



INTERNATIONAL CONFERENCE ON MULTI-NATIONAL CONSTRUCTION PROJECTS
“Securing high Performance through Cultural awareness and Dispute Avoidance”
SHANGHAI, CHINA
November 21-23, 2008

THE USE OF PUBLIC SECTOR COMPARATORS IN MULTINATIONAL PUBLIC PRIVATE PARTNERSHIPS

Denny McGeorge¹, Sidney Newton², Dennis Lenard³ and Marcus Jefferies⁴

1. The University of New South Wales, Australia (d.mcgeorge@unsw.edu.au)
2. The University of New South Wales, Australia (s.newton@unsw.edu.au)
3. The University of New South Wales, Australia (d.lenard@unsw.edu.au)
4. The University of Newcastle, Australia (Marcus.Jefferies@newcastle.edu.au)

ABSTRACT

The Public Sector Comparator (PSC) is a costing methodology used by government agencies to compare a proposed public private partnership project with a conventionally financed project providing the same performance deliverables. It is used in various configurations by a number of countries, including the United Kingdom and Australia. There is now widespread debate on the reliability, accuracy and relevance of a PSC approach. In particular, concern is growing over the reduced emphasis a PSC approach brings to the quality of the end product and the requirements of the end users. These concerns are magnified when considered in the context of multinational involvement in public private partnerships.

This paper discusses a range of emerging issues associated with a PSC approach, giving particular reference to the implications for multinational organisations. Two basic arguments are developed:

- (i) that the PSC methodology is really only about the bidding process, when public private partnership projects require a far longer term consideration. Certainly future cash flows are discounted, but with an over-emphasis given to the final discounted figure rather than the entire cash flow profile. The focus on a final figure makes the choice of discount rate central, and alternative discount rates can pre-preference certain multinational bids over others.
- (ii) that the PSC methodology is really only about costs, when value is the more appropriate consideration. A focus on costs is most likely to preference local bidders with established cost bases. Multinational bids tend to leverage on broader quality considerations, which suggests that the PSC methodology should be extended to include calculations to assess the total (environmental, social and financial) project value.

Keywords: Public Sector Comparator; Value for Money; Public Private Partnerships.

PPP TERMINOLOGY AND DEFINITIONS

Many papers on Public Private Partnerships (PPPs) begin with the comment that PPPs are notoriously difficult to define. Definitions tend to depend on a commentator's own particular perspective and range from the very general to the quite particular. Additionally the

terminology used by various government agencies can be confusing and seemingly contradictory.

For example Evans and Bowman (2005) cite a definition of PPP by Stern and Harding (2002) as 'a loose term applied to any venture which embraces both public and private sectors'. On the other hand they cite a much narrower definition of PPPs from Webb and Pulle (2002) as partnerships between the public and private sectors for the financing, design, construction, operation and maintenance, and /or the provision of assets or infrastructure and associated services that have traditionally been provided by the public sector.

Hodge and Greve (2005) also subscribe to the view that few people can agree on a definition for PPP. They note that PPPs have been defined in a number of ways, namely:

- As a new governance tool that will replace the traditional method of contracting out of public services through competitive tendering
- A new language in public sector management, designed to cover older established procedures involving private organizations in the delivery of public services
- A new way to handle infrastructure projects such as building tunnels and renewing harbours
- 'PPPs' and 'contracting' used interchangeably to describe contracting between governments and the private sector.

In the UK, Treasury addressed this issue in its report 'Public Private Partnerships: The Government's Approach' (2000), under the heading of 'What Are Public Private Partnerships (PPPs)?' To quote:

"Public Private Partnerships bring public and private sectors together in long term partnership for mutual benefit. The PPP label covers a wide range of different types of partnership, including:

- the introduction of private sector ownership into state-owned businesses, using the full range of possible structures (whether by flotation or the introduction of a strategic partner), with sales of either a majority or a minority stake;
- the Private Finance Initiative (PFI) and other arrangements where the public sector contracts to purchase quality services on a long-term basis so as to take advantage of private sector management skills incentivised by having private finance at risk. This includes concessions and franchises, where a private sector partner takes on the responsibility for providing a public service, including maintaining, enhancing or constructing the necessary infrastructure; and
- selling Government services into wider markets and other partnership arrangements where private sector expertise and finance are used to exploit the commercial potential of Government assets."

This consideration of PPP terminology is intended to underline the need for care in the use of the term to ensure that the contextual meaning is understood clearly. For the purposes of this paper we have adopted one of the very general definitions given by Hodge and Greve (2005) viz. that "PPPs are a new governance tool that replace the traditional method of contracting out of public services through competitive tendering".

PUBLIC SECTOR COMPARATORS: CONTEXT AND DEFINITIONS

As Hodge and Greve (2005) discuss in their introduction to 'The Challenge of Public-Private Partnerships, Learning from International Experience', very large commitments are being made by governments with the private sector under the aegis PPPs. In Australia, for example, this will have amounted to \$Aus20 billion (approx. \$US14 billion) from the period of 2003 to 2008. In the UK, by October 2005, 700 PFI transactions had been signed by central and local governments with a total capital value of approximately £50 billion (approx. \$US80 billion) (Partnerships UK 2006). As may be expected, this scale of 'contracting out' has added

considerable fuel to the emotive 'public versus private debate'. Sheil (2003) is of the view that PPPs represent not simply privatization by stealth but "privatization plus stealth". Quiggin (2004) presents a similar, if less forceful case in stating that: "In most cases the PPP approach involves an inappropriate allocation of risk between the public and private sectors, an excessive cost of capital, and an inappropriate bundling of risk through the use of a single private partner (or consortium) rather than separate contracting for separate project stages." Crouch, in an article expressing his views on the UK situation entitled 'PPP's are rotting to the core', presents the argument that "...corporations that are winning the contracts do not themselves have the experience of providing the services. Their core business is winning public contracts across a range of sectors" (2003). This is a recurring theme amongst critics of the PPP approach, namely that the major private sector players' expertise lies primarily in the organization and winning of tender bids rather than actually undertaking the work, specifically where the work extends into facility management.

Ideologically, the fundamental argument is whether the private sector is inherently more efficient than the public sector in the provision of goods and services. The Public Sector Comparator (PSC) is therefore central to this issue given that its primary purpose is to determine whether or not the private sector actually can perform more effectively than the public in a particular circumstance, based on a hypothetical comparison. Leigland (2006) writing on the adoption of PPPs in developing countries such as South Africa makes the following interesting comment that "The PSC method is meant to meet the need to make a compelling argument in favor [sic] of using private participation rather than traditional public works approaches". The phrase 'need to make a compelling argument' would certainly be interpreted by opponents of PPPs as typifying the use of PSCs to achieve a particular/desired outcome, rather than used to provide an objective comparison. In fairness to Leigland, other parts of his paper do examine the drawbacks of PPPs and PSCs, but the phrase "need to make a compelling argument" does bring the objectivity of PSCs into question. This question on the objectivity of PSCs is the central issue of this paper.

The PSC does not suffer from quite the same definitional problems as PPPs however that is not to say that defining PSCs is a straight forward task. For example, the definition of a PSC as given by HM Treasury (2006) is that "The PSC provides a quantitative analysis to support a qualitative judgment of the best procurement option, taking into account the risks of each procurement approach as a means of informing a wider value for money assessment." In other words, as defined by Treasury, the PSC is to be used to identify a preferred procurement option: it is intended to inform a choice of procurement route, not an assessment of competing bids. Treasury elaborated on this point in 2006 (HM Treasury 2006) by stating that "At the procurement stage the value for money appraisal should focus on the effects of market conditions and competition issues on the bids received, and will not be an evaluation of PFI as a procurement route, *which will have already been tested using the reformed PSC*" (our emphasis). Treasury in its 2003 report acknowledged that "a number of procuring authorities had treated the PSC as a pass/fail test to justify the choice of a procurement route, and potentially striven for spurious accuracy".

Treasury's emphasis on the use of PSCs to determine a procurement route as opposed to being used as a pass/fail mechanism to select a winning consortium is interesting. Internationally, (perhaps with the exception of the UK) there would seem to be a tacit assumption that the primary purpose of PSCs is in fact to inform decision takers as to the financial merits of competing bids. For example, the definition given by Leiglan (2006) is typical of the generally accepted view that the "PSC is a risk-adjusted financial model of a hypothetical public sector project. It estimates the total costs to the government of achieving the targeted outputs, assuming that the project is handled in the normal way, with reasonably foreseeable efficiency improvements."

PRIVATE SECTOR PERCEPTIONS OF PSC's

In a recent study of major private sector players in PPP consortiums in Australia, McGeorge et al (2007) found that attitudes towards the current application of PSCs in Australia ranged

from being critical of the accuracy of PSCs, to the use of the PSC merely to justify risk transfer, to support for the improved accountability. Typically, however, the view was that PSC criteria were either so poorly defined or not even disclosed that they could be (and are) used simply to manipulate results and cast a more favourable light on the public sector client in value for money terms. Used in this way, the PSC can unduly influence the size and scope of projects and even whether or not a project proceeds. It is also the case that bidders resent the lack of transparency, and the distorting effect that “hidden” performance criteria can exert. For example, in those jurisdictions where the mechanics of the PSC is not disclosed to bidders, concern was expressed that bidders are effectively bidding “blind”.

Whilst such perceptions specifically relate to the views of the private sector in Australia, they are also indicative of the current debate being conducted internationally regarding the usefulness and accuracy of the PSC. Bult-Spiering and Dewulf (2006) in their monograph ‘Strategic issues in public-private partnerships: an international perspective’ express a view that the PSC can be used incorrectly as a pass/fail test despite the fact that there are “many uncertainties involved in the calculation and the fact that the numbers could have been manipulated to obtain the desired results.”

PUBLIC SECTOR POLICIES ON PSC’s

From the foregoing discussions it can be seen that there is some evidence based on an empirical study, albeit largely restricted to Australia, that the private sector has a number of qualms *vis a vis* the effectiveness and fairness of PSCs and in the policies used by the public sector in the implementation of PSCs. In Australia some of this disquiet can be sheeted back to the wider issue of the genuineness of the ‘partnership’ in PPPs. This line of argument is advanced by Curnow et al (2005), who argue that in the context of social PPPs there is a strong body of opinion to support the contention that these are not true partnerships and there is a clear need to reduce the ‘tokenism’ of Australian PPPs. They argue that the public sector needs to make PPPs more attractive to the private sector and clarify the identification of risk if they wish to transfer more responsibility for that risk to the private sector.

In the UK, which is generally acknowledged to having initiated the PPP movement, issues associated with the appropriateness of PSCs have been taken on board by Treasury which has attempted to address many of the criticisms made by the private sector there on PSCs. In its report ‘PFI: meeting the investment challenge’ (2003), Treasury committed to “reform the Public Sector Comparator (PSC) to ensure an economically rigorous appraisal of a project’s outline business case prior to its procurement, to allow an alternative route to be chosen at this stage if it offers better value for money.” Whether or not these objectives have been fully achieved is perhaps a moot point, however, Treasury’s analysis of the effectiveness of PSCs in a UK context would seem to be a good starting point in summarising its pros and cons.

As a first base, at least in principle, the PSC provides a key tool for evaluating the value for money of PPP projects. The PSC provides a quantitative analysis to support a qualitative judgment of the best procurement option, taking into account the risks of each procurement approach as a means of informing a wider value for money assessment. However, the PSC is focused only on a narrow band of criteria on which future project options can be considered. It’s also the case that the PSC exercise is often done at a stage where it is not possible to take sufficient account of the wider factors associated with PPP programs, such as the generally increased pre-contract costs.

Further, there are a number of issues relating to the effectiveness of the PSC as an appraisal tool, particularly where it is used as the single pass/fail test to justify the choice of a PPP procurement route. Both the National Audit Office and Treasury emphasise the dangers of putting a disproportionate reliance on a single figure comparison. They now argue that the PSC should continue to have an important role, but as the second stage in a three stage process with emphasis being placed on the need to achieve value. The suggestion is that the existing PSC should be reformed into a comprehensive project appraisal carried out at the outline business case stage, i.e. prior to procurement and the role of the private sector, with

the quantitative aspect remaining part of a broader qualitative approach to the assessment. At this stage the procurement team should be in a position to look in greater detail at the specific characteristics of the project. It should be able to make an informed judgment as to whether the original choice of PPP or conventional procurement, made on the basis of the investment programme assessment, is confirmed. Should the specific characteristics of the project suggest that value for money would best be achieved through alternative procurement options, there should be sufficient flexibility within internal budgets for investment to ensure that the best value for money options are taken forward. At this point appraisers should also be preparing for the third stage, considering the project in the light of the potential strength of market interest.

It remains however a reasonable assumption to make that from a global perspective, with the exception of the UK (and this of course is a very large exception), the PSC is still seen as being primarily about the bidding process and the selection of the preferred bidder by making a hypothetical comparison with a notional public sector project. Discussing the adoption of the PSC approach in developing countries (specifically Africa) Leigland (2006), in an interesting critique on the current UK situation, makes the point that the earlier U.K. Treasury approach (i.e. the pre 2003 situation) may be more appropriate for developing countries, with the shortcomings of the PSC offset by simple but specific procedural rules for using conventional costing methods and informed expert judgment and for countering optimism bias. Certainly the situation in Australia is similar to the pre 2003 era in the UK and is likely to remain so until a PSC disclosure policy is adopted by all states.

DISCUSSION SPECIFIC TO MULTINATIONAL PPPs

This paper has touched on some of the ideological issues associated with PPPs and how these relate to an implicit assumption that the private sector is inevitably more efficient than the public sector. PPP projects, by their nature, tend to be high profile with a considerable element of political risk. The users of the project and long-term stakeholders are by-and-large the general public. Thus PPPs are often the subject of intense interest and emotive debate. By way of example Walker and Walker (2000) express the view that “PPP’s are misleading accounting trickery of the worst entrepreneurial kind”. Or Linder (1999) described PPPs as a ‘grammar of multiple meanings’ in which “The language of PPPs... is a game designed to ‘cloud’ other strategies and purposes.”

Notwithstanding the trenchant nature of the above comments, there is no doubt that PPPs are part of the contemporary procurement landscape and are here to stay. However, it is worthwhile acknowledging the depth of feeling which exists between the protagonists and antagonists of PPPs if progress is to be made on how to move from simply evaluating the cost of a project to assessing its long-term value.

In the particular context of multinational PPPs there are several key aspects of the PSC approach that impacts on bidders:

- *Local Cost Data.* Even in general, local knowledge of costs is important. But this is all the more so when the costs are projected over a 25-30 year life-span, as is the case in many PPP projects where an element of facility management is often included. The situation almost requires multinational bids to include a local partner to inform the facility management aspects. Of course, it is the choice of discount rate that is particularly critical in this regard. There is at least the perception that discount rates used in the PSC approach tend to be higher, in order to favour the higher initial cost weighting of a PPP project over a fully-public project. The public sector is generally considered better able to finance ongoing costs over initial costs. It might be argued that the larger multinational bidder is also better placed to mediate costs over the longer term, and would be similarly disadvantaged by the use of a higher discount rate in any PSC comparator calculation.
- *Dealing with Difference.* There are well-documented problems with the standardisation of how PSCs calculate and compare alternative project proposals. With large projects there are always going to be differences in how different organisations respond to the design

- brief, certainly between private and public sector solutions. The lack of a common methodological framework for such a comparison affects every party, but particularly multinational bids, where the project proposal is more likely to be novel in the local market context. This also references the issue of subjectivity, which is often raised as a concern with the PSC approach. Several cases of “manipulation” have been found (U.K. House of Commons, Committee of Public Accounts, 2003), generally in terms of favouring the PPP *per se*, but it does open the way to manipulations motivated by broader political interests that might again disadvantage the multinational bidder who lacks local political influence.
- *Value for Money*. Most commentators now support the use of a PSC alongside a range of other assessment tools, including the more qualitative aspects of track record, public interest, etc. It does appear that the PSC approach is subjective in itself, and having a range of subjective measures provides some sense of balance to the consideration of alternative bids. However, any suggestion that the PSC might distinguish projects in terms of affordability and/or value for money is now being challenged. For the value drivers to be effective what is needed are genuine partnerships between the public and private sector (Curnow et al, 2005). There is thus a growing call for the PSC to be used as a starting point only, and as a vehicle for exploring and agreeing project scope with bidders at the pre-bid stage. This would also extend to the optimum allocation and transfer of risks between the various parties. With multinational bidders, these allocations and possibilities may be very different to local bids. In the context of value for money, therefore, the revised use of a PSC might improve the opportunity and capacity of a multinational bidder to offer the most effective project solution.
 - *Staged Penetration*. The argument being advanced in this paper is that multinational organisations who wish to expand into market sectors (other than perhaps the UK) may find that firstly they will have to win market share on the basis of competing on a conventional PSC (bearing in mind that in some instances this PSC may not be disclosed) and then progress to the broader (and more progressive) criteria of quality of delivery and value.

The key aspects of a PSC approach to multinational PPPs are clearly not unique to that context, but apply more broadly to PPP projects in general. However, certain aspects are more particular and of more significance in the multinational context. A consensus appears to be emerging around the policy solutions required, especially in terms of the PSC. Effective implementation of these policies, as experience has shown, is exceedingly difficult when public, local and multinational concerns so often contradict each other.

REFERENCES

Bult-Spiering, M. and Dewulf, G. (2006) *Strategic issues in public-private partnerships: an international perspective*. Oxford: Blackwell Pub.

Crouch, C. (2003) PPPs in perspective - The core of the problem. www.publicfinance.co.uk, *The Internet Magazine of the Public Sector*, 3(229).

Curnow, W., Jefferies, M. C. and Chen, S.E. (2005). Unsustainable Bidding Costs - A Critical Issue for Public Private Partnerships. *Public Private Partnerships - Opportunities & Challenges*, Hong Kong

Evans, J. and Bowman, D. (2005) Getting the contract right, In: G. Hodge and C. Greve (Eds) *The Challenge of Public-Private Partnerships, Learning from International Experience*. Cheltenham, Edward Elgar Publishing Limited, 62-80.

HMTreasury (2000) *Public Private Partnerships: The Government's Approach*, Norwich: HMSO.

HMTreasury (2003) *PFI: meeting the investment challenge*, Norwich: HMSO.

HMTreasury (2006) *Value for Money: Assessment Guidance*, Norwich: HMSO.

Hodge, G. and Greve, C. (2005) Public-private partnerships: a policy for all seasons? In: G. Hodge and C. Greve (Eds) *The Challenge of Public-Private Partnerships, Learning from International Experience*. Cheltenham, Edward Elgar Publishing Limited, 332-349.

Jones, D. (2003) Evaluating what is new in the PPP pipeline. *Building and Construction Law* 19(4), 250-270.

Leigland, J. (2006) *Is the public sector comparator right for developing countries? Appraising public-private projects in infrastructure*. Grid Lines Volume, DOI:

Linder, S.H. (1999) Coming to terms with public-private partnership: a grammar of multiple meanings. *The American Behavioral Scientist* 43(1), 35-51.

McGeorge, D., M. C. Jefferies, et al. (2007) Implications for design and build contractors bidding in public private partnership consortiums: an Australian perspective. *CME 25th Anniversary Conference*, Reading.

Partnerships UK (2006) *Report on operational PFI projects by Partnerships UK*, Partnerships.

Quiggin, J. (2004). Risks, PPPs and the Public Sector Comparator. *Australian Accounting Review*, 14(2), 51-62.

Sheil, C. (2003) Partnerships, Politics and the English Language, *Dissent*, 11(Autumn-Winter), 46-49.

Stern, S. and Harding, D. (2002) Profits and perils of public private partnerships. *Euromoney* (394) 126.

U.K. House of Commons, Committee of Public Accounts (2003) *Delivering Better Value for Money from the Private Finance Initiative*. London.

Walker, B. and Walker, B.C. (2000) Privatisation: Sell Off or Sell Out? *The Australian Experience*. Sydney: ABC Books.

Webb, R. and Pulle. B. (2002) *Public Private Partnerships: An Introduction*. Research Paper (online) <http://www.aph.gov.au/library/pubs/rp/2002-03/03RP01.htm> (accessed Feb 06).

Wynne, A. (2002) *Public-Private Partnerships: are the benefits available?* (online) http://www.accaglobal.com/pubs/publicinterest/activities/library/public_sector/ps_pubs/papers/ps_doc_011.pdf (accessed June 08).