Plenary 9: Value for Money

Tuesday, 15:30 to 16:30

CEPA

Session agenda

1. What does value for money mean?

2. When should a PPP be used?

3. The role of the public sector comparator

4. Is value for money meaningful in a country with limited Government resources?

5. Summary and further reading

What does Value for Money mean?

The principal reason for using PPPs is that, where a project is suitable, they can deliver better **Value for Money (VfM)** than the alternative options for procuring infrastructure or services

PPPs are likely to deliver VfM where:

- PPP project is using private sector skills across a number of disciplines
- the public sector track record of project implementation is poor
- bidders are competing to provide the best services over the life of the assets
- risks are allocated to the party best able to manage or absorb them

Risk transfer remains a key element of the value for money argument in favour of PPPs

Risk transfer – incentivising performance (I)

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Achieving risk transfer in PFI involves four key components:

- **Fixed price - Incentives to outperform (cost and innovation)**
- **Paying for availability**
- **Performance regime**
- **Adverse consequences for failure to deliver - liquidated damages / termination**

By fixing the price to be paid for agreed outputs/outcomes – with financial consequences for failure to deliver – the provider is subject to strong incentives to perform.

Risk transfer – incentivising performance (II)

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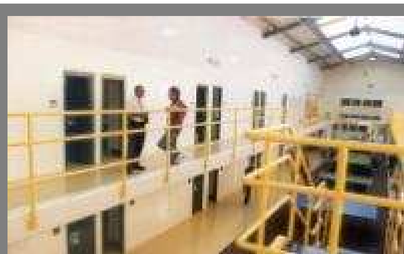
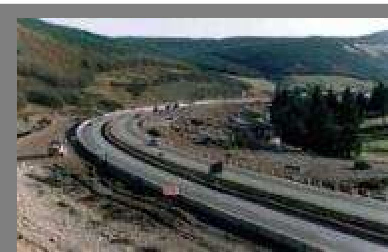
Prisons



- **Service Payment – Availability of cell only (therefore no volume risk)**
- **Performance:**
  - o Prisoner escapes
  - o Quality level of cell
  - o Educational attainment

Roads



- **Service Payment – Shadow Toll and availability (some volume risk accepted)**
- **Performance**
  - o Safety – 25% of economic cost of personal injury
  - o Lane Closure deductions

What does Value for Money mean?

PPPs are designed so that risks are allocated to the party best able to manage them

- Public sector should obtain **best value** because those with the greatest and most relevant expertise will be best able to manage or absorb risks, thereby pricing them more economically and minimising costs
- Important that public sector does not promote, or private sector accept, inappropriate risk transfer

Optimism Bias

Optimism Bias is the term used to describe the tendency for the public sector to underestimate project costs or be over-optimistic about project outcomes, e.g. underestimate project costs. Optimism bias needed to adjust projected public-sector outcomes for risk when considering project feasibility

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Designing PPP to deliver VfM - what are the critical success factors?

- **Carefully and clearly defined output specification.**
- **Performance and payment regime only transfers risks that the private sector can manage / and is transparent**
- **Comparative simplicity in contractual interfaces**
- **Intelligent customer (advisers as appropriate)**
- **Choosing the right PPP model**
- **Competition between bidders / benchmarking going forward?**

So, what kinds of projects are suitable for PPP?

- **Large Projects (to spread transaction costs)**
- **Fully specified output specification pre-bidding**
- **Front-ended expenditure profile (asset related-service)**
- **Limited complexity in contractual interface (high proportion of the final value add)**
- **Effective competition**
- **Stable requirements over contract life**

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A Public-Sector Comparator is intended to assess whether a PPP offers good VfM compared to public-sector procurement

Comparison of:

- An assumption of what the NPV costs of the project would have been had it been acquired through a conventional public-sector procurement; and
- The NPV cost of PPP Service Charges

If the NPV of the PPP cost is lower than the PSC, the PPP can be justified

Cost comparison

- Cannot assume costs will be the same for PSC and PPP
- Because risks are being transferred to the private sector, the PPP's costs will increase to compensate for this
- Impossible to take the benefit of private sector innovation into account in the comparison of a PPP to the PSC – cannot be predicted in advance

Discount rate

We know that choice of discount rate greatly effects the result – should the same discount rate be used for evaluating both the PSC and the PPP?

Issues for consideration:

- **Cost of capital for a PPP project typically higher than the public-sector discount rate**
- **Cannot assume costs will be the same for PSC and PPP**

Alternative approaches:

1. Use single generic/ sector/ project-specific discount rate for both the PPP and the PSC
2. Use the same 'public-sector' (i.e. risk-free) discount rate for both PPP and PSC, but adjust the PSC cashflows for risk (UK approach)
3. Use a discount rate which reflects the private-sector cost of capital for both the PPP and PSC, but adjust the PSC cashflows for risk (used in Australia)

Adjusting the PSC for risk transfer

PSC calculation will consist of:

- The unadjusted NPV of the PSC, i.e. that based on cashflow projections without taking account of risks retained by the public sector
- The NPV of risks transferred to ProjectCo under the PPP
- The NPV of risks retained by the public sector
- An adjustment to take account of the different tax positions of the PSC and PPP (if required)

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Is VfM meaningful in a country with limited Gov^{t} resources?

- **Pakistan's infrastructure investments estimated by PDF at $20 billion per year:**
  - Public sector can meet less than 50 %
  - Private sector currently contributes about 20 %, or $4 billion per year
  - There is a gap of about 30 %, or $6 billion per year
- **Need to increase the private sector contribution through PPPs, both at federal and provincial level**
- **This will also result in a better efficiency and quality of infrastructure services**

PPP provides a means of supplementing scarce public finances with private capital in order to meet the growing demand/ need for better and expanded public services

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Summary

- **Value for money is an important concept**
- **Requires knowledge about the alternative ways in which a project can be delivered**
- **Optimism bias is a concern – but also true for public sector projects**
- **Public sector comparator – good theoretical idea but questionable usefulness in reality**
- **Need to consider what the real constraints are**

Further sources

Online

1. Shugart on the applicability of the Public Sector Comparator: http://www.ppiaf.org/ppiaf/sites/ppiaf.org/files/publication/Gridlines-4-Is%20the%20Public%20Sector%20Comparator%20-%20JLeigland%20CShugart.pdf