Value for money?

Most practitioners agree that value for money should be the driving factor in any decision to use a PPP. However experience shows that this is rarely the case. There is no standard definition of value for money, and the methods for assessing it are subjective and open to manipulation. As the Chair of the UK Commons Public Accounts Committee stated in May 2012:

“When a public authority chooses to fund a project using private finance it must be able to demonstrate that this was the best way to deliver real value for money for the taxpayer, not just a way to keep the project off the balance sheet. For too long, public sector authorities have treated 30-year PFI contracts as the only game in town. This has to end.”

Even before the crisis, the idea that the private sector can build and operate infrastructure more cheaply than the public sector was somewhat counterintuitive, due to private companies' higher cost of borrowing and profit motive. Since the crisis, however the price of financing has risen, and the idea the PPPs can offer better value for money than public procurement is on thinner ice than ever.

**PPPs involve equity (shares) plus bank loans to provide funds for the Special Purpose Vehicle (project company), which is much more expensive than public sector borrowing.** Long before the financial crisis this was already an issue, however since the crisis the situation has been much worse. In the UK, the Commons Treasury Select Committee found that in 2011 the Weighted Average Cost of Capital for a conventional availability–based (and therefore low–risk) PFI project in the accommodation sector was in excess of 8.5 percent. This compared to the then long term government gilt rate of just over 4 percent. The Committee concluded that:

“Government has always been able to obtain cheaper funding than private providers of project finance, but the difference between direct government funding and the cost of this finance has increased significantly since the financial crisis. The substantial increase in private finance costs means that the PFI financing method is now extremely inefficient.”

In addition, unlike public authorities, private companies expect to make a significant profit on their investment. For example, UK construction company Carillion said in 2012 that it had incurred losses on certain projects but is making a return from PFI projects in excess of 15 percent. A UK National Audit Office report found that the expected return to investors agreed when PFI contracts are signed typically ranges between 12 and 15 per cent.

The Commons Public Accounts Committee has concluded that “the available evidence strongly

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suggests that, in the main, the returns which equity investors receive from PFI projects are too high for the risks they bear." According to Mark Hellowell of the University of Edinburgh, the annual PFI charges paid by the public sector could be 3 to 5 percent higher than is necessary because of the inefficiencies in the way that equity is priced in the deals.

Finally, the preparation of PPPs is long and costly. For the Edinburgh Infirmary hospital PPP in Scotland, for example, the bidding costs alone were GBP 7.4 million or 3.8 percent of the total investment cost. The UK National Audit Office estimates that on average the bidding costs account for 2.5–3 percent of the total project costs.

We have not been able to obtain comparable figures for other countries, but there is no reason to suggest why they should be very different.

These increased costs are supposed to be offset by the efficiency gains from using the private sector, however, it is doubtful whether these efficiency gains are really large enough to offset the higher costs, and even if so, whether they are in line with the objective of providing public services. (See the chapter ’Public services: Cutting costs or cutting corners?’

Since it is not possible to make a general claim that PPPs offer better value for money than public procurement, an important tool in assessing whether a PPP could be cost-effective is a Public Sector Comparator (PSC) calculation, which attempts to compare the costs of a PPP with that of the same project carried out through public procurement. However experience shows that often no such calculation is made.

In EIB–funded projects, the bank relies on the project promoter to carry out a PSC and does not usually check whether it has been done, or whether it has been done well:

"Only the projects in two countries had been the object of a formalised PSC process, although a third had used an ad hoc system. The Bank did not normally review the PSC, although the assumed cost and benefit figures were often used for the Economic Return (EIRR) calculation".

The Beiras Litoral and Alta Shadow Toll Road in Portugal is just one example of a project where no such calculation was made, and according to 2008 research on Spanish PPPs, a public sector comparator methodology has not been developed in Spain at all, in spite of the large number of projects taking place there.

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6 Presentation by David Price, Senior Research Fellow, Centre for International Public Health Policy, University of Edinburgh, 16 April 2008.

7 Campbell Thomson, Judith Goodwin: Evaluation of PPP projects financed by the EIB, European Investment Bank, March 2005, p.21

Even where PSC calculations are carried out, such as in the UK, the outcomes cannot be relied on. The UK’s PSC calculation has been widely criticised for rigging calculations in favour of PPP schemes. The National Audit Office’s deputy comptroller and auditor-general Jeremy Coleman has been one such critic, dismissing some calculations as “utter rubbish” and “pseudo-scientific mumbo-jumbo”.

The UK government has tended to prejudice the results of the PSC assessment before it has even begun by making it clear that public funding will not be available. As Jeremy Coleman put it: “If the answer comes out wrong you don’t get your project. So the answer doesn’t come out wrong very often.”

An interesting example of how PSC calculations can be manipulated is provided in a 2011 report by the House of Commons Treasury Select Committee. Even with the alleged manipulations it is interesting to note that the UK PSC has not always come out very convincingly in favour of PPPs. In the example analysed by the Treasury Select Committee, PFI had an alleged advantage over conventional procurement of just 0.03 percent – a tiny amount considering the uncertainties involved. For the D1 motorway in Slovakia, the advantage of a PPP was considered to be somewhat larger, at 5 percent, however this calculation also contains several unsubstantiated elements that could easily have tipped the calculation in the other direction.

While the UK PSC has several faults, and the methodology needs to be clear and publicly available to enable scrutiny and improvements, if PPPs are to be implemented, such a calculation does need to be carried out. However the PSC calculation must be done in good faith, not just to justify a pre-decided course of action.

In many PPPs outside of the UK, there is no evidence of value for money assessments having been done at all, and, where it does take place, the methodology is not publicly available. This is sometimes justified by the claim that there is no way of using public funds anyway, so it is PPP or nothing. However this claim should be treated with caution, as there is still no convincing evidence to suggest that a PPP is affordable if a publicly procured project is not.

A PSC also only makes sense if the possibilities being compared are actually similar. However, sometimes PPP projects have been developed to be larger than necessary in order to make it more appealing for the private sector to participate. This may happen, for example, in road projects – where building a highway may be preferred to rehabilitating and upgrading an existing road – or in incinerator facilities, where operators, being paid per tonne of waste treated, have a natural incentive to build a large facility rather than a small one. Other examples are the Zagreb Wastewater Treatment Plant in Croatia and the Walsgrave hospital in Coventry, UK.

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9 Nicholas Timmins: “Warning of 'spurious' figures on value of PFI”, Financial Times, 05.06.2002
10 ibid.