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

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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?

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)

o 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

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

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

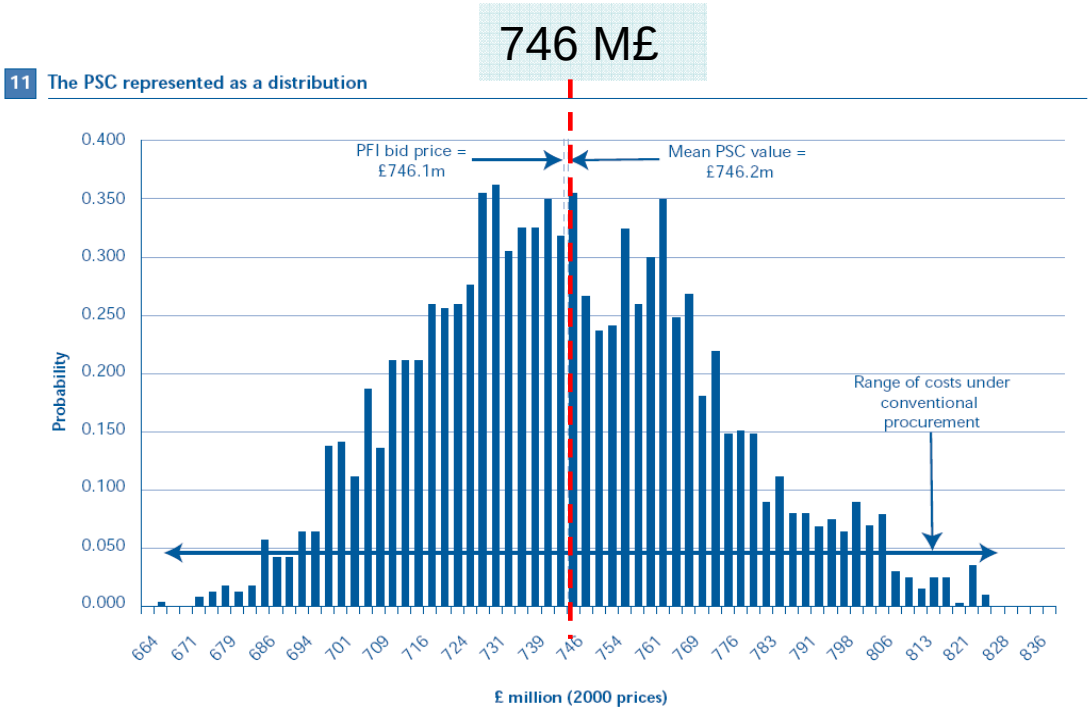
o In PFI contracts, monitoring costs should be proportionate to the consequences of poor performance (HMT, 2004).

o 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)



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

o 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.