PROJECT FINANCE ADVISORY

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Quality In Everything We Do

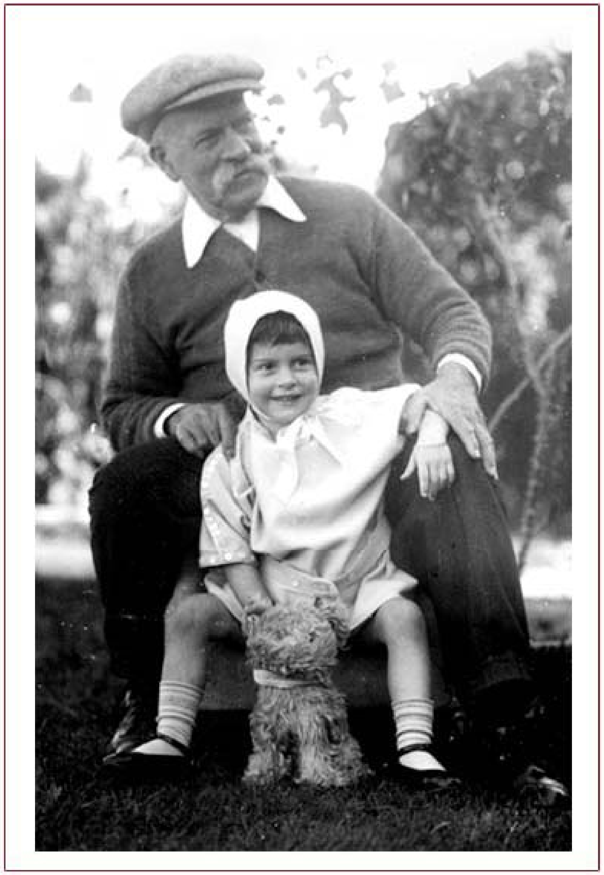
# Private Sector Participation and Investment in Physical Infrastructure for CAREC 5-7 March 2008, Tokyo

## Ensuring Value and Performance for Money


**Bill Banks Ernst & Young**

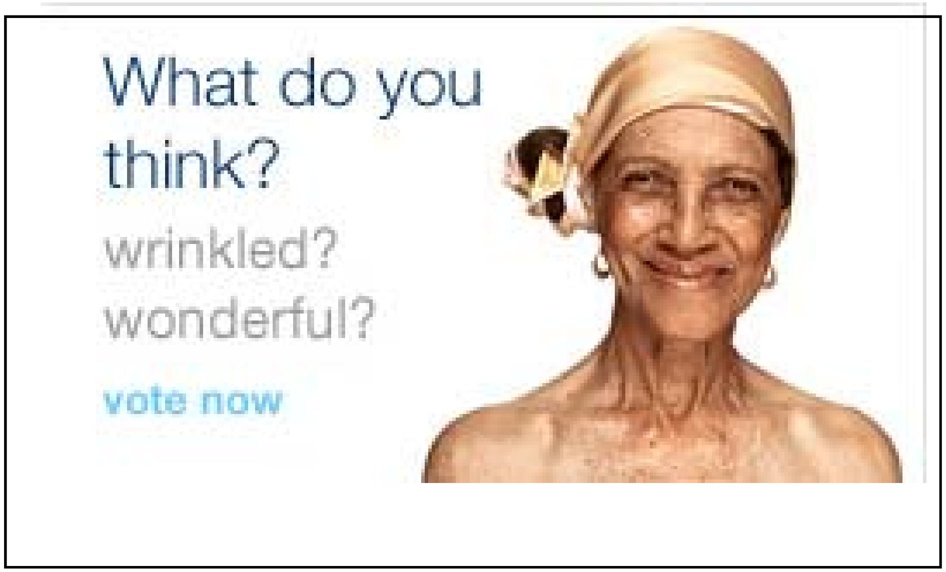

ADBInstitute

# Where lies the Value?



- Old or wise?
- Naïve or learned?
- PPP: Media hype or a godsend?

# Complexity of Value




- What is value?
  - Whose value?
  - What perspective?
  - How can we measure it?
    - → Reduced cost
    - → Improved quality / innovation
    - → Mitigated risk

# Value for Money (VFM) – Definition

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“ The optimum combination of whole life cost and quality (or fitness for purpose) to meet the user’s requirement”

(OGC, 2002b p6)

- VFM does not mean lowest cost

# Value of Money – Drivers

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Risk Transfer

Whole of Life Costing

Use of Output Specification

Competition

Performance Measurement & Incentives

Private Sector Management Skills

# VFM Drivers - Competition

- Use of competitive tension key part of any procurement
- Competition in key areas of PPP projects can reduce costs:
  - Construction and service provision contracts
  - Debt margins and equity returns
  - Pricing of risk
- Process typically structured to generate competition:
  - Initial process to short list strongest bidders
  - Request full proposals from 2-4 bidders
  - Maintain competitive tension for as long as possible

# VFM Drivers – Risk Transfer

- Optimal risk allocation of project risk is a key driver
  - Optimal allocation occurs when risk is allocated to the party able to manage it at lowest cost
  - Private sector is often better placed to manage project risks
- Transferring risk is not an end in itself
  - Inappropriate transfer of risk will lead to ‘premium’ pricing
  - PPP process seeks to identify the optimal allocation through the tender process by assessing market’s view of the cost of risks

# VFM Drivers – Output Specification

- PPP projects typically use ***output specification***
  - Define deliverables in terms of outputs required rather than inputs
  - Reconfigures asset procurement to services procurement
  - Allows bidders to consider best way of achieving outputs
- From the Government's perspective, the evaluation can focus on services delivered rather than the inputs
  - Government less concerned about competing technologies
- Output focus complements the performance-based payment regime typical for PPP projects

# VFM Drivers – Whole of Life Costing

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- PPP projects require bidders to consider whole life costs of a procurement
  - For assets, capital and lifecycle costs
- Whole of life focus drives efficiencies
  - Design to minimise overall costs e.g. use of construction materials to lower replacement or maintenance costs
- Whole of life approach transfers cost risks to private sector
  - Government insulated from higher maintenance or lifecycle costs over life of project



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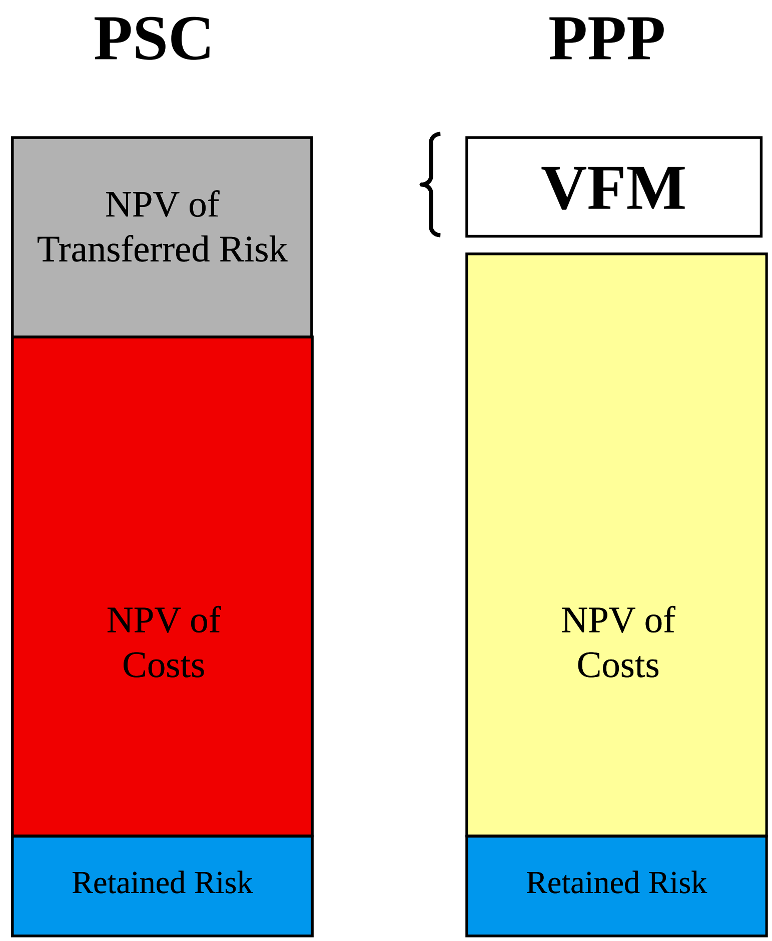
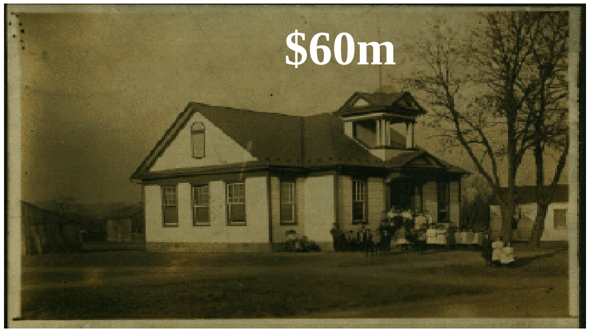
# Measuring VfM - Public Sector Comparator

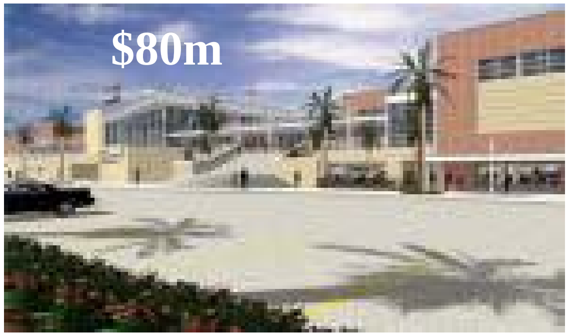
- The PSC is at the heart of PPP procurement:
  - Used to justify that the Government is getting VFM
  - Used to price the project
  - Used as a tool to evaluate bids



# Public Sector Comparator

**The Common Pricing Mistake…**




**Output Specification of Old School:**

- Lower quality materials / design - not designed with a whole-of-life approach.
- Back-log maintenance regime
- No performance deductions
- Lower operating requirements

**Output Specification of New School:**

- Designed and built on a whole-of-life basis
- Stringent maintenance regime to enure fitness for purpose over the contract duration.
- Penalties for under-performance

# Empirical Evidence: Supporting PPP

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- Study by the UK National Audit office (2003) on construction performance
- Traditional – 30% on time and 27% within budget
- PPP – 76% on time and 78% within budget

# What are the VfM drivers?

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## The VfM drivers are

- Improved risk management
- Ownership and whole-of-life costing
- Private-sector innovation
- Asset utilisation – third-party revenue opportunities
- Investor demand – generating product – thus cheap finance

## But Remember

- Not about off-balance sheet financing
- Only use if represents better VfM than other models
- Time to get signed contract
- Less flexible – incentive to get it right
- Only suitable for select projects

# Unsolicited Proposals - Beware

Before accepting or proceeding must demonstrate:

- Only the proponent, because it owns real property, intellectual property or some other unique element, can deliver the proposal's essential elements
- Unsolicited proposal will preserve considerable benefits for the Government and the community
- Unsolicited proposal would provide better value for money than a competitive tender process
- That the proponent has the expertise, experience and financial capacity to successfully deliver the project

# Ensuring Value and Performance

- Contract Award is beginning of Concession!  Public sector rate of effort needs to be maintained
- Effective Contract Management essential to ensure obtain VfM and Risk Allocation that has been negotiated
- PPP projects are typically complex and require effort to manage:
  - Payment mechanisms
  - Variations and change inevitable over the long term
  - Government can be a partner as sole or co-service provider
- Objectives of contract management are to:
  - Effectively manage Government's risks
  - Ensure outcomes bid are delivered

# Ensuring Performance – Payment Mechanism

- Payment Mechanism should provide realistic, challenging but achievable availability and performance standards for private sector
  - Must be capable of objective measurement
  - Must be recordable and reflect commercial reality!
- Provides private sector with incentive to meet the required standards and to rectify problems
- Allows payments to match standards of service – no service no fee!
- Encourages private sector to innovate and secure efficiency gains
- Essential that it is objective, transparent and easy to operate

# Ensuring Performance - Contract Management

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- Contract management framework to have 3 pillars:
  - Quality of Government's counterparty
    - Key issue is ongoing credit-worthiness of private sector entity
  - Quality of management of contract by public sector
    - Key issue is building and maintaining a relationship
  - Quality of the underlying contract
    - Key issue is clarity of performance requirements and reporting obligations
- Public sector needs to understand the business of the provider
  - Early warnings on health of counterparty

# Ensuring Performance - Implementation

- Role of contract administration manual
  - understand provisions of contract including dispute resolution
  - allocate responsibilities and resources
  - describe reporting and monitoring requirements (templates for payment and KPI monitoring)
  - contingency planning where service interruption
- Continuity and retention of corporate knowledge in public sector is crucial
  - Continuity of personnel from procurement process to operating phase
  - Commitment of senior staff to manage contract and build relationship

# Where lies the Value?

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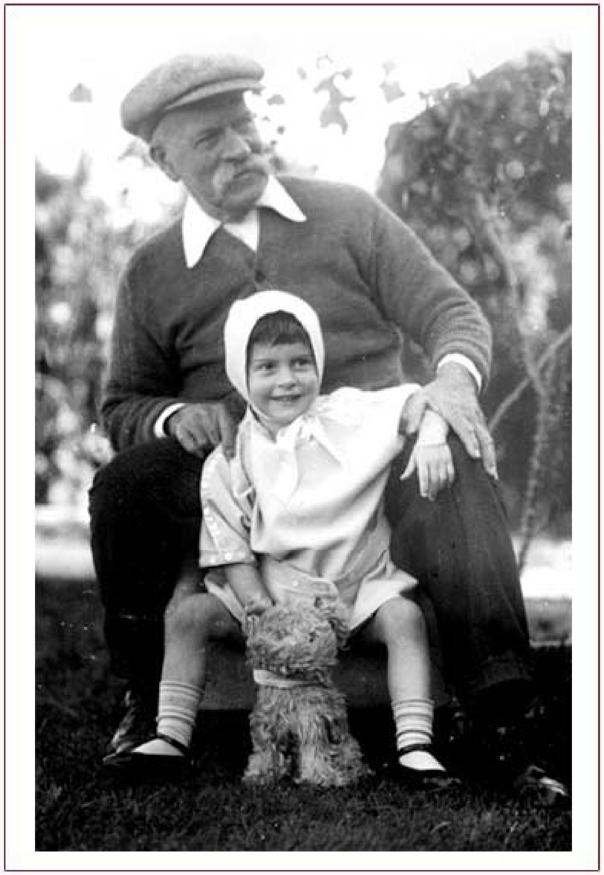

- Value is complex
- Empirical evidence suggests PPPs do deliver value
- Need to understand how
- And pick the right projects
- And make sure you follow through in implementation!



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