Evaluating the Value for Money Question in Public Private Partnerships in Nigeria

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ABSTRACT
The method used for choosing whether to finance a project through PPPs or via the traditional public sector budgetary process is usually to determine whether the PPP alternative presents better value for money (VFM). If it does, then the general rule is that the PPP option would be chosen, otherwise the government will default to traditional procurement. This makes the VFM process a very important decision making tool for the public sector in delivering infrastructure. However, a pertinent question is whether there is any use whatsoever in carrying out a VFM assessment for the sole purpose of choosing a viable procurement option in the first place. In other words, whether developing economies like Nigeria with little or no money to pursue infrastructure projects have any real alternatives to PPPs even when VFM analyses show that it is more cost effective to do a project through public procurement. Another important question is whether the public sector comparator that is the preferred tool for conducting a VFM analysis is a good device for such assessments in Nigeria, bearing in mind the amount of data and assumptions required to properly conduct such assessments. This paper answers these questions and proposes an alternative assessment tool for PPP projects in Nigeria.

Keywords: PPPs, VFM, Risk, Infrastructure, PSC

INTRODUCTION

I. What are PPPs?
There is no consensus on the meaning of Public-Private Partnerships (PPPs), hence a single definition of the concept does not exist. Therefore, there are variations in the way it has been defined. It is helpful however, that there is a general level of agreement of what the constituent elements of a PPP are and these common threads can be distilled from various definitions of the concept. The multitude of definitions in existence are influenced primarily by the fact that different professions, countries and institutions employ the concept to achieve their own specific needs and therefore their definitions of the concept seek to buttress these individual needs. Nevertheless, it is still a useful exercise to attempt a working definition of the concept before venturing into the main subject matter of this paper. This helps streamline the discussions that follow by pinpointing or ring-fencing the subject matter of discourse.

For the purposes of this work, a PPP may be defined as a long-term relationship between public sector agencies and private sector entities under which the responsibility for any or all of the combination of designing, financing, construction, management and operation of public infrastructure and utilities that were traditionally undertaken by the public sector are contractually shared and jointly undertaken by both the public and private sector, usually in proportion to the kind of risks each party can best carry.1

The point must be made that the characteristics or boundaries, of transactions which constitute PPPs, are not closed. For instance, the European Commission observed that PPP is still evolving and has

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divergent arrangements that may be adapted to suit the requirement of projects and project partners on a pragmatic basis.\textsuperscript{2} However, there are certain baseline characteristics that PPPs possess. The Malaysian PPP Guidelines lists them as:

- The relationship between the public and private sectors is based on a partnership, which means that risk is shared between both partners optimally as it is allocated to the party who is best able to manage it.
- The public sector procures specified outputs and outcomes of a service for the contract period whilst the private sector determines the required inputs to achieve the specified output. The private sector is given the freedom to introduce innovation into their design and development to reduce cost; there is thus an integration of design, construction, finance and maintenance and operation.
- Payment for services is based on predetermined standards and performances.
- PPP promotes a ‘maintenance culture’ where the private sector will be responsible for the long term maintenance of the assets throughout the operational period agreed upon by the parties.
- In some instances, there is an option for the transfer of the infrastructure asset back to the public sector at the end of the contract period.
- PPP involves a Whole Life Cycle Costing (“WLCC”) whereby PPP projects are usually awarded based on lowest total cost over the contract period compared to lowest construction cost under traditional procurement.\textsuperscript{3}

\section*{II. What are the Policy Reasons for PPPs?}

The major determinant factor for the widespread use of the PPP model for the provision of infrastructure across the world appears to be the inadequacy of public funds to meet the increased demand for infrastructure.\textsuperscript{4} There are other benefits inherent in the use of PPPs; for instance, the Netherlands has adopted PPP-type structures primarily to promote an efficient procurement regime and reform its public sector.\textsuperscript{5}

Other reasons for adopting PPPs include claims that PPPs provide better value for money and reduce governmental debt levels; while ensuring better efficiency in providing and running infrastructure services in more politically attractive forms than nationalization or privatization.\textsuperscript{6} While noting that the notion that PPPs have all these advantages over traditional procurement is not universally accepted,\textsuperscript{7} PPPs have continued to play an increased role in the provision of infrastructure across different sectors around the world. It is however the role of PPPs in creating better value for money in projects that forms the basis of this paper.

\section*{III. What is Value for Money?}

In considering whether to finance a project through PPP or traditional public sector procurement, the major consideration for government is usually whether the PPP alternative presents better value for money (VFM). If it does, then the general rule is that the PPP option would be chosen, otherwise the government will default to traditional procurement.

\textsuperscript{2} EC Guidelines for Successful Public Private Partnerships 2003 , (online) at: http://ec.europa.eu/regional_policy/sources/docgener/guides/ppp_en.pdf (last accessed on September 17, 2010)

\textsuperscript{3} Malaysian Public Private Guidelines (2009) PPP Unit, Prime Ministers Department Putrajaya (online) at: http://www.ucas.gov.my/html/themes/miu/content/ppp_bi_131109.pdf (last accessed on February 29, 2012)

\textsuperscript{4} Indeed, the first PPPs projects were done basically to bring private investments for public services. See D. Grimsey and M.K. Lewis, Public Private Partnerships: The worldwide Revolution’ in Infrastructure Provision and Project Finance, Edward Elgar Publishing (2004); Cheung, E. et al ‘Reasons for Implementing Public Private Partnership Projects: Perspectives from Hong Kong, Australian and British Practitioners,’ 27 (1) Journal of Property Investment and Finance (2009), 81-95

\textsuperscript{5} S. Harris, ‘Public Private Partnerships: Delivering Better Infrastructure Services,’ (Working Paper) Inter-American Development Bank, Washington DC pg.3

\textsuperscript{6} For instance, Savas is of the opinion that ‘privatisation’ and ‘contracting out’ are expressions, which generate opposition quickly. See E.S. Savas, Privatization and Public- Private Partnerships, New York: Chatham House (2000) 2

\textsuperscript{7} These claims have been vigorously challenged. See for instance D. Hall, Public-Private Partnerships (PPPs) Summary Paper, A Report Commissioned by the European Federation of Public Service Unions (EPSU) (2008) 6. Can also be found (online) at http://www.epsu.org/IMG/pdf/PPPs-summary-011008.pdf (last accessed February 21, 2012)
Therefore, in the first instance, a VFM analysis determines whether to use a PPP to deliver public infrastructure or not. Secondly and related to the first, is the ex-ante analysis of whether after the project has been developed and operated for a considerable period, it has delivered VFM. This is used to measure the success of the project.

It is difficult to find a universal concurrence on what VFM is, because of its political underpinnings. The definition of the concept depends on the motives and interests of the government. This may change over time due to different factors including political, economic and social developments within the country. In general parlance, the term “VFM” may either be used as an absolute or relative term. As an absolute term, it can be taken to mean that the benefits of purchase to the purchaser exceed the costs. As a relative term, it means that one of the options for meeting the purchaser’s needs provides greater benefits relative to cost than the other. The latter meaning best captures the concept in relation to PPPs.

According to the UK HM Treasury Value for Money Guide, VFM is “the optimum combination of whole-of-life costs and quality (or fitness for purpose) of the goods or service to meet the users’ requirements. VFM is not the choice of goods and services based on the lowest cost of the bid”. In essence, the UK HM Treasury’s definition underlines that in determining the value of pursuing a project as a PPP, the public sector must account for the cost savings to be made from the project over the lifetime of the project. In addition, it stresses that VFM assessment should ensure that the public agencies focus on the competency of the private sector and not only on securing the lowest bids. Therefore, it supposes that VFM is an a priori test to be conducted by the public sector before determining whether not proceed with a PPP or otherwise. If this VFM test fails, the project should be procured through the conventional public sector budgetary process.

A number of conditions ought to be met to ensure the achievement of VFM in PPP projects. Firstly, it is recommended that projects should be procured and awarded in a competitive environment. Secondly, economic appraisal techniques including proper appreciation of risk should be vigorously applied, and risk allocated between the public and private sectors so that the expected value for money is maximised. Finally, the comparisons between publicly and privately financed options should be fair, realistic and comprehensive. The situation is different under traditional public procurement where the decisions on options to follow in procuring a particular project is based on a cost-benefit analysis that does not consider alternative ways of procuring the project but assumes a particular commercial approach, which is often procurement by the public sector. Once the procurement approach is decided, the public sector sets in motion a competition between bidders where price and non-price factors are assessed to ensure that VFM is achieved. The difference is that in PPPs, the test for VFM is two-pronged: first there is competition between bidders like under traditional procurement. Secondly, the choice of a particular arrangement is also tested to ensure that it is capable of delivering VFM to the government.

Usually, proper risk allocation in a project contributes to the attainment of VFM. For instance, Cheung et al carried out a comparative study of Hong Kong, Australia and the United Kingdom and discovered that proper risk allocation was the greatest VFM enabler in all three jurisdictions.

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11 ibid
authors discovered that when risks are handled well, fewer pitfalls are experienced and this leads to the achievement of VFM. In a similar vein, Bing Li et al whilst conducting research on the factors that enhanced VFM in PPP projects found that the top three factors are efficient risk allocation, output based specification and the long-term nature of contracts. This conclusion was similar to the result reached by Arthur Anderson.

A. The Public Sector Comparator

VFM itself is a broad term that captures both the financial and non-financial elements of evaluations. To ensure that the analysis of the two alternatives available to the government is comparable, there will be a need for proper accounting for quality of services, price, timeframe, risk apportionment and certainty. VFM is often computed in most jurisdictions by using a benchmark called the Public Sector Comparator (“PSC”). In simple terms, the PSC determines how the public sector chooses when to use a PPP or otherwise. The PSC describes the options and assesses what it would cost the public sector to provide the outputs it is requiring from the private sector on its own. Thus the private sector bids are assessed against the PSC to determine which option between the two will guarantee better VFM.

In most countries, the method of calculating VFM using the PSC is that the Net Present Value (NPV) of the risk-adjusted PSC is compared to the NPV of the proposed future service fees or benefits paid to the private sector bidder over the life of the PPP. It is based on estimates of full costs, revenues and risks set out in cash flow terms, discounted at a public sector rate to the NPV, which is compared with the discounted value of payments under the PSC along with the adjustment for risks and costs retained. Once the NPVs of both PSC and that of the SPV have been prepared and adjusted to an equivalent footing, then a simple comparison of both will be undertaken. Note that there are different approaches to this in certain jurisdictions. However, most of them are mere variants of the methodology discussed above.

The use of the PSC has inherent challenges mainly as a result of the difficulties involved in obtaining data to make the comparison. This is the reason why the Nigerian PPP Policy accepts that the government cannot rely on the PSC in calculating VFM at this early stage of its PPP development. However, the Policy also concedes that it may do so over time when the country collates enough evidence of outturn costs to be able to rely on PSC effectively.

It is noted that it is not wise to jettison the PSC merely because of paucity of data. According to Grimsey and Lewis, the PSC performs other roles apart from calculating VFM:

a) It promotes full costing at an early stage in project development.
b) It provides a key management tool during the procurement process by focusing attention on the output specification, risk allocation and comprehensive costing.
c) It provides a means of testing value for money.
d) It provides a consistent benchmark and evaluation tool.
e) It encourages competition by generating confidence in the market that financial rigor and probity principles are applied.

15 ibid.
16 Li, B. et al, ‘VFM and Risk Allocation Models in Construction PPP Projects’, Preliminary result of on-going PhD research, School of Built and Natural Environment, Glasgow Caledonia University. (online) at: http://www.reading.ac.uk/AcaDepts/kc/ARCOM/eorkshop/04-Edinburgh/06-Li.pdf (last accessed August 12, 2012)
18 Takim, R. et al., Supra Note 85
21 ibid
22 Ismail, K. The Malaysian Private Finance Initiative and Value for Money Supra Note 83
23 Supra Note 85
24 Nigerian PPP Policy Supra Note 57
VFM can be measured against a number of proxies, including the business case, the PSC and by benchmarking costs.\textsuperscript{26} VFM is usually associated with three “Es” i.e. Economy, Efficiency and Effectiveness.\textsuperscript{27} Therefore in seeking VFM, three initial strategies should be deployed: effective evaluation mechanism; viability of PPP contractor and commitment to VFM.\textsuperscript{28} The baseline cost of the PSC is usually based on historical cost for services adjusted based on project future demand, demographical changes and political considerations.\textsuperscript{29} Long term forecasting requires assumptions to be made about the future, which limits the accuracy of any PSC valuation. The National Policy on PPP in Nigeria also considers VFM proposition as the most appropriate way of maximizing the overall benefit of a project.\textsuperscript{30} The Policy concedes that there is no simple rule that can be used to satisfy a VFM test because of the difficulty in measuring quality and cost of the service as well as the unavailability of relevant data. It however states that the assessment of VFM should consider the whole life cost of the service requirement not just the initial cost and associated risks, which may have financial impact.\textsuperscript{31}

B. The Issues with VFM

There are other criticisms about whether VFM is achievable in PPP projects. This is usually centered on high transaction costs; for example, regarding legal fees and the length of time it takes to negotiate and conclude a PPP transaction.\textsuperscript{32} It is argued that this may not encourage the attainment of VFM in PPPs.\textsuperscript{33} It has also been contended that PPPs increase public sector risk rather than reduce it, increase service costs for the public and shut out the entry of small companies thereby reducing competition.\textsuperscript{34} According to Parker and Harley, the early history of PFI in the UK was troubled by private sector complaints of over-protracted and wasteful project bidding and aborted projects.\textsuperscript{35} The National Audit Office of the United Kingdom estimated that the average cost of taking part in a PFI bidding process was between £0.5m and £2.5m.\textsuperscript{36} Partnership UK tried to mitigate this through the introduction of model contracts and other similar measures.\textsuperscript{37} It is generally agreed that if VFM is to be attained in PPPs, they have to genuinely result in lower costs over the project’s life cycle for a given quantity and quality of service.\textsuperscript{38}

Also, another point which is readily made is that the concept of VFM is predicated on the assumption that both parties negotiating the PPP contract are acting in good faith and in the protection of their own interests. In the case of the public sector, it is to pursue optimal risk allocation and ensure that only the most economically and efficient project is pursued through the PPP. Parker and Harley,  

\textsuperscript{26} National Audit Office, Managing Resources to Deliver Better Public Services, HC 61-1, Session 2003-04, London.
\textsuperscript{28} Takim, R. et al. ‘The Malaysian Private Finance Initiative and Value for Money’ (2009) 5(3) Asian Social Science P. 103
\textsuperscript{29} The Nigerian National Policy on PPP recognises that there are probably no robust database of outturn costs for similar projects procured and so concludes that public authorities in Nigeria will not be able to reliably estimate ex ante costs for estimating VFM in PPP projects.
\textsuperscript{30} National Policy on Public-Private Partnership (PPP), a document of the Infrastructure Concession Regulatory Commission
\textsuperscript{31} ibid
\textsuperscript{32} Grimsey D. and Lewis M.K (2005) Supra
\textsuperscript{33} ibid; Ahadzi, M. and Bowles, G. ‘Public- private Partnerships and Contract Negotiations: An Empirical Study Construction Management and Economics’ (November 2004) 22, 967-978; Ng, A. and Loosemore, M. Supra Note 78
\textsuperscript{34} Moore, W.B. and Muller, T. ‘Impacts of Development and infrastructure Financing’ (1989) 115(2) Journal of Urban Planning Development ASCE. pp. 95-108
\textsuperscript{36} The National Audit Office, 1997. The PFI Contracts For Bridgend and Fazakerley Prisons, HC 253, Sessions 1997-98 London; Cited in Parker, D. and Harley, K. ibid
\textsuperscript{37} Parker, D. and Harley, K. Supra Note 126 above.
\textsuperscript{38} ibid
basing their argument on ‘public choice’ theory in economics, are of the opinion that the public sector will most likely act in their own self interests. Consequently, they might not be ready to pursue efficiency in PPPs when they are unable to share in the cost savings of the government. The public sector may therefore only pursue projects that do not adversely affect their position, status or income. In which case, the public sector may employ several measures including very low PSC figures to deter the private sector from pursuing the project.

It is also difficult to obtain evidence of the capital cost of comparable, conventionally financed projects in order to aid proper PSC computation because construction costs are well known to vary widely depending on time, place, circumstance and specifications and even from tender to tender in the same time, place, circumstance and based on the same specifications. There is however considerable literature on the merits of VFM in PPPs. For example, Grimsey and Lewis, who have variously defended the position that PPPs actually deliver value for money, argue that PPPs appeal to people in charge of allocating public sector resources because they offer one way of resolving the large cost overruns and delays in traditional public procurement methods for infrastructure. This is due to the limited reliance on the usually cumbersome public sector budgetary process, the greater incentive to deliver projects quicker by a more commercially oriented private sector and the optimal transfer of risks, which incentivises the private sector to manage projects better. The major factor that ensures cost savings and therefore better VFM in PPPs is the private sector’s innovation and efficiency. Due to the fact that the private sector is responsible for the whole process including design and the actual provision of services, this synergy helps for achieving the lowest possible total life cycle costs while maximizing profits. Also, a transparent and efficient procurement process is essential for lowering transaction costs as it shortens the time spent in negotiations. According to Arthur Anderson, the six main factors that ensure VFM in PPPs are risk transfer, long term nature of contracts, the use of output specifications, competition, performance measurement and incentives and private sector management of skill. The most important factors are said to be competition and risk. In fact risk transfer was said to account for 60% of the total cost saving for PFI projects in the UK.

C. The Operation of PSC-VFM in Selected Countries

Below is a snapshot of how the PSC-VFM is utilised in a number of countries.

1. United Kingdom and Australia

In both the United Kingdom and Australia, a PSC – VFM after bids test is required prior to the final approval of the project. This procedure basically compares the financial differences between two procurement options (traditional procurement and PPP) for the same project. This is done by preparing a hypothetical set of costs for the public procurement of the project delivering the same output, including an evaluation of the project risk borne by the private sector. This hypothetical costing is compared with actual cash flows to be paid by the private sector provider, plus the value of any residual cost and risk transferred and therefore retained by the public sector. The PSC procedure is therefore based on “estimates of full costs, revenues and risks set out in cash flow terms, discounted at a public sector rate to an NPV. It is compared with the discounted value of payments under the PSC along with the adjustment of risks and costs retained.”

This UK and Australian model has been adopted in many countries including Hong Kong, Japan and Canada with slight variations. For example, the main difference between the UK model and the Australian Model is that the latter has an additional assessment tool called the

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39 ibid
40 ibid
41 Nisar, T. M. Supra Note 116 Pg. 1-19
43 Andersen, Supra Note 82; see also Grimsey, D. and Lewis, M.K Supra Note 132 pp. 35-378.
44 Ibid
46 Ibid
Public Interest Test (PIT). This is to ensure that a broader assessment of the public interest is taken into account before a project can be offered as a private finance project. The PIT requires the completion of a checklist, which includes project effectiveness, impact on stakeholders, public access and equality, consumer rights, security, privacy and other associated non-economic costs and benefits.47

2. Malaysia
In Malaysia, the evaluation of a tender for VFM is done by evaluating the costs and benefits of the project. The bidding proposal is compared against the PSC of each project. The capital expenditure and the maintenance cost of the project must be less than the PSC benchmark before a project can be awarded to the private sector partner.48

3. United States
In the United States, most of the contracts for the provision of private prisons require that private firms offer services at 5-10 percent below what it would have cost the state to provide a similar service.49

4. Japan and Netherlands
In both Japan and the Netherlands, an early indication that VFM will be achieved in a project is a prerequisite for a PPP project to proceed.50 VFM is assessed before bids are requested, by using a hypothetical PSC and a shadow PSC. This involves an initial theoretical assessment and subsequently the original assumption of VFM may be rechecked with a PSC. This second PSC test may be worthwhile because in practice, the initial estimate of bidders’ prices will often diverge widely from outturn.51

IV. CONCLUSION
A pertinent question is whether developing economies like Nigeria with little or no money to pursue infrastructure projects have any real alternatives to PPPs even when VFM analyses show that it is more cost effective to do a project through public procurement. There seems to be just a single option available to these countries for carrying out projects, which is through the PPP. The comparative testing schemes in such countries involve the governments merely going through the motions before deciding on the premeditated option to procure the projects through PPP.52

It is debatable whether the PSC is suitable for developing economies like Nigeria where there is paucity of government money to pursue credible public procurement alternatives. The Nigerian PPP Policy advocates for the postponement of the use of the PSC until the government accumulates sufficient historical data from actual PPP transactions for use in modelling the PSC.53 This seems to be a sensible approach since the country has only completed a few PPP deals.54 The other likely problem to be encountered with the use of the PSC and other comparative assessment methods in Nigeria is that since the PSC is a mere hypothetical scenario,55 relying on estimations made by public

51 Ibid
52 It is however claimed that VFM also helps the public sector understand how the project risks can be allocated between the public and private sectors and also that the VFM tool also helps give the government confidence about the use of PPP and that scarce resources would be well spent. See for example Flores, J.L. (2010) ‘The Value of the “Value for Money” Approach When There’s No Money’ In IFC Advisory Services in Public-Private Partnerships: Smart Lessons from Infrastructure, health and education: International Finance Corporation, pg. 7
53 Nigerian National PPP Policy, ICRC Abuja Nigeria
54 Only a few projects have reached operational phase in Nigeria.
agencies and experience of staff, it may be easily manipulated. This is even more likely in developing countries like Nigeria where corruption is endemic. However, before the government accumulates credible data to enable the use of the PSC, it must seek other credible alternatives to the PSC to evaluate the attainment of VFM in PPP projects. This is important as PPP projects should not be done just for the sake of it, but should be assessed to determine its economic and social value. For this reason, a merger of the American model - due to its simplicity, and the PIT in the Australian model, containing additional qualitative factors which pay attention to the social importance of PPPs, seems to be the perfect option for Nigeria. Notwithstanding, PSC assessment should not be the sole basis of measuring VFM, since its methodology has obvious limitations as discussed above. However, where the PSC is adopted, public agencies especially in developing economies must evaluate their capacity to manage large, complex, long term projects and the overall interest of the public must also be put into consideration in conducting the PSC test.

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