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Public-Private Partnerships: Affordability, Value for Money and the PPP Process

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The Economics of PPPs: Affordability, Value for Money and Risk Sharing

Why choosing the PPP route?

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What are the determinants of government commitment in PPPs?

- Budgetary constraints and fiscal opportunism

- Economic efficiency in the whole life of the project

Experience shows the promises of cost savings are not always and significantly kept

- Transaction costs induced by the competitive process and the contractor monitoring

- The additional cost of private financing compared to sovereign debt must be taken into account

- The lack of competition for the market for some contracts or informational asymmetries induce rents for private contractor.
Some figures on cost savings promised by PPPs

The UK example
- Arthur Andersen and Entreprise LSE (2000) : 17%
- On average, savings are assessed by the NAO as < 10%
- for the MoD they range from 20 % (White fleet) to 4 - 5 % (DFTS / Skynet V)

Financial costs

- A public programme financed through guilt is 150bp cheaper
- Financial tools allow to limit to 80bp the additional cost
- For HM Treasury (2006), they just represent 5% of the overall cost of a project
Transaction costs

- They can outweigh the potential savings of PPP (Williamson, 1976)

- If PPPs allows to reduce public procurement expenditures, what are the cost of cost savings?

- Two types of transaction costs must be highlighted:
  - Ex ante (bidding and contracting costs)
  - Ex post (monitoring costs)
Ex ante costs

They can deter potential competitors from bidding and cancel the potential benefits of PPPs

- Bidding costs represent 3% of the project total expected cost: It is three time higher than the costs induced by conventional procurement schemes.

- The public body is often bound to compensate the costs incurred by reserve bidders to make sure of a sufficient competitive pressure.

- Advisory costs for the public partner amount to 3.7% on average but can reach 10% for very complex project.

- Because of such costs, HM Treasury considers that the minimum capital value for running a PFI is £20M.
**Ex post transaction costs**

- For the USA, monitoring costs are assessed between 3 and 25% of the capital value of PPP contracts.

- For the franchised UK railways, franchise management represents a third of the SRA operating budget.

- In PFI contracts, monitoring costs should be proportionate to the consequences of poor performance (HMT, 2004).

- Monitoring could be realised through value testing mechanisms (as benchmarking or market testing). Such provisions exist in 250 PFI contracts but potentially increase transaction costs.
The critical dimension of the decision to commit into a PPP contract is the optimal risk management and not really cost savings.

A proof by the Main Building Redevelopment contract of the MoD

- Public and private costs are both estimated at £ 746M
- The private solution was chosen because it protects government from cost and delays overruns
PSC distribution for the MBR (NAO, 2002)

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Cost overruns are the main source of hidden costs in traditional procurement schemes.

So even if private finance induces additional financing costs, choosing a PPP could be analysed as an insurance premium paid by the government against unexpected costs.
The decision to enter in a long term contract despite higher expected costs could be analysed in terms of risk adversity.

By choosing a PPP, Government values cost certainty in procurement.
Two different levels must be considered (Blanc-Brude, 2007):

1. **At the project level**, a fixed price contract eliminates (or could eliminate) the risk of wasteful time or cost overruns.

2. **At the portfolio level**, contracting with a fixed price scheme and within a scheme in which government is bound to make payments all the contract long, eliminates the risk of sub-standard maintenance and congestion.
Two concluding remarks about risk transfer, affordability and value for money

1. The economics of PPP contract lies more on optimal risk allocation than maximal risk transfer

   • A total Risk Transfer is an illusion: risk would be re-internalised by the Government
   • The risk premium in the case of an excessive transfer would undermine the value for money
   • The principle of PPP is to allocate the risk to the party, which is able to manage it at the lower cost.
2. A sub-optimal risk allocation could be induced if accounting strategies interfere with the government trade off between PPP and traditional procurement scheme.

- An opportunistic strategy could sacrifice the value for money to the contract’s consolidation within the accounts of the private partner.

- If government searches to get the project “off the books”, he could ignore both value for money and affordability considerations.