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Introduction

Poorly Administered Cost Calculations:

*Florida Department of Corrections*

- An initial cost comparison of the Florida correctional system showed that public prisons were 7% more cost effective than private prisons.

- A second, and more complete, cost comparison found that the private prisons had cost savings ranging from 14-27% depending on the facility.

- The critical difference was that the first cost calculation did not include indirect administrative costs or compare the specific services performed by each.
The Problem

In the past, and even currently, governments (federal, state, local) use their own make-shift systems for determining the costs of a given project or service venture. Since there has been no standardized method for estimating the associates costs, the result of such practices have been the omission of critical costs.
Introduction

Frequently omitted costs by the public sector:
- Employee benefits (pensions, healthcare, etc.)
- Office space
- Utilities

Problems from poorly executed cost calculations:
- Intended goal of project or service not fulfilled
- Additional costs to taxpayers
- Contract termination
- Lack of use of alternative methods of providing a service, such as Public-Private Partnerships (PPP)
Public-Private Partnerships:

- Contractual agreements between the public and private sector to provide a specific good or service
- Utilize public and private sector benefits while sharing in the risks and rewards

There are many advantages to using public-private partnerships (PPP). These advantages include:

- Provide budgetary room
- Reduce public-sector risk
- Increase transparency and accountability
- Innovation
Prior to entering into a PPP, the public sector should conduct a Public Cost Comparator (PCC).

The PCC is a tool used to calculate the opportunity costs and true costs of providing a service or project.

- Quantifies the benefits of PPP
- Makes it possible to compare the tangible and intangible assets of the public sector to private sector provision

A PCC can also be used to compare multiple private sector contracts, as well as, measure the successfulness of the project during the implementation process.
What is a Public Cost Comparator?

There are three critical aspects of the PCC:

1. The PCC should be expressed in terms of net present value (NPV) terms.

2. The PCC should be based on recent public methods of providing a defined output.

3. The PCC needs to take into account the risks that may incur by the method of implementation chosen.
The components in conducting a PCC differ vastly the more detail oriented and cost specific you become, since public private partnerships range from infrastructure endeavors to contracting out a simple public good or service.

Aspects of the PCC in a PPP:

1. Understanding the Discount Rate
2. Understanding Risks
3. Understanding Costs
4. Value for Money (VfM)
Decision Making Tools

Risk Assessment
A thorough evaluation of the risks retained, transferred, and shared must be conducted. This component is distinguishable from any other assessment in that the public sector faces very different risks than their private counterparts.

Determination of the Discount Rate
Since the project is over several years a Net Present Value must be determined to perform a proper and accurate Cost Benefit Analysis.
Decision Making Tools

Weighted Average Cost of Capital (WACC) =

\[ \frac{E}{V} \times R_e + \frac{D}{V} \times R_d (1 - T_c) \]

- Includes equity and debt-used as the private sector discount rate.
- The government uses their cost of debt as the discount rate.

\[ R_e = \text{cost of equity (CAPM)} \]
\[ R_d = \text{cost of debt-market cost of debt} \]
\[ V = E + D \]
\[ E = \text{market value of the firm’s equity} \]
\[ D = \text{market value of the firm’s debt} \]
\[ \frac{E}{V} = \% \text{ of financing that is equity} \]
\[ \frac{D}{V} = \% \text{ of financing that is debt} \]
\[ T_c = \text{corporate tax rate (or applicable tax rate)} \]
Public Cost Comparator
The public cost comparator needs to be assessed to use as a comparison to the private sector bids. In constructing the PCC there are several different costs to consider in the analysis.

Value for Money (VfM)
The VfM as defined by the Department of the Treasury is the “optimum combination of whole life costs (capital and operating) and quality of services to meet the requirement of the public sector.”
Understanding Costs

The ultimate rule for decision making following a VfM assessment is that there must be a net-benefit for the public sector in order to enter into a public-private partnership.
There are four main cost analyses involved in completing a full PCC.

**Total Value of PCC =**

Raw PCC + Competitive Neutrality PCC + Transferrable Risk PCC + Retained Risk PCC
## Financial Evaluation of Raw PCC

**Raw PCC**

A raw PCC is conducted by completing a simple cost analysis as if the public sector was to distribute the good or service all on its own.

<table>
<thead>
<tr>
<th>Direct Capital Costs</th>
<th>Direct Maintenance Costs</th>
<th>Direct Operating Costs</th>
<th>Indirect Capital Costs</th>
<th>Indirect Operating Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Design costs</td>
<td>• Raw Materials</td>
<td>• Inputs</td>
<td>• Corporate overheads</td>
<td>• Partial use of plants/equipment</td>
</tr>
<tr>
<td>• Land and other development costs</td>
<td>• Tools/Equipment</td>
<td>• Employees</td>
<td>• Non core IT and equipment</td>
<td>• Partial use of administrative buildings</td>
</tr>
<tr>
<td>• Raw Materials</td>
<td>• Labor</td>
<td>• Insurance</td>
<td>• Employees</td>
<td></td>
</tr>
<tr>
<td>• Payments to external actors</td>
<td>(wages/salaries)</td>
<td>• Building Services</td>
<td>• Facilities management</td>
<td></td>
</tr>
<tr>
<td>• Equipment</td>
<td>• Capital Improvements/up grade to facilities or expansions</td>
<td>• Employees not directly involved</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Payments for procurement</td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>
Financial Evaluation of Raw PCC

Raw PCC includes:

- Only financial costs and benefits (if applicable)
- Purchase of fixed assets but not their depreciation
- Maintenance costs over the life cycle of the project
- Third party financing included

Raw PCC does not include:

- All risks, contingencies, and adjustments
- In the Raw PCC, everything is assumed to work perfectly

Raw PCC = (operating costs - third-party revenue) + capital costs
Competitive Neutrality PCC

All inherent advantages and disadvantages of the public sector are removed to create comparable project cost.

- Advantages = Costs
- Disadvantages = Benefits

Steps:
1. Identify overall effects of government ownership including financial advantage and disadvantage
   - Examples: paying land tax, local government rates, stamp duties, payroll tax, price overheads, accountability costs,
2. Estimate the value of each element quantified per unit need in the project.
3. Find total of Competitive Neutrality PCC by assessing the net advantage
Transferred Risk and Retained Risk PCC

*Transferred Risks PCC*

The benefits of innovation and technology that are apart of the private sector are considered a value-add to the bid.

*Retained Risk PCC*

The public sector has unique and specific risks that cannot be shared across a partnership, such as political risks.

**Steps:**

1. Identify project risks
2. Quantify consequences of each risk
3. Establish the probability of each risk
4. Calculate the value of each risk
# Risk Identification

<table>
<thead>
<tr>
<th>RISK CATEGORY</th>
<th>EXAMPLE RISKS</th>
<th>RESPONSIBILITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance</td>
<td>Secure finance, price escalation</td>
<td>Public</td>
</tr>
<tr>
<td>Ownership</td>
<td>Uninsurable loss/damage to assets, public/third party liabilities</td>
<td></td>
</tr>
<tr>
<td>Design &amp; Development</td>
<td>Development problems, testing problems, delivery design, Design/Development variations</td>
<td>Shared</td>
</tr>
<tr>
<td>Operation</td>
<td>Asset/service performance and availability, Repairs/maintenance, Security, changes in demand, third party revenue</td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td>Fixed time/cost, delivery schedule, environmental issues</td>
<td>Private</td>
</tr>
</tbody>
</table>
Best Practices

After speaking with people from both the public and private sector, a number of best practices have been identified.

1. Understand the Uniqueness of the Project
2. Include Everything, But Be Wary of Bias
3. PCC is Not a Final Step
4. Be Realistic, Not Overly Optimistic
5. Identify Strengths AND Weaknesses
Understand the Uniqueness of the Project

“One Size Fits All” does not work in these situations - Every project is unique and requires an unique approach.

Partnerships should be viewed as business relationships - The process is not a war, but a mutually beneficial agreement.
Include Everything, But Be Wary of Bias

Identifying *all* the aspects and costs of a project can make the difference between determining whether or not a PPP is cost effective.

Not including certain costs within the calculation will *bias* the results greatly.
PCC is Not a Final Step

Since a PCC only provides half of the decision making equation, a PCC can only be considered as one way of navigating the maze of options in determining Value for Money.

PCCs need to be a "decision aid tool, not a decision making tool."
Be Realistic, Not Overly Optimistic

Public sector estimates on costs have been historically inconsistent and too optimistic in terms of a projects cost, timeline, and ability to generate revenue.

Though PPPs tend to experience on average a substantially higher cost than originally estimated, the rise in cost is significantly lower than the average costs rise that are seen in traditional government projects.
PPPs are not a panacea. It is crucial that all avenues for savings and efficiencies be realized.

- The General Services Administration (GSA) has previously-negotiated discounts for supplies used in government projects.

The PCC is unique in that it aids the decision making process by helping the public organization identify its own strengths and weaknesses.
Closing

• Due to a lack of resources the public sector needs to use the most cost effective methods for providing services and projects

• Partnerships with private sector organizations can lead to cost-savings, increased transparency, and innovation

• Public sector needs to conduct a PCC prior to providing a service to:
  • Assess total costs of public sector provision
  • Properly compare public vs. private sector provision

• A PCC includes all costs appropriately, including:
  • Raw Costs
  • Risks - transferred and retained
  • Discount Rate
  • Competitive Neutrality