

FORMAL AND INFORMAL CONTRACTING WITH THE COMPETITIVE DIALOGUE PROCEDURE

MIEKE HOEZEN

Public Works and Water Management Ministry of Infrastructure and Environment
The Netherlands

HANS VOORDIJK AND GEERT DEWULF

Construction Management and Engineering, Twente University
The Netherlands

Abstract

Recent developments in the construction industry led to the need for both more and changing formal contractual arrangements and for improved informal cooperation. In this context, the Competitive Dialogue (CD) was introduced by the European Commission in 2004. This procurement method consists of several discussion rounds between the principal and potential suppliers, during which all aspects of the tender can be discussed. The CD procedure aims to align complex demands of principals with possible solutions that contractors have to offer. It is, however, unclear how formal and informal structures and processes in the CD are interrelated and are determining its effectiveness. Major question is how processes and products differ between CD-procured projects and comparable projects which are traditionally procured. Insights of both formal and informal contracting processes are combined in a theoretical framework. Differences in (in)formal process and contract development between projects procured by the CD procedure and by traditional procurement procedures are studied in four comparable construction projects.

Keywords: procurement, contracts, relationship development.

INTRODUCTION

The combination of increased project complexity (Baccarini, 1996; Laufer *et al.*, 1996; Alderman *et al.*, 2005; Walker, 2007), changed role of the government (Blanken, 2008) and the sector's poor professional functioning (Latham, 1994; National Audit Office, 2001; Dorée, 2004) form the context in which several changes in the construction industry are embedded. These changes are twofold: on the one hand they are aimed at new structures (formal processes and contracts) and on the other at new working relationships (informal processes and understandings).

Formal tasks and roles of the market and of government have changed. Public clients have less influence on the contents of works and confine themselves to monitoring and checking the public's interest. Conversely, market organizations have, alongside the executive, also more substantive tasks. Stemming from these changing tasks and roles, structures have been amended and are continuously developing. Integrated contract forms, PPP constructions and active discussions on aspects such as prices, risks and contractual terms are becoming more common during the procurement of construction projects. Further, there is also growing attention paid to the 'soft' aspects of construction. The call for new cooperative forms, increased mutual trust, improved communication and mutual understanding becomes louder.

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CD procedure aims to align complex demands of principals with possible solutions that contractors have to offer (Hebly and Lorenzo van Rooij, 2006). It is, however, unclear how formal and informal structures and processes in the CD are interrelated and are determining its effectiveness. In essence, there are two perspectives. In the first perspective, formal and informal structures and processes in the CD are serving as alternatives: what is arranged in a contract does not need to be discussed informally and vice versa. In the second perspective, formal and informal structures and processes are considered as complementary. Formal contracting processes can lead to informal processes such as the development of mutual expectations and social relationships.

Major question is how formal and informal structures and processes differ between CD-procured projects and comparable projects which are traditionally procured. Insights of both formal and informal contracting processes are combined in a theoretical framework. The outline of this study is as follows. In the next section, formal bargaining and informal sense making *processes* and the *products* of contracting - the formal and informal contract - are discussed into detail. It is explained that the linking concept between process and product is understanding. Based on the previous steps, propositions are developed based on both the policy rhetoric for the design of the CD procedure and on the theoretical insights. Subsequently, the empirical research design is presented. Differences in (in)formal process and contract development between projects procured by the CD procedure and by traditional procurement procedures are studied by selecting four comparable cases. Finally, the result are discussed and conclusions drawn.

THEORETICAL FRAMEWORK

Basis of the theoretical framework is the process model of Ring and Van de Ven (1994). This model gives an overview of how both formal and informal processes are involved in relationship development. However, in order to understand how these processes are interrelated, especially during the (in)formal contracting with the CD procedure, this model is expanded with the models of Ring and Van de Ven (2000) and Vlaar, Van den Bosch and Volberda (2006). These three relationship development models are combined into one framework for studying formal and informal contracting processes in procurement by the CD procedure. Central elements in this framework are formal bargaining, informal sense making (Weick, Sutcliffe and Obstfeld, 2005), the formal legal contract and the informal psychological contract (Rousseau, 1998). These elements will be further elaborated upon in the following sections and will guide the data collection and interpretation.

Formal bargaining

Relational development academics identify the following four mechanisms that occur in bargaining:

- *Focusing attention*: Vlaar et al. (2006) show how formal processes focus attention by pointing at order and content of decisions which are to be made.
- *Forcing articulation, deliberation, and reflection*: when bargaining over possible terms and conditions, parties are forced to make their individual and mutual goals explicit (Blomqvist et al, 2005, p. 501).
- *Interaction*: formal bargaining implies that parties exchange ideas about future tasks and outcomes by conversations and dialogues (Nellore, 2001; Yakura, 2002; Putnam, 2003).
- *Reducing biases, judgment errors, incompleteness and inconsistency*: the fact that in interorganizational bargaining processes usually several people are involved, compensates

for deficiencies in individual thought processes (Katz and Kahn, 1966; Ketokivi and Catañer, 2004).

The identified output of the bargaining process form conditions for the second part of the negotiations stage of procurement: informal sense making. Vlaar et al. (2006) state that formalization “enables, or even forces collaborating parties to engage in sense making, helping them to create common ground and achieve mutual understanding” (p.1622).

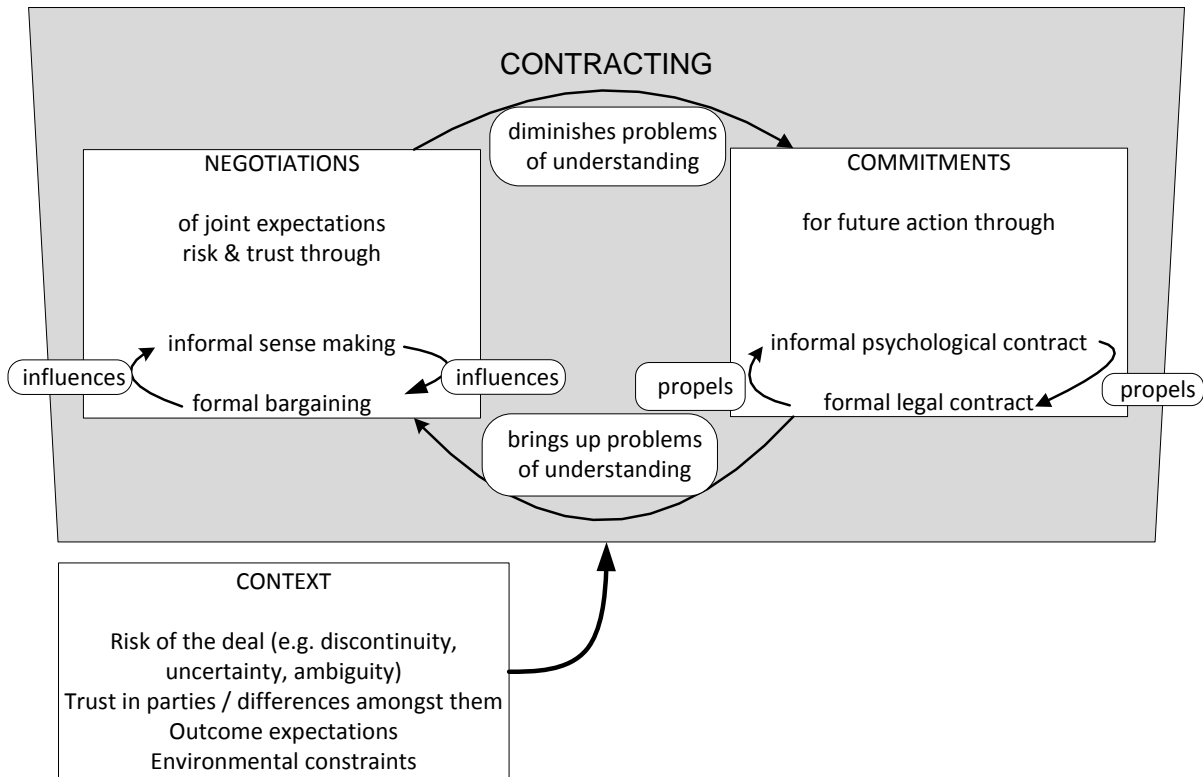


Figure 1: Theoretical framework

Informal sense making

Sense making is a social process during which organization members interpret their environment in and through interactions with others, thus constructing observations that allow them to comprehend the world and act collectively (Sandelands & Stablein, 1987; Starbuck & Milliken, 1988; Isabella, 1990; Sackman, 1991; Weick & Roberts, 1993). During the contracting process, two parties with differing patterns of beliefs and assumptions are to create coherent understandings in order to come to collective action (Maitlis, 2005; Weick, 1993). Since the two parties intend to work together, they will strive for congruency in views on purpose and expectations of the relationship. Sense making processes are therefore assumed to play a central role in the procurement of a project. These processes form “the primary site where meanings materialize that inform and constrain” action (Weick et al. 2005, p. 409, citing Mills, 2003: p.35). Weick (1995) describes the sense making process as an enactment process: parties produce part of the environment they face (p.30). The result of the sense making process in interorganizational contracting is to understand the transaction, the context of the transaction, the value of it to the other party and to oneself. Shared understanding between the two parties is reflected in mutual beliefs, norms, values and routines. These form the basis of the first part of the Commitments stage of procurement: the informal psychological contract.

Informal psychological contract

The psychological contract consists “of unwritten and largely non verbalized sets of congruent expectations and assumptions held by transacting parties about each other's prerogatives and obligations” (Ring and Van de Ven, 1994, p.100). Following the literature review of Van Den Brande et al. (2002), four aspects of these contracts are considered: subjectivity, reciprocity, implicitness, and obligation. These “elements of quasi-moral involvement among parties” are much more common among members of an internal organization, but can and do appear in a market context as well (Williamson, 1975, p. 38). Yet, in this research the term *informal (psychological) contract* is used. This term is used to make clear that it is opposed to the formal (legal) contract. Kadefors and Laan (2010) state that *informal control* is “about purposefully establishing norms, values and routines, to reduce discrepancies in goal preferences and inclinations towards opportunism. Consequentially, informal control reduces risk through the establishment of shared values. In this study, the informal contract refers to the implicit set of expectations between the client and the contractor and which is, unlike the written contract, continually changing.

Formal legal contract

Ring and Van de Ven (1994) describe how the informal contract becomes formally codified. As individuals act as agents for their organizations, these organizations will require formal documentation and standardization. Thus, the informal commitments made by negotiating individuals will be left in writing for their organizations and for other individuals acting as agents for those organizations. When the formal legal contract is perceived as a reflection of formal control, it contains both limitations of opportunities for opportunism and limitations of material incentives to utilize these opportunities. There are several mechanisms by which contracting parties could address these forms of control. The mechanisms, which are derived from transaction cost economics, are shift in rights/power of decision, rewarding systems, monitoring, and bonding. Vlaar et al. (2006) argues that formalization may also have negative effects on sense making, causing new problems of understanding. It may make events more comprehensible and controllable than they really are; it may lead to formalism, causing rigidity and a loss of creativity and flexibility, and diminished trust. Next to that, the writing of formal contracts may cause large efforts and huge transaction costs.

Understanding as a key concept

In the previous sections, the cycle negotiations – commitments – negotiations is elaborated upon. Key concept in this cycle is *understanding*. When having made sense of new situations, people desire to enact the input to their sense making processes back into their world to reorder it (Weick, 1995). The resulting collective consciousness, common reality, or shared *understandings* offer them a unitary basis for action. For those points on which this collective consciousness, common reality or shared *understandings* are reached, parties are in the commitments stage of contracting (Ring and Van de Ven, 1994). Yet, processes of informal sense making do also propel new formal bargaining processes. These new bargaining processes facilitate new sense making processes, which in turn could improve *understanding*. Ring and Van de Ven (1994) indicate that formal and informal processes are interacting during each stage of the development process. It is not just as if formal bargaining leads to a formal contract and informal sense making to a psychological contract. However, where Ring and Van de Ven (1994) assume formal and informal contracts to be each other's substitutes (existence of an informal contract diminishes the need for establishing a formal contract), the insights of Vlaar et al. (2006) suggests that formal and informal contracts serve more as complements. Developments in the informal contract effectuate developments in the formal

contract and vice versa. Understanding is assumed to be the main force in these developments.

PROPOSITIONS ABOUT THE WORKING OF THE CD PROCEDURE

The model developed, depicting how formal and informal processes and products are playing a role in inter-organizational contracting gives us an idea of the dynamics in (in)formal contracting processes involved in procurement processes like the CD procedure. This leads to the following propositions.

Context

The CD procedure was meant for the procurement of complex projects, of which technical, legal and/or financial solutions were not objectively specifiable by the contracting authority. Complex projects could be characterized by high levels of risk and insecurity about what to expect. This context is therefore included in the theoretical frame. Following Ring and Van de Ven (2000), we assume that the environmental aspects which are of importance are risk, initial trust levels, outcome expectations and environmental constraints.

Proposition A: The contracting process is influenced by aspects from its environment, like risk, initial trust levels, outcome expectations and environmental constraints.

Understanding, negotiations stage and commitments stage

The CD procedure is a new approach to tendering, with the expectancy to influence the execution of the project. One could argue that tendering equals the negotiations stage of the model developed, whilst the construction of the project starts in the commitments stage. This might sound logical when considering the contract which is signed at the end of the tendering as the formal legal contract. However, this is not in line with the assumption in the model developed that understanding and problems of understanding determine whether or not negotiations start or commitment is reached. Given this assumption, contract close cannot be seen as a demarcation point where the negotiations stage becomes commitment stage. Even the contract which is signed will be renegotiated in new series of formal bargaining and informal sensemaking. However, the contract which is signed at the end of tendering is meant as a formalization of the understandings reached during the tender negotiations and parties intend to commit to the agreements reflected within.

The parties involved might understand each other on some aspects of the contract and face problems of understanding on others, during any stage of the project. However, since it is not possible to both understand and have problems to understand at the same time, the parties are in either the stage of commitment or in the stage of negotiations for each of the aspects apart. This means that commitments and negotiations are substitutes of one another.

Proposition B: During all phases of a project, from initiation up to delivery, the parties involved go from commitment to negotiations and back, depending on whether there is understanding or not.

Proposition C: On several aspects of the project the parties are in either the stage of commitment or the stage of negotiations. Commitment and negotiations do, however, not coexist within an aspect: the two stages are serving as substitutes.

Formal and informal processes and products

Within the stage of negotiations, both formal and informal contracting processes take place. The processes of formal bargaining and informal sensemaking are both meant to decrease problems of understanding. When understanding has been reached, the stage of commitment

contains both formal and informal contracting products. The formal legal contract and the informal psychological contract are both reflecting the understanding which has been reached. The assumption in the model that within stages formal and informal processes or products are interacting, holds that formal and informal processes are each other's complements, just as formal and informal products.

Proposition D: Formal and informal processes and products serve as complements of one another.

These propositions are a starting point from where we will be looking at the practice of CD procurement.

EMPIRICAL RESEARCH DESIGN

To study the difference in (in)formal process and contract development between projects procured by the CD procedure and comparable projects procured by different procurement procedures, it is important that the selected cases are comparable. An embedded multiple-case study required in this case at least four comparable projects: two projects procured by the CD procedure, and two projects which are traditionally procured. Within those projects, four formal and four informal contracts are analyzed. The four projects selected are part of a maintenance program of highways including fly-overs, overpasses and other related objects in co-operation with the private parties.

Data are collected through a series of in-depth face-to-face interviews with both a contractor and a principal in four construction projects and additional interviews with informants who can say more about the projects in general (see Table 1). The description and analysis of the four case projects is based on concepts as discussed in the theoretical framework. By comparing the parties' experiences in both the tendering and the execution stage of traditional procured case projects with the parties' experiences in those stages in CD procured case projects, conclusions are drawn about the effect of differences in tendering for the construction stage of projects and the effectiveness of the CD procedure.

		Participation level		
		Fully participated in a traditionally procured project	Fully participated in a CD procured project	Generally involved in projects
Role	Principal	2	2	3
	Contractor	2	2	1

Table 1: Number of interviews, differentiated by participation level and role

Each interview took 60 to 90 minutes and was guided by case study protocols. The interviews were recorded and transcribed for systematic analysis, and complemented with information from the evaluation report, the procurement documents, contractual documents and requests to change contractual terms after contract close. This was all loaded into the data analysis program QSR NVivo, which was used to attach labels from the theoretical frame to empirical information. Using the program, text fragments with identical labels were easily compared, patterns were discovered and from that, conclusions were drawn. We sought for formal and

informal interaction patterns, and especially for similarities and differences between the traditionally procured projects and the CD procured projects. In the upcoming sections, attention is given to the traditionally procured projects and the CD-procured projects respectively.

TRADITIONALLY PROCURED PROJECTS

Problems of understanding

When the construction stage started, right after contract close, the Dutch Highways and Waterways Agency (the principal in the cases studied) and the winning contractor did not have had much contact. Except for the public inquiries during the procurement stage, no information exchange had taken place. Therefore, the mutual understanding about the meaning of the contract, its scope and the plans which were made by the contractor had to grow during the construction stage. There were several situations which caused problems of understanding in those early stages of the construction stage.

The first problems of understanding arose from different interpretations of tasks and duties. This had mainly to do with the fact that neither Agency nor contractors were having experience in the procurement of contracts with a design component under System-based monitoring (a new monitoring system of the principal or Agency). At the one hand, there were the contractors who thought it was odd that the Agency did not know what to conclude from the state assessments (did the whole bridge had to be replaced or would it be sufficient to reconstruct parts of it?). At the other hand, there was the Agency, feeling that it was the contractors' responsibility to make that decision and then put a price on it.

When the contractors started their work, they were confronted with an actual state of objects and roads, which turned out to differ from what was written in the assessment of the Agency. This caused problems of understanding. In the contracts it was agreed upon that in case of incomplete or insufficient data, or when the actual state of objects and roads turned out to be worse than one might expect from the state assessment, extra work would be for the Dutch Highways and Waterways Agency's account. The clauses of the contract provided that contractors would claim nonexistent extra work, by stating that when differences were discovered, the Agency would have to be contacted. Extra work should only be carried out after the Agency's consent. In practice, this was not as simple as one might expect, since works were mainly carried out during the night. And then, no agency employees were present or reachable at their offices.

The contractor's plans which were assessed by MEAT criteria to win the contract were only the outlines of the working and monitoring plans. These had to be specified after contract close, and accorded by the Agency. System-based monitoring was new to both the Agency and the contractors, which made that in both projects the contractors had a hard time finding the right abstraction level (resulting in loads and loads of paperwork to prove their efforts), and the Agency took its time to check the plans, and refuse them several times. It somewhat hovered between monitoring the process from distance and checking upon the details of the product itself. However, there was not all the time to keep checking and re-checking since the closure of roads involved was due on a fixed date, which came closer soon. This put high pressure on the development of the working and monitoring plans.

Summarizing, the early months of the traditionally procured projects were not contributing to positive development of the relationship between the Agency and the winning contractors. At contract close there were small problems of understanding about the working roles which each party should take. When the actual state of objects and roads turned out not to match with the description in the state assessments, these small problems of understanding grew big. The discussions over extra work which had been performed without consulting the Agency at forehand and the long time and extra versions it took before the working and monitoring plans were accepted, added to the mutually sensed feeling of misinterpretation of working roles

Negotiations and commitment

From the previous part it showed that especially the informal understanding of what was written in the formal contract differed between the Agency and the contractors. This caused that the relationship in both projects developed in negative vicious cycles. However, both the Agency and the contractors involved in the projects were committed to the projects. They were, therefore, willing to cooperate for the benefit of the project

Besides practical solutions with regard to entering the objects and highways without accepted working and monitoring plans at the closure dates, also the working relations became looser. In both projects a project re-startup was organized, which helped in the sense making process of both parties involved. After renegotiations, the parties had reached mutual understandings about the job which had to be done and the roles both parties had to take. This helped to finish the last part of the project by changed working routines and in a better working atmosphere than was the case during the first part.

Summarizing, whereas at the start of the construction stage of the traditionally procured cases the parties involved had no strong expectations, their attitude towards each other had become somewhat negative after the first construction months. Pragmatism and some project re-startups created renewed mutual understanding though, so that the last months of the construction stage went much more cooperative and smooth.

CD PROCURED PROJECTS

Problems of understanding

Already during the dialogue, the first problems of understanding arose. The first issue was the time to go through the Agency's available information. Candidates felt they could not assess how (in)-complete this information was, so that they could hardly determine what the assignment to the engineering firm would have to include. The available information was too much, and too poor. Besides, the engineering firm's appointed assessment time (15 minutes per object) was judged as too insufficient. Furthermore, candidates felt that the state assessments in their selves had to be judged too soon after delivery. However, they did not make a big deal of this towards the Agency, causing it being not discussed yet noticeably an issue.

Second cause for problems of understanding was assigning an engineering firm. It was the Agency's intention that candidates would jointly be responsible for drawing the engineering firm's assignment. However, the fact that this firm was appointed and paid by the Agency gave a different signal to the candidates. Besides that the contractors did not feel responsible for the contents of the state assessments, the given situation did also cause them to behave

opportunistically. Respondents from both the Agency and the contractors state that the drawing of the assignment to the engineering firm ended up being more a game between the candidates than a proper attempt to get the right information.

All five Agency respondents and two of three candidates agree that the candidates were more active with each other than with getting the right information in the state assessments. As if eliminating competing candidates was more beneficial to win the bid than cooperating to get clear sight of the risks of the project. This caused friction at the Agency's side about the candidates' interpretation of tasks and duties. Contractors held the opinion that they would not have to check the situation of the objects and roads themselves, since all knowledge had been delivered on paper. These problems of understanding were, however, not expressed during the dialogue. So although all parties came out of the dialogue with the expectation of having signed proper contracts, the execution of the projects showed that the understanding of these contracts was not mutual at all. Agency and contractors came to stand against each other when the actual state of objects and roads appeared not to match the expectations, formed by the state assessments.

There were several problems. First, in one case it is not clear whether a problem is the contractor's responsibility or the Agency's. Secondly, during the state assessment some things have been overlooked and later on it turned out that something was wrong. The Agency felt that the candidates had to have this checked upon, and since they did not do so, the Agency held them responsible to pay for the extra costs. Contractors held different opinions, and put claims on the Agency. Third, whilst the Agency employees were unanimous in their opinion that contractors did not feel responsible enough and were not truly committed to the project, the contractors complained about the Agency taking the contract too literally, not thinking in terms of project interest, but from the Agency's single-angled interest only. This was especially reflected in issues concerning the system-based monitoring. Both contractors and Agency employees felt that the system was too extensive for the small job maintenance actually is. However, with two parties holding different working routines, with claims being put and a monitoring system which is new to all parties involved, negative vicious cycles were developing. This caused for contractors that small shortcomings could result in large payments which were retained

Summarizing, problems of understanding during the procurement stage of the CD procured cases were increasing throughout the construction stage of those projects, due to differences in interpretations and expectations. During the dialogue conversations most of these issues were not discussed and therefore unexpressed towards each other.

Negotiations and commitment

Just as in the traditionally procured projects, the CD procured projects developed along negative vicious cycles as well. From the previous part it showed that especially the informal understanding of what was written in the formal contract differed between the Agency and the contractors. In attempts to make sense of the situation, both parties in each project sought for explanations. These were found mostly in doubting the other party's professionalism.

The parties kept fighting their differences about the actual state of works and roads, so these were only solved by tough renegotiations. The first situation (defining which scenario the found problem concerns) was looked at per occasion by the Agency. For the second situation (things were overlooked during the state assessments) the Agency and some contractors went to court. When in the first case verdict was given in favor of the contractors, the Agency and

the concerning contractor entered in a mediation process which lead to settlement. This settlement was then translated to all the other cases so that new agreements were reached about the responsibility for the state assessments.

Along with the settlement over the responsibility for the state assessments an arrangement was made over the shortcomings. Contract managers did not have to decide for themselves any more whether or not something was a shortcoming or defect; their bosses from the Agency in Utrecht took care of it from then on. It helped, according to the informants, however this did not bring in empathy or affect.

Summarizing, due to the fact that problems of understanding remained unspoken, the negative attitude of both parties towards each other influenced the manner in which they both made sense of new cues. Problems of understanding only increased during the construction stage, due to negative vicious circles of internal sense making instead of expressing problems of understanding towards each other. Tough negotiations and even law suits gave verdict in the worst cases, but could not relieve the relationship between the Agency and the contractor.

DISCUSSION

When problems of understanding due to differing ideas about risk allocation arose, the starting situation at contract close was different in the CD procured cases than in the traditionally procured cases. In the traditionally procured cases, both parties entered the construction stage rather blank: the principal and the contractor did only start to get an idea of who the other party was and what was important to him. In the CD procured cases, however, when the construction stage started, both parties had formed an image of the other one already.

Whereas in the CD procured cases renegotiations did only emphasize existing differences in norms and values, working routines and inability to empathize, which caused problems of understanding only to become worse, the contrary happened in the traditionally procured cases. There the renegotiations lead to understanding, empathy / affect and mutual working routines, even though the norms and values of the parties involved did not correspond at all spheres.

Summarized, when problems of understanding about the risk allocation had been discussed during the dialogues, it would have been likely that what happened in the traditionally procured cases would have also happened in the CD procured cases: starting to make sense of the situation without having an idea of the other party already. But since these conversations did not take place during the dialogues, the implementation of the CD procedure turned out to be less effective than expected. Both parties held the idea that the dialogue conversations had lead to proper understandings at both sides of the table. Renegotiations would not have to be necessary if the other party would act as agreed upon.

Given that the parties were not aware of the differences in understanding between them, negative cycles began to develop: observed shortcomings by the Agency were followed by proposed amendments of the contractors, followed by rejections of the amendments and putting payments on hold by the Agency, after which there was only one way out of the negativity to make the projects succeed: a conciliation board. After settlement, the parties in the CD procured cases did not work along fine and easy as was the situation in the traditional

procured cases. Instead, the working routines remained distant and stiff, due to the fact that notwithstanding open, trust-building CD conversations, the relationship was disturbed by both parties' responses to disagreement about the risk allocation.

CONCLUDING REMARKS

The major question was how processes and products differ between CD-procured projects and comparable projects which are traditionally procured. The actual *formal* contracts do not differ much between CD procured and traditionally procured projects. It was shown that problems of understanding were key in the development of contracts in both types of contracts. The *informal* contracts and the processes to solve problems of understanding in the construction stage of the project do differ when comparing CD procured projects with traditionally procured projects. Processes of sense making determine how parties enter into the bargaining process to a large extent. This explains why renegotiations over risk allocation differ between the CD procured cases and the traditionally procured ones. In the CD procedure parties get to know each other better during the procurement stage. This makes that sense making processes at contract close develop different than in traditionally procured cases. Interaction between principal and contractors during the contracting process make that informal contract and formal contract develop simultaneously. When the informal contract is mutually understood by both contracting parties, this might result less problems of understanding during the construction phase of a project. However, in the cases problems of understanding were only bigger for the CD procured projects compared to the traditionally procured projects. We explain this by the stressing that the dialogue conversation did not cover the whole contract. Although developing simultaneously, formal and informal contract did not develop parallel. Instead, the two grew away from one another. The answer to the major question indicates that the CD procedure's design and its side-effects influence the forming of both formal and informal contract. The results also indicate that formal and informal contracts are dynamically interrelated. Problems of understanding have showed to be key in the development of both formal and informal contract.

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