did not lead to a decrease in violence. On the contrary, the hasty transfer of sovereignty and the attempt to "Iraqify" the conflict, according to several sources, seem to have even worsened the security situation (ICG 2004: 7).

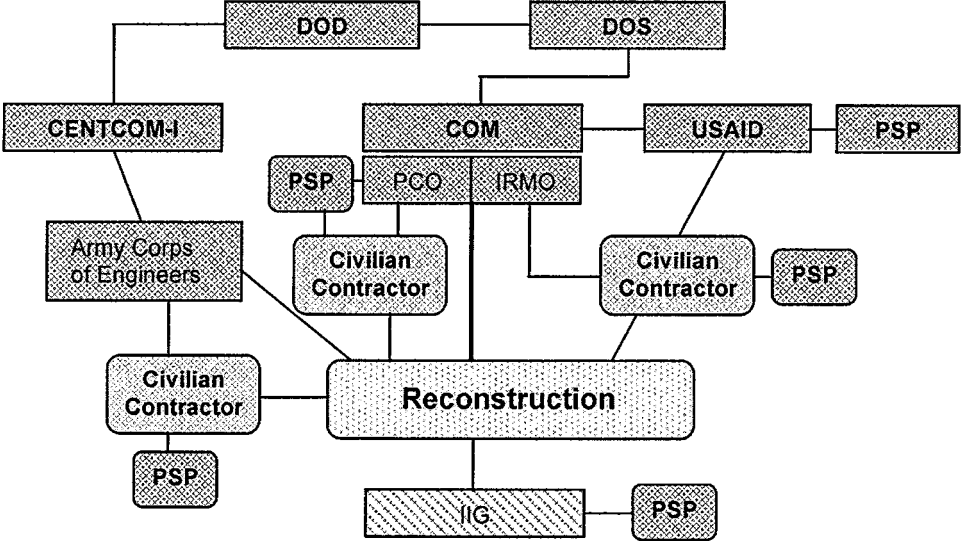
3.2 *Reconstruction*

As pointed out before, the post-conflict environment in Iraq was expected to be relatively benign and only few plans for other conditions were made. As a result, the Armed Forces with their Army Corps of Engineers and several US agencies like the Agency for International Development (USAID) acted rela-

tively independently and uncoordinatedly in the first days of the reconstruction process (Ward 2005: 1). After the establishment of the CPA things improved as Bremer’s administration had clear policy guidance on reconstruction while the Armed Forces would take responsibility for security matters (CPA Regulation 1/2003: sec. 1).

After the dissolution of the CPA at the end of June 2004, the last institutional changes had been executed: Overall responsibility now lies within the competency of the US ambassador in Baghdad, who has been appointed Chief of Mission (CoM). The Iraq Reconstruction Management Office (IRMO), a section of the US embassy, has taken over reconstruction policy guidance while the Project & Contracting Office (PCO)² deals with the direct contract management, finalizing a complicated structure of responsible institutions and agencies and companies:

Figure 1: Iraqi Reconstruction simplified (2004–2005)
 – InstTaylor itutions, Agencies, Contractors and PSPs –



- Legend:
- | | | | |
|------|--|-----|------------------------------|
| COM | Chief of Mission | DOD | Department of Defence |
| DOS | Department of State | IIG | Iraqi Interim Government |
| IRMO | Iraqi Reconstruction Management Office | PCO | Project & Contracting Office |

2 PCO is established as a temporary organization within the DoD, but its personnel in Iraq is assigned temporarily under the CoM’s authority.

While US pre-war and early post-war estimates for the overall cost of reconstruction in Iraq in the years 2004 to 2007 were between 15–20 bio. USD (CBO 2004: 4), real expenses up to mid-2005 have been much higher; 60 bio. USD have been made available or pledged by the US. In addition, seized Iraqi funds and international donors will run Iraq and revive its damaged infrastructure (Merle/Witte 2005). The US alone has appropriated almost 30 bio. USD for reconstruction projects until fall 2005. Approximately one quarter of these funds had to be spent on security due to the rising insurgency movement, reducing funds for reconstruction projects. The result is a growing gulf between the projects formally proposed and those finally completed, named internally “reconstruction gap” (SIGIR 2005b: 3).

In March 2005, for example, USAID canceled two electric power generation programs to provide 15 mio. USD for additional security measures for another site. Eventually, the Army Corps of Engineers decided that protecting 14 of the 23 concerned electric substations would be too expensive and therefore limited the overall program to 9 stations (GAO 2005a: 4). US and international reconstruction efforts are so to speak trapped in a vicious circle: Economic reconstruction depends upon a secure environment, while security depends largely on a successful reconstruction process (Henderson 2005: 4). Although such a short outline of the Iraqi reconstruction could not describe all its complexity, it can be concluded that, in light of this situation, the providers of security have been assigned with a truly crucial task for the overall success of the process.

3.3 *The Role of Private Contractors in Iraq*

During and after the end of military operations in Iraq, the US administration relied on the work of private military contractors (PMCs) in various functions more than in any other war before. They built and partly operated US bases before the invasion, provided logistics and support as well as maintenance for weapon systems during the actual combat, trained later on the new Iraqi army and finally provided security after the beginning of the reconstruction process (Singer 2005a: 122). The Special Inspector General for Iraqi Reconstruction (SIGIR) states that approximately 25,000 non-Iraqis currently work as contractors entrusted with military or security related tasks in the country. This group of civilians has the highest rate of casualties, as of November 2005, out the 147 US civilian deaths in Iraq, 120 or 82% have been contractors (SIGIR 2005b: 13). For the DoD, these contractors fall in two broad groups: on the one hand there are “Contractors supporting Deployed Military Forces”, e.g., providing transportation, laundry, mortuary or food services. On the other hand “Contractors not in Direct Support of Deployed Military Forces” per-

form the reconstruction in the true sense of the word or provide security services for prime reconstruction contractors (US DoD 2005: 3).

It is the latter, and notably the providers of private security, which are of particular interest for this examination, for two reasons. Firstly, the massive deployment of companies involved is a new phenomenon, whereas the use of external logistic contractors or private system operators deployed with the troops has a longstanding tradition within the US military doctrine. Secondly, their operations are particularly related to the perilous and unstable situation in post-war Iraq, as the US military is only responsible for providing security for the civilians under DoD contracts, but not for other US agencies (like USAID) or civilian reconstruction contractors (US DoD 2005: 6).

Exact figures of how many of these companies have been operating so far in Iraq are difficult to obtain, since, according to the Government Accountability Office (GAO), none of the US agencies now active in the reconstruction of Iraq can provide consistent numbers. Thus, the most reliable sources are expert studies which are based on CPA information and which say that there are around 60 PSPs, most of them US or Britain based, with at least 6,000 non-Iraqi employees serving in armed tactical roles (Isenberg 2004: 7). As to the services provided, these companies may differ due to their size and specialization, yet they can be divided into three main service groups: (1) Protection: Personal Security Details (PSD), convoy protection including instant respond forces and site protection; (2) Consulting: Security & intelligence reports and security management advice; and (3) Training: Training in security and military tasks (GAO 2005a: 9; N.N. EHC 2005).

Spending on these companies is difficult to track as the SIGIR report quotes: "Despite the significant role played by private security providers in enabling reconstruction efforts, neither the Department of State, nor DoD, nor the U.S. Agency for International Development have complete data on the costs of using private security providers. Even at contract level the agencies had only limited information readily available." (SIGIR 2005b: 14) However, the GAO mentions obligations as of December 2004 of more than 766 mio. USD for PSPs and this only for the reviewed agencies and reconstruction contractors (GAO 2005a: 3).

Due to the absence of effective national or international laws, the legal status of PSPs and other military contractors in Iraq is ambiguous and highly political. According to official US sources and therefore their interpretations, UN Security Council Resolutions authorized the CPA to temporarily exercise power in Iraq. Based on that, CPA Order 17 gives US forces and officials, as well as contractors and their employees, immunity from Iraqi laws, as they are subject to the exclusive jurisdiction of their sending state. However, in order to prevent acts of serious misconduct, contractor personnel can be tem-

porarily detained by Multinational Forces (US DoD 2005: 11). This general status had been transferred into the Iraqi transitional law after the vanishing of the CPA, but it is unsure what will happen to this *carte blanche* for PSPs after the establishment of a constitution, parliament and government at the end of 2005 (Isenberg 2004: 48). But Iraqi criminal law is not the only “source of trouble” that will have serious implications for the companies’ future business environment. The development of Iraqi trade law will also have direct implications (N.N. 2005).

According to DoD reports, US military forces in Iraq generally do not have a command and control relationship with PSPs or their employees if there is no direct contractual relationship between the DoD and the security providers. This general status may vary, if security providers are entering military installations or commit serious actions of misconduct. For example, some private security employees were forbidden to use an army unit dining facility, as they insisted on carrying loaded weapons while having dinner (GAO 2005a: 21).

Coordination and communication between the PSPs and the military have developed during their engagement in Iraq since spring 2003. Whereas the relations with the military were initially based on personnel contacts and/or “liaison officers”, the coordination has followed a more structured approach since October 2004 (N.N. EHC 2005). Six Reconstruction Operations Centers (ROCs) in Baghdad and five provincial cities which serve as the “interface” for civil/military relations became operational, managed again by a PSP, namely Aegis Defence Services Ltd. Besides developing a common picture for contractors and the military about the security situation in Iraq and coordinating company concerns, the centers have a clearly operational function, e.g., setting up convoys and providing rapid reaction forces in case of their attack (GAO 2005a: 23). The performance of these centers, which are offering their services on an open-to-all and cost-free basis, is rated differently. Whereas a US company was highly satisfied with the provided services, a French company expressed concerns about the low level of shared intelligence information.

In the reported period of time from May 2003 to October 2004, no disciplinary or criminal charges were brought against security providers (US DoD 2005: 14). However, incidents have been reported where security providers have been detained for alleged shooting on military forces or civilians without any charges following the incident up to today (White/Witte 2005; Merle 2005).

Due to the number of different players, guidelines and policies for the process of reconstruction, four possible groups of contracting partners for Private Security Providers, can be distinguished that are relevant to a princi-

pal agent setting analysis: (1) The Department of State and other civil US agencies (including the former CPA) are contracting security providers for safety reasons, as their protection is not provided by the Multinational Forces; (2) Prime reconstruction contractors like large engineering or service companies have usually accepted the clause to take responsibility for their own security in their own reconstruction contracts; (3) The DoD, which hires PSPs for guarding military facilities or Corps of Engineers reconstruction projects, in order to relieve US troops from additional tasks; and (4) The Iraqi government itself, which needs temporary support for protecting important economic installations like e.g., oil refineries and pipelines, which are a preferred target of insurgent attacks.

It has become clear that the use of private contractors in an occupied, postwar country comes with a myriad of political, economic and legal complications which makes contracting in the fog of war a complex task with various groups of possible contracting partners. To reduce complexity, the third part of this analysis will focus on applying the theoretical findings on the first of these groups, namely US agencies and Private Security Providers. This is due to the fact that information about these cases is far more often available to the public than details about military or fully corporate contracting.

4 Application of the Theory

Even if the prior findings cannot be regarded as a complete market study for private security services in Iraq, the context in which the principal-agent relationships take place and to which theory will have to be applied, has been described. General market conditions of private security in Iraq are those of a rapidly evolving market with a strong demand, but a relatively unconsolidated supply side, a phenomenon also known as the “Baghdad bubble” (Boxell 2005: 1). In other words, even if high-value contracts are assigned due to the urgent need for private security services, principal and agent have been largely unprepared for such a boom; the principal because of incorrect political assumptions on the post-war situation in Iraq; the agent because of short-term engagement without any early warning before the war on the high quantity of services needed (Isenberg 2004: 10).

The overall assumption of the principal-agent setting is that certain agents will not comply with the negotiated contract if they see better chances to maximize their profit function in another way. They can do so by overbilling the principal or underperforming their tasks. So before looking at the principal’s possibilities to minimize this behavior, it is necessary to see if there are any relevant cases of described contractual hazards in Iraq. Even if

the accessible data is limited, there are reported cases, namely the case of Custer Battles LLC being blamed for over billing and a case of non-compliance to its contract of aforementioned Aegis Defence Ltd.

Custer Battles, a US security and risk consulting company founded in 2001, won one of the first high-value CPA contracts to provide security for the Baghdad International Airport, worth 16.8 mio. USD. Later on, the company won several other logistical and security contracts, including one to provide security for the exchange of Iraqi currency (Eckholm 2005). In 2004, Custer Battles was accused in a whistleblower case of having used 'shell' companies in the Cayman Islands to fraudulently overcharge on US government contracts by inflating prices through false invoices of more than 10 mio. USD (McLure 2005). Although the case is pending the DoD barred the company from any further contracts in October 2004 (Eckholm 2005).

Aegis Defence Services Ltd., a British security company, was awarded with the biggest single security services contract in Iraq worth 293 mio. USD in May 2004 to manage the abovementioned Reconstruction Operations Centers in Iraq and to provide security for the personnel of the Project & Contracting Office (Drummond 2004). Later on, SIGIR found in one of its audits several issues where the company did not comply to its contract. These issues include insufficient proof of weapons qualification or vetting of its Iraqi employees (SIGIR 2005a: 4). The audit report finally stated that "there is no assurance that Aegis is providing the best possible safety and security for government and reconstruction personnel and facilities" (SIGIR 2005a: 7). As shown, there are indeed specific cases where the agent did not comply to the principal's interests, due to certain contractual hazards. This leads us back to the initial question, what circumstances or settings can hold the agent accountable to the negotiated contract?

4.1 Rules and Norms

General rules and norms, which are guaranteed by functioning legal institutions and law enforcement authorities, are suggested to be generally in favor of the principal's need for compliance. The existence of such advantageous circumstances in Iraq can surely be denied, at least for the examined period of time. Though, as pointed out in section 2, the agent is excluded from Iraqi law and put under civil and criminal law of his sending state. Regarding the US, legal actions against non compliance of federal government contracts come under the Federal Acquisition Regulation system (FAR). The system provides uniform policies and procedures for the acquisition of goods or services by all executive agencies and allows, in cases of non-compliance, to impose certain measures such as termination of the contract (FAR 2005; US

DoD 2005: 13). However, the complex contracting situation, due to the widespread use of subcontractors from other countries by the agent, can certainly complicate the situation.

A relatively unexpected add-on to civil law issues has been the agent's fear of liability for death or injuries of its own personnel given the killing of four employees of the US security company Blackwater LLC by Iraqi insurgents in March 2004, which has been widely covered by the media (Price/Neff 2004). Later on, the families of the killed employees sued the company. They alleged that Blackwater was partly responsible for its employees' deaths, as they had been sent out understaffed and without proper equipment (Dalesio 2005). Even if the outcome of this case cannot be estimated today, senior managers described the impact on the company's current proceedings: To avoid liability, major US companies would strictly follow all relevant legal guidelines and default settings prepared by the Pentagon or the State Department (N.N. 2005), as accordance with government specification provides certain protection from private liability under US law (Carter 2004).

The fact that in the case of Iraq the principal had the possibility to free its agent from coming under Iraqi legislation and to put him under US legislation has strengthened his capability to raise the agent's compliance, as contracts fall under the FAR system, is not very astonishing. Yet much more interesting is that the principal can use the agent's fear of civil law liability to increase its compliance. This indicates a general advantage of using publicly traded or at least bigger US companies even if they might be more expensive instead of foreign companies or smaller start-ups which can more easily disappear in the fog of war in case of liability.

4.2 Market Incentives

Market incentives, and competition, play a crucial role in all principal-agent relationships, as they give the principal the possibility to simply change his agent in the case of misconduct. In Iraq, the degree of competition has changed during the examined period of time. In the beginning, the principal found himself relatively unprepared for a situation in which he had the immediate need to improve security without knowing the market and the potential agents offering private security services (GAO 2005a: 16). Therefore, the principal (in that special case the CPA) awarded single source contracts, mostly to small, unknown companies like Custer Battles, in order to avoid lengthy allocation procedures. But this strategy changed as the principal found out more about the market and its conditions and as more agents entered the private security market in Iraq. Accordingly, the PCO contract (originally announced by the CPA) to manage the six Reconstruction Opera-

tions Centers faced fierce competition between DynCorp International LLC, an established US Defense service provider, and Aegis, the British newcomer. The contract was finally assigned to Aegis because of its better overall rating (based on technical competency and evaluated costs) in a transparent proceeding (GAO 2004: 4). As an effect of this situation of higher competition and the resulting fear of losing its follow-up contract, Aegis proved to be highly responsive when confronted with the accusation of partial non-compliance with its contract, and improved the notified issues rapidly (SIGIR 2005a: 21). These details show how competition may help not only to bring down prices, but also to hold agents more accountable. Of course, this works only if the agent seeks a prolonging or renewal of his contract, which underlines the advantages of long-term principal-agent relationships also in the field of private security (Boxell 2005).

4.3 *Contract Design*

Apart from these more general conditions, the principal also has the opportunity to enhance the agent's accountability on the single contract level, as he can negotiate a highly specific contract determining the agent's operative or financial decisions as exactly as possible. However, this is extremely difficult in such a highly complex environment as a post-war country (Singer 2003a: 152). For Iraq, these difficulties to seize the peculiarity of military/security tasks into a contract are best illustrated by the SIGIR audit on the Aegis contract. The contract required that all Aegis personnel providing Personal Security Detail (PSD) services be trained in special skills like convoy driving, counter sniping, evasive driving, and hand-to-hand-combat, including also hostage rescue and chemical and biological warfare. As Aegis could not prove that its employees were able to perform hostage rescue and to react on chemical and biological attacks, the company was indeed non-compliant with the contract. However, further examinations revealed that this clause of the contract did not reflect reality in Iraq at all, as only highly specialized coordinated military forces would have this capability. Consequently this was clearly beyond the scope of Aegis's small PSD teams. Therefore, the concerning passage of the contract had to be changed and fees had to be newly calculated (SIGIR 2004a: 5).

Financial specifications in private security contracts in Iraq have also been limited as deployment had to be performed rapidly, sufficient accuracy of foreseeable costs was not given, and contract officers lacked experience in the private security sector. Due to this, most of the contracts awarded to Private Security Providers were in the beginning based on a so called Cost-plus-fixed-fee basis (as for example the Aegis contract) which guarantees the

contractor a fixed fee as a payment basis and reimburses him in addition for incurred costs up to a certain level (FAR 2005: 16.1–3). These kinds of contracts almost have a built-in mechanism to inflate costs, as it is easy for the agent to make up costs which increase his profits (Schreier/Caparini 2005: 30). Therefore, the Special Inspector General for Iraqi Reconstruction strongly encouraged the contract awarding agencies to use “fixed-price direct contracts” which are far more based on detailed specifications and functions of services instead (SIGIR 2005b: 7).

4.5 *Monitoring and Oversight*

Principal-agent theory underlines that the principal should install sophisticated mechanisms of monitoring and oversight to guarantee the agents’ compliance. And, as in the case of Iraq, if the safety of the principal’s own employees is at stake, one should expect that adequate measures would have been put in place. But this has not been the case, at least not globally. Regarding the armed forces, the DoD’s Office of Inspector General stated in one of its reports that examined the Army’s contracting and monitoring procedures during the early days of the occupation: “officials performed little or no government surveillance on awarded contracts in 13 of 24 cases” (DoD IG 2004: ii). Even if these contracts do not lie within the scope of this examination, the survey indicates a devastating picture of the overall contracting situation especially in the beginning of the occupation and reconstruction process. Concerning the principal-agent setting that is relevant to this study, a SIGIR audit found that the Project & Contracting Office in Baghdad, which was responsible for managing and overseeing the Aegis contract, “did not effectively administer the contract to ensure compliance with the contract requirements”, and identified further deficiencies in the monitoring of the contract (SIGIR 2005a: 7). These deficiencies have been caused by inexperience in security contracting matters of PCO personnel due to a high staff turnover. Furthermore, it was stated that staffing has not been appropriate to the workload of 6,500 contracts and task orders administered by the PCO at the time of the audit’s fieldwork. As a result, one contracting officer administered approximately 50 contracts at the same time (SIGIR 2005a: 11). These examples show that the principal’s potential to reduce its agent’s non-compliance by monitoring and oversight depends on his willingness and capability to create appropriate monitoring structures and therefore, to accept certain monitoring costs.

5 Conclusion

As it has been shown, it is possible to apply the theoretical findings of Institutional Economics to the highly complex situation of contracting Private Security Providers in Iraq. Doing this, it can be concluded that the principal needs to carry out improvements in various fields in order to reduce the agents' possibilities to conduct hidden actions and comply to his contract. General rules proved to be in place with the FAR system. However, punishment of non-compliant companies, like banning from new bids, should be performed continuously and existing loopholes for sub-sub contracting should be closed. The described market incentives work if the companies seek future contracts. Therefore, it is advantageous to rely on quality companies with a solid business management and to build up long-term relationships with them. These findings are strengthened by the fact that larger or publicly traded companies fear liability under civil law, much more than start-up security companies, which tend to disappear much more quickly after the first boom or in case of charges.

Single-source-cost-plus contracts have proven to be ineffective in holding companies in the security sector accountable. As lots of contracting experiences have been gained over the last years, it should now be possible to draw up more specified contracts based on stronger competition. Last, but not least, as outsourcing seems to be a long-term trend in the military and security sector, the agencies concerned have to develop better structures to oversee and administer contracts effectively instead of practicing a contract-and-forget mentality.