Abstract

This paper explores some underlying incentive issues associated with the Least-Present Value of Revenue (LPVR) auction proposed by Engel, Fischer and Galetovic (2001) to allocate public- private partnership contracts. We also explore the implications for the cost of capital faced by the concessionaire when there is a risk of default. The extent of this risk also depends on the nature of the tender and associated contract.

While the LPVR auction variable-term contract addresses the adverse selection issues associated with ensuring that the lowest cost firm wins the tender, it fails to consider ex-post (moral hazard) distortions that might emerge when the firm faces a guaranteed rate of return under a zero net present value auction. We then consider a fixed-term contract, which provides the firm with an incentive to exert an effort to boost demand (thus increasing expected revenues at the least cost). Under a fixed-term contract the firm faces a bankruptcy risk and, therefore, potentially higher cost of capital than under a variable-term contract.

In particular, we show that when renegotiation is not possible, a variable term contract can be welfare dominated by a fixed term contract if the extent of moral hazard is sufficiently high to offset any increase in the cost of capital. We extend our analysis to consider the impact of renegotiation. We show that the positive incentives for cost reduction that exist under a fixed term contract may disappear when renegotiation is feasible. In this case, whether a fixed-term contract welfare-dominates a variable term contract will no longer depend only on the trade-off pointed out above but also on the effect generated by the disutility cost that arises from the firm being subsidized by the government to avoid default.