The missing link

by Mike Levin

Defining value for money in P3s

IF YOU'VE EVER sold a house, defining its value is a mix of market appraisal and timing, plus the unquantifiable factors resulting from it having been your family's home. For the buyer, value is based on price, quality and whether the building will maintain these factors in the future.

Public-private partnerships (P3s) are the flip side of the same coin. Buyers (the government and its public service) need to calculate market valuation as well as user perceptions, now and in the future. Sellers (the private-sector partner) need only satisfy accountants and shareholders.

If P3s are the inevitable economic tool of future service-and-infrastructure provision, a universally accepted value-for-money definition is mandatory – a problem right now because no such definition exists – at least not one whose logic can't be picked apart by a first-year economics student.

Those tasked with negotiating partnerships need someone, somewhere, to define exactly the government's objectives – structural and financial – for P3s. Without unambiguous policies, there is less chance of measuring performance. And without transparency (real cost to the taxpayer), no amount of statistical smoke and mirrors can prove, or disprove, whether a P3 is the best tool available.

It's early days for this new approach in Canada, but the government is starting to see through the fog of proponent-versus-opponent polarization that clings to the P3 debate.

John McKay knows enough to admit he doesn't know much about P3s – yet. He's learning quickly because Prime Minister Paul Martin has asked him to be the Parliamentary Secretary to the Minister of Finance for P3s.

McKay, a Liberal MP from Scarborough East, feels the government's inexperience with partnerships leaves big question marks behind vital issues such as which form of accounting to use and which risks to transfer between partners. "The fiscal planning for P3s at all levels of government is pretty circumscribed, so I'd have to say [the public sector] has an exploratory role right now," he says.

But McKay does know one thing about trying to analyze alternative delivery: "The money part is easy to figure out. The value part is a very tough when policies drift and bills can be hidden behind the skirts of general taxpayers."

At the Canadian Union of Public Employees, Director of Research Blair Redlin agrees that determining cost effectiveness is mired in a swamp of contradictory opinions and auditing processes, and it is creating mistrust on both sides. "Why are we going through these contortions when we can't even define value for money? There's not enough effort by the public owner to do an accurate assessment of a contract."

If value for money is simply defined as the highest benefit for the lowest cost, the only barrier to P3 acceptance would be ideological resistance. Unfortunately, as Canada takes its first anxious steps down this partnership path, the full range of parameters is only starting to emerge.

Unlike the more-mature P3 process in the UK, Australia and Europe, Canadian P3s don't have a statutory body that sets rules. Here, too, are obstacles. P3 opponents want the various auditors general (AGs) in charge because they believe P3s are an accounting exercise. Proponents feel AGs should be the clean-up team, but shouldn't be involved in proposing and negotiating because they have no real experience with business contracts. The only point of agreement is that someone needs to take control.

Getting the best deal possible for taxpayers means creating efficiency, and it isn't always predicated on lowest cost. It comes from balancing fairness with accountability, expenditure with stewardship. But mostly the delivery of value comes from competitive pricing that results from a transparent stating of needs.

The first step is a level playing field where both sides use the same accounting practices. The Canadian government uses an accounting system that does not factor in the full costs of a project over its lifetime. It's like buying a house and thinking that the purchase price is all you'll ever have to pay while you live in it.

It looks good on political resumes because this style of accounting doesn't add to future government debt until a guarantee or take-or-pay contract (where the supplier is paid whether or not the service is delivered) has to be covered out of the public bank account.

"Life-cycle costing has to be the only way because when you're servicing debt off the operating books, you have to go back to the taxpayers every year," says Jane Peatch, executive director of the Canadian Council for Public-Private Partnerships. "It is impossible to tell if a project offers value for money if you're not revealing the true extent of financial obligations."

The private sector uses full-accrual accounting, which can provide precise monitoring and reporting. It is, so far, the best way available to analyze financial efficiency, assuming true figures aren't hidden under claims of commercial confidentiality, a common refuge for both opponents and proponents.

"Accurate information is critical to get a fair evaluation. If the government is going to use P3s, it must make sure the entire contract is available for review, which means getting stakeholders involved at all levels," says Redlin.

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Maybe the private sector should adopt the government's style, says McKay. "Either way we need a template to start what, at this point, is a trial-and-error process."

Those interviewed for this article agree that accounting consistency is child's play compared to risk allocation. In a market economy, risks determine reward, and in any good partnership, risk is assigned to the side best able to handle it.

"Unfortunately there is no culture of risk evaluation in the public service. In fact, governments are risk-averse compared to the private sector," says McKay. "Which risk is which is not yet fully understood. Only through negotiation do you get risks onto the table, and only through many negotiations do you understand who to allocate them to."

In a highly simplified definition, there are three types of risk in a P3:

- project risk, relating to financing and operations;
- social risk, relating to the public expectations and government obligations;
- political risk, relating to a government's ability to change policy and regulations, and therefore financial outcome, in the middle of a contract.

Project risk is straightforward enough for both sides to understand through a classic risk/reward formula. Theoretically, value is achieved when the partner taking the financial risk gets the profit, assuming the project's goals are achieved. Of course, this only works if each side equally understands the financial impact of each risk and is willing to renegotiate during the life of the project to maintain efficiency.

"It's easy to do the metrics of costs. The difficulty comes when you have to factor in the hidden costs (insurance, health issues, environment) that aren't directly related to the project, and these can be quite emotional," says Abraham Akkawi, of P3 Advisors.

He refers to the perception that no matter what a P3 contract states, Canadians expect their government to assume responsibility for any problem that happens on a highway, in a hospital and in a school, or for any policy change that affects service delivery. This subjective aspect can never be tagged with a dollar figure, which makes social and political risk allocation appear as much a test of faith as financial ingenuity.

Chris Stoney a professor of public administration at Ottawa's Carleton University, who studied England's first decade of P3s before moving to Canada, says, "Equitable [risk allocation] is often impossible to achieve because of the deep, almost philosophical, view of how people see the state's role. In the public view, value for money is about democracy being done; in the government's view, it happens if the economic benefits outweigh the political costs. The only way to get it into a contract is with trust and commitment on both sides."

At least one private-sector attitude is easier to read. "The buyer has to be the one to figure out [risk allocation] and value for money. But in [the government's case], you're asking them to analyze something they don't have a handle on. When we're spending a million dollars [on a request for proposal], we want to know it will be a fair competition," says Dwight Brown, VP and district manager of PCL, a nation-wide construction giant with P3 experience.

The CD Howe Institute calls it "asymmetries in negotiating strengths" – another finger pointing at the public service's perceived inability to define value in a P3 because it doesn't understand the intricacies of market bargaining.

Which is why Industry Canada created the public sector comparator (PSC) to help understand risk and other P3 issues. Based on models in the UK and Australia, the PSC leads public servants through an evaluation of the true costs of in-house delivery. The result is supposed to help determine whether public or private sector is best suited for a project.

The PSC's premise is that value for money is not always about lowest cost, and it leads readers through quantitative and qualitative due-diligence process while emphasizing the absolute need for full and transparent disclosure, better known as accuracy and honesty.

On the quantitative side, it explains the costs of borrowing and life-cycle maintenance as well as how to understand financial risk. There is an emphasis on the value of competition and innovation as well as regulation (the stick) and alternative profit centers (the carrot) like third-party revenues.

On the qualitative side, it deals with the balance of public-and-private-sector interests and how to address such issues as human resources and environmental impact. Accountability gets lots of attention, as do the inevitable ethical questions that arise among partners with different objectives.

Perhaps most important are explanations of the types of P3s and how to evaluate and mitigate risk in each. "There are a lot of what-ifs, which help show how to capture direct and indirect costs properly, such as learning to attach risk to borrowing," says Akkawi. "Understanding risk-adjusted quantification of costs is the only way you'll get to a definition of value for money."

The ultimate promise of P3s is that they will become the kind of economic generator that government, self-admittedly, can no longer create. There is an incredible amount of information available that both supports and negates this theory – often heard during harshly ideological spitting matches – and most of it marginalizes the public service and the taxpaying public.

Until the discussion shifts from defining the "value of P3s" to "value for money within P3s," Canada's experience with alternative partnerships may well be more error than trial.

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More info

Industry Canada's Public Service Comparator is available at
http://strategis.gc.ca/epic/internet/inpupr-bdpr.nsf/vwGeneratedInterE/h_qz01557e.html.

One of the better descriptions of how to understand value for money in a P3 can be found at
www.excelsior.pwcglobal.com/utils/downloads/partnerships.pdf.