



Public sector comparators and value for money in PPP

In the context of Public-Private Partnerships (“PPP”), governments are often faced with the decision as to whether to adopt the PPP mechanism for procuring public service capital projects or to fund such investments conventionally, either from tax revenues/budget or with loans raised against a government guarantee.

If the public financing option is chosen, the underlying financial obligations will be ‘on balance sheet’ for that government. With respect to the PPP option, under current “guidelines”, the financial obligations may, or may not, be ‘on balance sheet’, depending on the allocation of the underlying risks.

At the same time, governments will have to ensure that whichever mechanism chosen also offers best value for money, normally done through the development of the so-called Public Sector Comparator (“PSC”).

The decision, therefore, as to which procurement option to adopt and the basis upon which such decision is taken is critical and has long-term implications.

When undertaking investment analysis of a range of project opportunities, the conventional method for determining objectively the value of one opportunity against another is to calculate the present value of each option. As investment projects in public service assets have benefits and cost recovery spanning many years, e.g. 20-30 years for a PPP contract, the discount rate chosen to bring future values back to today’s terms is key.

Conventional investment theory dictates that the discount rate to be used is the opportunity cost of capital, e.g. the interest rate for 30 year government bonds, by way of example. It is, of course, important to choose a discount rate which reflects the overall time horizon, or life cycle, of the investments. Additionally, each opportunity has to be analysed against a common time horizon.

A second issue is how to treat inflation. Inflation exists in every jurisdiction, so the choice is whether to base the PSC on constant prices (the “real” basis) or at current prices (the “nominal” basis). The appropriate discount rate will be higher if the comparison is done at current prices because the discount rate will be applied to actual cash flows and reflect nominal rather than real interest rates.

A further issue is the relevance of tax receipts in the comparison. With a private sector-funded project, usually some corporation tax will be generated by the special-purpose project company, plus, possibly, some capital gains tax (CGT) should the equity investment in the project company be sold on at a later date in the project cycle at a profit.

In most cases, CGT is treated as a windfall tax and, therefore, is not part of the basic project assessment. With respect to corporation tax, some governments insist that it is excluded from any conventional procurement versus PPP-type comparison, as it would be generated anyway by investment in alternative opportunities, if it was not invested in the PPP under examination.

Other commentators, however, insist that corporation tax should be included as part of the calculation, since capital markets are open and alternative opportunities for the investor are unknown. Capital markets are certainly more international these days, so alternative opportunities outside the national jurisdiction of the host government may well be available, - and, hence, of no taxation benefit to the host government - so, arguably, any such corporation tax generated should form part of the assessment, as it represents a contribution to national budgetary revenues.

There appears to be no set guidelines on this issue. Prudent analysts may consider both possibilities in their calculations.

To date the UK Government has launched around 900 PPP-type projects. The UK Government, when it undertakes analysis of investment options for public service investment projects, expresses data in real terms rather than nominal.

The UK Government dictates (via its 'Green Book') to its ministries and agencies (and, in effect, because of the control of capital expenditure allocations, also to sub-national authorities) how to undertake investment analyses and determines the discount rate to be used to express future values in today's terms. From 1991 to 2003 the discount rate was 6% 'real', which, with inflation through the same period being, typically, 2-3%, gave an approximate equivalent 'nominal' rate of 8-9%.

On the other hand, from 1991-2003 the cost of 30 year UK Government bonds ("gilts") varied, but on average was 5.5-6%. This, of course, is a 'nominal' value.

Hence, one can see that, by imposing a 6% 'real' discount rate for such analyses, the UK Government was imposing a higher rate of discount than conventional investment analysis would suggest.

The consequences of using a real discount rate of 6% were twofold:

- Firstly, this choice favoured PPP/PFI options against conventionally funded alternatives. In cash-flow terms, under a PPP more of the payments to be made by the service purchaser (i.e. public sector), which include the cost of funding the underlying asset, are later in the contract period than for conventional funding. If one calculates the value of a 3-3.5% differential in present value terms over 30 years, this shows an advantage to the PPP option amounting to 35-37% in present value terms, purely by using such artificially high discount rate. The result was that a number of deals, e.g. West Middlesex Hospital PFI, were undertaken as PPP, when, with a more realistic discount rate, the PSC would have favoured funding them conventionally
- Secondly, if the underlying cash flows from an analysis done in real terms are to be used for budgeting purposes by the contracting authority at a later date, they will underestimate the unitary/availability payments to be made to the PPP company as they exclude the impact of inflation. This may well be the main reason why many UK NHS Health Trusts, who undertook PFI/PPP projects some years ago, now find they are difficult to afford, i.e. the Trusts have under-budgeted. Fortunately, inflation has been relatively low in recent times, so the impact has been more limited. But when inflation is high, under-budgeting arising from the use of a high discount rate could be very significant.

In 2003, the UK Government changed the discount rate from 6% to 3.5% 'real'. Given that inflation was low at around 2-3%, this discount rate thereafter reflected the nominal rate prevailing at the time (5.5-6%).

To counterbalance this change, the UK Government introduced the concept of "optimism bias" to reflect, as they thought, the inherent under-estimation of costs that government departments had demonstrated over past decades. A report on a number of major projects undertaken previously showed various levels of cost over-runs, and so the empirical concept of optimism bias was introduced as a multiple to be applied to the public sector reference project in the PSC to cover this possibility. This adjustment often made the difference between PPP being assessed as value for money or not.

It is commonly the case that Governments over-spend on projects. However, no other government has formalised the over-runs into a specific rule as has the UK through the application of optimism bias. Other governments often prefer to evaluate these possibilities through conventional sensitivity testing on 'base case' cost estimates.

Some also argued that the project sample used to justify the UK optimism bias multiples was insufficiently representative. Furthermore, if it were true that publicly financed projects had typically overrun by 40%, others argued that a strong project manager could be employed to control costs at 10% of the project cost, plus be paid another 10% as a bonus for success, leaving the public sector still better off by 20% than had been the case previously, without the additional complexity and potential inflexibility inherent in long-

term PPP contracts.

The overall net effect of the introduction of optimism bias was to re-create the bias in favour of the PPP option which had arisen through the use of an artificially high discount rate before 2003.

Of course, a pure financial comparator does not give a complete picture. In addition, other factors such as higher performance standards, innovation in design, construction and delivery, transfer of technology, safety, etc., - all somewhat subjective issues - have to be taken into account before arriving at a final figure for value for money.

Other issues to be taken into account include:

- Urgency for investment in public service assets. PPP generally take much longer to prepare, bid and negotiate than conventionally-funded projects
- High upfront costs of PPP due to the complexity of PPP and the time and expense of bidding for such deals. This means that investors and lenders will normally only entertain opportunities which exceed a particular threshold in value, e.g. around €30 million. Furthermore, only large contractors and operators normally have the resources to support such deals. This can have implications for the level of competition between bidders for such contracts.

So PPP are not a panacea. Neither should they be used as a credit card for governments and they are certainly a source of "free finance". As for all investments, prudence is required and special note taken as to the potential long term and contingent liabilities that PPP can create.

Martin Blaiklock (Consultant, Infrastructure & Energy Project Finance -
tmblaiklock@aol.com)