CORRECTED VERSION

PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

Subcommittee

Inquiry into Private Sector Investment in Public Infrastructure

Melbourne – 30 April 2002

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Witnesses

John Fitzgerald, Director, Commercial Division; and

Glenn Maguire, Assistant Director, Commercial Division, Department of Treasury and Finance.

The CHAIRMAN - I declare open the Public Accounts and Estimates Committee briefing on Private Sector Investment in Public Infrastructure. I welcome Mr John Fitzgerald and Mr Glenn Maguire from the Commercial Division, Department of Treasury and Finance, to this hearing.

All evidence taken by this committee is taken under the provisions of the Parliamentary Committees Act and is protected from judicial review. However, any comments made outside the precincts of the hearing are not protected by parliamentary privilege. All evidence given today is being recorded. Witnesses will be provided with proof versions of the transcript early next week.

Mr MAGUIRE - Thank you, Mr Chairman. We have prepared some slides which I will take the committee through today and talk to. The slides address the points that were raised in the letter from yourself to the Treasurer in which you asked to have a briefing. Also there is a prior point I would like to cover which covers the key messages that I wish to draw to the committee's attention before we address those points.

The document is an overview of the presentation. Again the key issues are in the front; we will then address each of the remaining points in your letter to the Treasurer.

Power Point presentation.

The key messages up-front: The objective of the current approach of Partnerships Victoria is value for money. It is not another kind of borrowing or off-balance sheet mechanism. The prime objective of this current policy is value for money. The four main value-for-money drivers are: efficient risk transfer; and there are some risks in projects - for example, that the private sector is able to better manage than the government has historically been able to. Secondly, whole-of-life costing, which is primarily about making a decision up-front about looking into capital costs and your operating costs over the period, and making decisions as to how best to build the original facility, taking into account the maintenance and refurbishment costs over time; so making a whole-of-life decision at the outset. The third area is that while specifying the requirements in output terms rather than input terms, there is often greater scope for innovation from private parties, and that can lead to different approaches that we may not have done ourselves. Fourthly, the process itself is a very rigorous considered process under this policy, and that does lead to better planning up front and often avoidance of some of the problems that can and have occurred under other approaches.

The next point we would like to make up-front about our message is that Partnerships Victoria is another step in the learning process. The two previous governments have had policies that involve the private sector in public infrastructure. We have tried to learn from both of those policies and processes, and also from overseas and other national experiences to develop the current policy.

MrTHEOPHANOUS - Would you prefer us to interrupt during the presentation, or do you want to go right through and come back?

Mr MAGUIRE - It is whatever is easy for you, and what best serves the committee.

Mr FITZGERALD - I think it would be worthwhile interrupting, providing we try to get to the end within the time allocated.

Mr MAGUIRE - The point I was making at the end there was that this process will evolve over the next years to come as well.

To address the track record, we will do this briefly but we will address more fully in our submission. There are really three distinct periods from 1990 to now. First 1990-1992. We have a list of projects over the page. The rationale for those, from our brief look, has been to primarily get off-balance sheet transactions. That was certainly achieved. Some of them have actually caused some problems down the track, often because of the government's tax indemnity, but I won't want to talk too much about that because my record on that period is not particularly strong.

The next period 1992-1999 really starts at about 1994, to be honest.

I will have a quick look at the projects we have identified for the 1990-1992 period that we consider may be relevant to the committee's inquiry.

Mr FITZGERALD - I think a point worth making there is particularly the German cross-border leasing arrangements, and the Victorian accelerated infrastructure program which were very much about leasing-type arrangements, so they were financing arrangements to take advantage of tax breaks or deductions that were available at the time, and also to get these transactions off-balance sheets, so very much financial implications and outcomes.

MrTHEOPHANOUS - Except at the time the Auditor-General did not agree - certainly in relation to the tram lines - that they could not be classified, that they were in fact a lending arrangement rather than a leasing arrangement.

Mr FITZGERALD - I am not sure whether that was subsequent to the closing of the transaction or he made that determination during the course of the transaction, but I know there were issues. I certainly agree with you that some of these transactions didn't achieve what they set out to achieve.

Mr MAGUIRE - Going back to the 1992-1999 period. The rationale was different here; there was certainly a focus on value for money. Although whether or not it fully took into account the risks transferred is a matter for discussion. The second rationale was that it provided some benchmarking for government providers. This is particularly in areas like prisons and hospitals where the full services were actually transferred to the private sector and one of the benefits was seen to be to provide a benchmark for the government for those same services.

A third rationale is to bring forward major projects where user-pays could be involved, and Melbourne City Link is an obvious example of that. A further feature of the projects in that period was the focus on service provision rather than the asset per se. So if a contract was entered into in terms of the private party providing services, they were paid for services, and the asset in a sense was a bit secondary.

MrTHEOPHANOUS - Why isn't getting it off the balance sheet included in the 1990-1992 list? I would have thought that City Link took at least $2 billion potentially off the balance sheet. If you had built it using public funds you would have had at least $2 billion on the balance sheet that you don't have. Why aren't you counting that?

Mr MAGUIRE - I don't know whether that was as important a driver as the other ones that are there. The government at the time made a decision not to actually borrow the money and do what you say.

MrTHEOPHANOUS - Not increasing debt was an issue, wasn't it?

Mr MAGUIRE - Yes.

MrTHEOPHANOUS - Which means keeping it off the balance sheet. I am trying to understand the distinction you make.

Mr MAGUIRE - I think bringing forward major projects with user pays, that would apply. The other types of projects, the prisons and hospitals, would have been clearly off the balance sheet because of the nature of the project in its own right. So I think what you are saying would apply not to that.

MrTHEOPHANOUS - Why have you got Loy Yang B on the 1990-1992 list?

Mr MAGUIRE - That was a sale, as far as I can see, more than a public-private partnership type of arrangement.

Mr FITZGERALD - In respect of new infrastructure.

MrTHEOPHANOUS - This was a 40 per cent sale of Loy Yang B and an agreement which involved a management structure - the thing being run by the people who had the 40 per cent - and so there was a significant public involvement in it given the virtue of the fact that the government owned 60 per cent, or in various ways owned 60 per cent.

Mr MAGUIRE - I do not have a detailed knowledge of that period but we are happy to include that on the list, and we will certainly have a look at it.

MrTHEOPHANOUS - I am asking if there is a reason for it.

Mr FITZGERALD - Two distinctions. In relation to your first question, what we are trying to show is the trend as to what has transpired in the early period to the second period. In the first period there was a lot of focus on getting things off the balance sheet as one of the key drivers. In the second period, yes, a number of projects were off the balance sheet but it was more as a result of the transaction rather than a driver for the transaction, so we are really just trying to show a trend there.

In relation to your second question the current Partnerships Victoria policy for the procurement of public infrastructure through the private sector really does focus on new infrastructure, and that's what the policy is about. Then we excluded some transactions such as Loy Yang B, and others in fact, in the list from this analysis, otherwise we would have a crossover of much more privatisation-type transactions as opposed to purely new infrastructure transactions. So that's the rationale behind it, but yes, there are many debates and arguments or views you could have about partnerships.

MrTHEOPHANOUS - I think Loy Yang B is a very interesting one, because I was involved in it. I know you have to push on.

Mr FITZGERALD - In our submission we can certainly include some details about Loy Yang B.

Mr RICH-PHILLIPS - That was the Mission Energy, was it?

MrTHEOPHANOUS - Yes, very much a partnership, a 40 per cent sale, and there was a management agreement. It was new infrastructure, because it was actually to build the power station, so it fits in with all the categories.

Mr MAGUIRE - That is a list of the projects we developed through the period 1992-1999. There is no privatisation involved there at all. They are all partnership-type projects.

Ms DAVIES - Mildura had a hospital, it was a rebuilt hospital, but it was the privatisation of an existing service, surely; it is not new. It is a new building, but it was not a new hospital.

Mr MAGUIRE - Okay. We are certainly talking about the definition at the moment, which we certainly can discuss, that it was new infrastructure involved. And in that sense a new hospital had to be created, so it was done as an infrastructure project. I don't deny that there was a previous hospital up there, but it is the case in some of these projects that there were existing services that were actually incorporated into these projects. There was certainly water treatment being done in each of those projects there, but the new plants gave a much better water treatment service than what had been done before.

You could probably argue the same thing happened in Mildura, and even the City Link incorporated part of the old Tullamarine Freeway, so these are operating in conjunction with the current services. Again definitions issues can be part of this.

In terms of the record of those projects - and we will not dwell on it too much today - but you need to look at the impact on tax payers, service recipients, and the broader community. The Russell Report attempted to do this for some of those projects. I think their view was the tax payers probably did fairly well. I don't know if they fully addressed the issue of service recipients, but there were mixed reactions about wider community issues like disclosure and transparency.

There is no doubt at that time Victoria was a world leader in this area, along with the UK, and that makes it difficult in some areas because you are pushing out boundaries that other people haven't addressed so you do happen to run into mistakes that other parties don't run into.

Ms DAVIES - I take objection to 'world leader'; that is a value-laden term. One could describe it is as a rogue, too. Value-free language is perhaps more appropriate.

Mr MAGUIRE - So a word such as 'pioneer' is preferable?

Ms DAVIES - No, not really; I regard that as value-laden, too.

Mr MAGUIRE - We are trying to get our point across, that there was not much precedent around the world at that time.

Ms DAVIES - 'Unprecedented' might be a better word perhaps.

Mr MAGUIRE - Some lessons we can obviously pick up straight away from these projects, and perhaps looking particularly at the Latrobe Hospital and the Port Phillip prisons ones where in some cases there was a focus on maximum risk transfer rather than optimum risk transfer.

The CHAIRMAN - I am interested in the term you use 'excessive risk transfer' and precisely what you are meaning by that and saying by that; are you saying that there was a failure to recognise what was appropriate to transfer?

Mr MAGUIRE - Part of it, I think, was the fact that because it is a relatively new area there is a push to push the boundaries out, and in some instances they actually went too far. That was, I suppose, part of the fact of trying to work out where the market had actually settled, where the previous people were. In some cases I think there were some risks where we thought the government could have pushed over even though the government might not have been in the best position to actually handle it.

The CHAIRMAN - Was that, in your view, a result of it being like the early days without precedent when people were not generally attuned to assessing risk and identifying risk, allocating risk?

Mr MAGUIRE - That is the major factor; I would agree with that.

Mr FITZGERALD - That is a very valid comment. There was a learning period, and I think the view that was taken at the time was to try to transfer as much risk as possible, but not a lot of analysis around what the actual cost of transferring that risk was, because perhaps the private sector weren't the best party to manage that risk.

Mr CLARK - In your submission can you give some examples?

Mr FITZGERALD - Will do.

The CHAIRMAN - The other question that flows from that to me, and you might also like to address, is whether there was an adequate skills base within the public sector to do with at that time.

Mr FITZGERALD - Again we will take a look at that in our submission.

The CHAIRMAN - I ask that as a question on notice, if you like.

Ms DAVIES - For clarification can I ask: are you saying that in those projects the actual risk was pushed on to the private sector? I would have thought that our experience since has demonstrated that in fact a lot of the risk, the potential profits have been pushed to the private sector but the risk ultimately has stayed with the state.

Mr MAGUIRE - I think we need to talk about the difference. Most of these involve public services and the government is actually responsible for those being delivered, but these contracts do transfer the financial risks of those being provided to the private sector partner. So I think there is a distinction between those two things, and we need to take that into account at the start.

If in the Latrobe Hospital case we had to make sure the services were being provided by the government; that was the government's role. But financially the contract was not successful for the private parties and hence it failed. So they certainly lost money on the arrangements, but we had to get in there and step in and make sure the hospital kept providing the services.

Ms DAVIES - So ultimately the risk went back to the state. The same with public transport. You can say that the risk was with the private sector in that they were losing money, but the consequence is not that they keep losing money, it is that the public sector steps in and accepts the risk and pays over the money. I don't see how - I mean ultimately in each case they have been rescued by the state, the risk has not stayed with the private company.

Mr FITZGERALD - That's true. I think there are two issues there. One is, yes, ultimately where public services are involved the state will have to step in and provide those services. Again we will address this in our submission, but if you look at Latrobe Hospital and the current situation with the public transport, there were considerable losses suffered by the private sector in those facilities, in their investment. So yes, they have taken financial risk and it has come home to bear on them, but ultimately the state has had to step in. So there has been a financial benefit to the state and a financial risk passed to the private sector.

When these transactions have to come back to the state, the view that is being taken now from a policy perspective is that we were pushing the envelope too hard; therefore these businesses wern't sustainable, and we need to remember that for these businesses, when we are asking the private sector to participate on a whole-of-life basis, the investment is for the next 25 years. So the transaction has to be structure as far as possible in a sustainable way, otherwise, yes, we end up having to prop up these companies or taking those services back.

So I think where we are heading now, which we will discuss as we go forward, is a much more balanced approach. To give you one quick example: in hospitals, bidders for private hospitals bid against case-mix funding, and that was our benchmark. It is interesting that even some of the public hospitals were having some financial difficulty meeting our own benchmark, so it does call to question whether that benchmark was properly structured in the first place.

The CHAIRMAN - It calls to mind that one the risks – and I don't know how you can factor this in or whether you should - but it is a non-economic risk, and that is political risk and what sort of role political risk plays in the evaluation of the project, because I think much of what Susan raises actually relates to political risk as much as economic risk.

MrTHEOPHANOUS - I think the other thing is the relationship between price and risk. And again, because I was directly involved in Loy Yang B, I can tell you that the way it worked was that you could virtually increase the amount, the price you got for the 40 per cent that you were selling, proportionately to what you put into the other contract about how much they were going to get for each bit of electricity they produced. So the contracts were directly related. If you put in a long-term guaranteed price for the electricity, the price went up for what you would get for the actual power station; and if you tried to make that market-driven, the price came down. So there is a direct relationship between what happens to one as against the other, and that is a big issue for governments when they are considering this.

The CHAIRMAN - We had better let you move on from the historic to the current and the future, I think.

Mr MAGUIRE - I am just trying to rescue this slide again. As we had a bit of a lull, it has gone to sleep on me.

Ms DAVIES - Can I go back? Are you going to provide more detail on those existing contracts in your submission?

Mr FITZGERALD - Yes, we are proposing to in our submission.

Ms DAVIES - In your lists, you said, I note, that you are talking about new infrastructure that was provided. Can you tell me whether you will provide information on contracts on Seal Rocks, which was originally going to be publicly owned infrastructure which was contracted out to a developer?

Mr FITZGERALD - I am certainly happy to do that.

Ms DAVIES - I think that might be a useful exercise, as it has been such a problematical issue.

Mr FITZGERALD - I don't know the history of Seal Rocks and why it was developed as a concept. We did have it on the list.

Ms DAVIES - It was originally planned to be part of the nature reserve which was publicly owned. It was originally planned as a development by the nature park, and it was taken out as a privatised entity by the previous government. But are there other contracts that you originally had on your list that you have taken out?

Mr FITZGERALD - No, I think that is the only one. The only reason I did that was that it was my understanding, but obviously incorrect, that it was always a private sector initiative.

Ms DAVIES - It wasn't. There was a development planned there; there was money put aside for it as part of the nature park, and that was cancelled by the previous government and contracted out as a private development.

Mr FITZGERALD - Certainly in view of that, we will include it.

Mr MAGUIRE - Pushing on. Where we are now - looking at the last three years - the initial focus has been the development of the policy and implementation framework for the Partnerships Victoria projects, and that has taken a fair bit of time. This policy was put out in June 2000. A year later we put out a whole lot of guidance material, which is very substantive. During that period we were also working with the departments trying to identify suitable projects to be done under this particular policy. We certainly were not going to rush projects that were not simple into a market that was not ready.

Over the last year a number of projects have entered the market. We have now got nine into the market. A couple have already been signed, including the County Court which carried over from the previous government. I will list the projects over the page.

The comment at the bottom is it too early to assess the benefits of the current policy in terms of value for money as we have only had two contracts signed, so we cannot assess value for money over a wide range of sample projects, and none of them have been commissioned yet.

MrTHEOPHANOUS - Which two are signed?

Mr MAGUIRE - The County Court one was signed in June 2000, and a waste water treatment plant at Wodonga was signed in December.

The CHAIRMAN - Is it possible to make any comparison between the 1992 Magistrates Court partnership and the recent County Court one; the way in which they were done? That might be useful.

Mr MAGUIRE - We can have a look at that.

Mr RICH-PHILLIPS - Was the Wodonga one signed last December, 2001?

Mr MAGUIRE - Yes.

Mr FITZGERALD - We will provide an earlier submission, but if you just flick to the next page – a number of these projects, contracts, will be closed in the next few months, so we are proposing to make a second submission in perhaps July or August of this year which would try and assess the outcomes of those contracts as least. Nothing will be built by then, but -

Mr CLARK - What has happened to the Alfred Hospital car park project? It was on your list at one stage, but it is not there now. Has it slipped off by accident or has it bitten the dust?

Mr FITZGERALD - No. We did receive a bid. There was one preferred party that was in a preferred submission in respect of that project, on which we build our benchmark or our public sector comparator. My understanding in that this bid failed to meet the public sector comparator, so we are looking at that. We are now looking to see whether it makes more sense for the Alfred Hospital or the government to build it directly.

Mr RICH-PHILLIPS - I notice in the document we have been given, the overview document, it refers to two tests - the comparator test and the public benefit test - for choosing public partnership or private partnership. Are those tests applied to all significant infrastructure projects? Is it government policy to check every project against these before proceeding to decide if it should be a partnership?

Mr MAGUIRE - The whole purpose of looking to do it under this partnership policy - we will certainly put up a public sector comparator which will be then compared against the bids when they come in, and that is a major value-for-money assessment. The public interest test actually occurs a bit earlier in the process; that occurs before we decide to put the project to the market and before the commencement of the tender process. We want to be sure we can cover all the public interest indicators suitably before that particular process proceeds to provision of services.

Mr RICH-PHILLIPS - Would you apply the public benefit test to all potential infrastructure projects and check whether every project or any project should be a partnership project?

Mr MAGUIRE - The public interest or cost benefit I may wish to clarify with you there. Is this the cost benefit you are talking about?

Mr RICH-PHILLIPS - No, this is on page 5 of the overview.

Mr MAGUIRE - That is a public interest test.

Mr RICH-PHILLIPS - I assume those two criteria - that and the comparator test - are the basis on which you decide whether a project should be a partnership or not. What I am asking is are all potential infrastructure projects benchmarked against those two tests? Is it government policy to consider all potential projects as partnerships?

Mr FITZGERALD - There is an overriding view that all projects should be considered as Partnerships Victoria partnerships, and therefore both tests would apply. However, in practice there might be reasons when government announces a particular infrastructure project, and it takes the decision this is a public build, public delivered project – rather than a partnership. It is seldom that occurs, but that can occur. When that does occur, government or the state would undertake a public interest test, but it would not be undertaken as formally as this policy sets out, so there is no formal policy in respect to that. Certainly there would be no public sector comparator built in the same formal way as we would build it here. So certainly this policy takes the analysis of both those tests a lot further than traditional funding.

Mr RICH-PHILLIPS - How is that decision made to proceed with a public sector project rather than a partnership project? The initial stage, is that done by a portfolio minister or does it involve Treasury?

Mr FITZGERALD - It would involve a committee of cabinet; probably either the infrastructure development committee or the economic development committee. I could give you an example which might be the best way. One piece of infrastructure being currently developed is the extension of Collins Street - bridge to Spencer Street railway station. There was never any consideration of that being a partnership project because it really does not make sense. If you think about it, there is an existing publicly owned street, there is a publicly owned Docklands precinct on the other side, there is a publicly owned station in the middle, and really there is no case, I think, to go to the private sector to build that piece of infrastructure on what is totally publicly owned and operated infrastructure. There was no ability to isolate it as a project. However, if you look at the Spencer Street Station project, there is a clear envelope or footprint in respect to the land, and it was determined that land can be made available for commercial development and investment, and therefore interest the public sector. There are services associated with the station which enabled us to consider whether the public or private sector are able to better manage those services. So does that help?

Mr RICH-PHILLIPS - Yes, it does.

Mr FITZGERALD - That is probably the best example; it is a good example. There might be others, but primarily that judgment is about the suitability or the interest of the private sector in a project.

Mr RICH-PHILLIPS - If cabinet establish a prima facie case that it is potentially a public partnership, is the analysis - the comparator test, the public benefit test - done by Treasury or by the department?

Mr FITZGERALD - It is the responsibility of the department for both the public interest test and the public sector comparator. However, Treasury is significantly involved in that process, so we tend to have one or two officers working with the department, and ultimately that decision has to be taken – again I would have to check - but I think it is by the Economic Development Committee.

Mr MAGUIRE - There is also a further slide later on which indicates the value-for-money drivers; there are four or five of them. We actually take them into account when we look at a project: efficient risk transfer, whole-of-life costing, scope innovation, et cetera. So we actually look at that in a fairly qualitative fashion to see whether the project has those basic attributes.

The CHAIRMAN - We have a little over five minutes left, and given our tight time line, we are going to need to stick with that.

Mr MAGUIRE - The next slide looks at the legislative policy frameworks and practices. The legislative framework has no specific enabling general legislation. In terms of policy, you have obviously seen the policy document; that was based on a range of other factors - the government's selection platform, the previous government's policy, what's happening in the UK, and research by people like Raphael Arndt.

Ms DAVIES - What is IIPV?

Mr MAGUIRE - That is the previous government's policy for private division of public infrastructure. It is called infrastructure investment policy for Victoria, and was released in 1994. That guided the policy for those particular projects.

Ms DAVIES - And the UK PFI?

Mr MAGUIRE - That is the private financing initiative. That is the English name for these types of projects.

The CHAIRMAN - Is that their current name?

Mr MAGUIRE - They use a term, public private partnerships but that covers a range of different types of subsets.

The CHAIRMAN - They sort of have subsets, don't they?

Mr MAGUIRE - Yes, they have wider markets and joint ventures, and they have a number of subsets.

Turning to the slide again: In practice, this guide material sets out a very detailed process for running these projects - and I have some slides that cover that in a moment. We have also learnt from previous practice here and from other states. Also in the UK there was a very good report done in 1997 called the Bates Report, commissioned by the incoming Labor government at the time; that looked at practical issues in doing these types of projects, the role of Treasury and departments and that was a useful report. If you don't have that report, you should try to get it.

Here is the process that is outlined in our Partnerships Victoria material. It is an eight-step process. The first four steps on this page occur before the project actually goes to the market. You will see the first two steps are actually concurrent with projects that are to be done under the normal traditional public funded approach. The business case is much more fully done for a Partnerships Victoria project before funding is approved. And the fourth step, project development: we work on getting the project ready to go to the market, look at the procurement team, look at the commercial principles and start looking at the PSC, et cetera. So that is all done before we go to the market. The second lot of four steps: the first three of those are during the tendering or the procurement process, and the last step relates to once the contract has been awarded. On the left-hand side you will see three diamonds - two here and one on the previous page. That is where cabinet approval is required to proceed to the next step. So it is a very rigorous process, and I think it is one of the keys – well, these things need to be done properly, but I think this process helps them to be done properly and on time.

Mr HOLDING - Where is that?

Mr MAGUIRE - It is those three diamonds on the left on the first page, left-hand side: approval to invite expressions of interest, and approval to issue the project brief. The final contract signing doesn't need to go back to cabinet if the bids come in as delivered within budget; there are no other major issues involved, and the minister and the Treasurer can agree to that.

This talks to that slide in many respects. This next slide talks to the previous chart slide. One thing I would like to note in the second dot point is that projects that will require government funding are actually given full funding before they go to the market. A current example is the prisons project which is expected to go to the market next month, and Berwick Hospital, which is already in the market; there has been money fully set aside to actually build those projects under a public build if required, if the bids don't come in and beat our own benchmarks. If we decide, once we have seen the bids process to proceed with the private sector approach we simply convert that capital funding to a recurrent stream over a certain period of time, so they are fully funded before they go to the market. The role of DTF, I think John has mentioned. Probity is important. We employ a probity advisor for all these projects. I will come back to contract management later if there is time.

Public interest **-** I have a number of slides, and we might not have time to go through them in detail. It was a key part of the Bracks government's election platform relating to community concerns. There are eight specific public interests areas identified. The public interest test comes back to the question we had before. We do an initial test to see whether they are likely to be passed for a project before we actually put up a funding submission. We do a full test before we release the project to the market, and then we confirm before the contract is signed that the contract fully caters for all public interest elements. I might leave that now. They are the eight public interest areas; very comprehensive.

In public interest we identified for each of those elements a standard against which to test the public interest, and then we make an assessment. I have an interim example, one which has not been necessarily finalised but it was been done six months ago in the early stages of the prison project. It is difficult to read. But one of the elements is equity; that is, can disadvantage groups effectively use infrastructure? We looked at what standards might apply; and there are three different discussions on standards. Look at the second one: prisoners vulnerable to self-harm. The current government has developed a building design review project (BDRP) which basically designs a cell to eliminate hanging points, and that will be mandatory in the prison design for new prisons, so that will be covered in that particular respect. The third one is standard; the rights of prisoners are covered by the Corrections Act 1986. Obviously that will also apply to private providers to any role they might have in providing building for the prison. I have got another example over the page which I will not talk to given our time; it is about public access and how again we devise the appropriate standards to measure public access against and assessment of whether or not we can do it with a private provider involved.

Ms DAVIES - Was there any such test of public interest or value for money under the policy of the previous government?

Mr MAGUIRE - It is difficult for us to speak on that fully given our limited involvement. Value for money - they certainly put up what was called benchmarks, and they were financial and risk benchmarks; they were certainly there. The public interest test, I think, was probably done in not in quite as formal a manner as what has been proposed here.

Mr FITZGERALD - Not as formal or analytical as this process.

Mr MAGUIRE - Assessment of value for money, which is obviously a key reason as to why you may be curious as to why we do these things. Initial assessment before the tender process, the next slide addresses that. I will come back to it in a moment. Making an assessment during the tender process, we look at how the PSC looks or compares with the bids coming in. We also look at the impact of the private sector's proposal on efficiency of running the core services, so looking at a hospital project, for instance, if the design put forward by the private sector party has a positive impact on how efficiently we can run the hospital obviously that would be taken into account. If there is a negative impact obviously that would also be taken into account. Qualitative assessments are also considered, like is this likely to be sustainable, this particular contract; what is the substance of the private provider? Have they provided or offered better services than what is in the contract? So things like that are taken into account.

You asked us to address the benefits to the community. They are particularly taken into account, the public interest assessment, and also for a major project the cost benefit assessment is done before the funding is put up to see whether the project should go ahead at all irrespective of whether it is publicly or privately delivered.

This next slide is an example - it is of five projects that have been picked out that are currently being run. The risk drivers are across the top: risk transfer, whole-of-life costing and innovation. The asset/site utilisation is about the scope for third-party revenues to be involved which can lower the net cost to government.

The CHAIRMAN - What does a bracketed tick mean?

Mr MAGUIRE - It means perhaps there is limited scope for innovation. The bracket is there for prisons because the government is actually specifying the designs for individual cells.

The CHAIRMAN - I am just wondering how it differs from a cross.

Mr MAGUIRE - It is not quite a full tick, but it is a limited tick. I will leave those with you, I think.

MrTHEOPHANOUS - Do you make a distinction between those projects like prisons where in effect the client is actually the government? The government pays an amount of money for each prisoner to be there, and something like City Link where the client is actually public, so the public is paying City Link? Is there some difference in the way that you analyse those two types of arrangements? Obviously, in the case of the prisons example, it seems to me that what you've got is a long-term commitment by the government to actually provide funds, and indeed prisoners to put in those cells, so the arrangement is a bit different to City Link where there is no arrangement to actually provide people to drive their cars down and pay their money; do you make any distinction on that basis?

Mr MAGUIRE - We do, through the financial analysis of the public sector comparator. That will build up the costs and risks associated with the project, both the capital cost and the recurrent cost. If it is a prison, the sum of those parts is what the public sector comparator is. With a City Link, for example, the third or the next piece of information is what revenue, government or a private sector operator would receive from the public to use that and therefore you start to diminish the cost by that revenue. So it flows in – yes, there is provision within the public sector comparator to capture external revenue.

MrTHEOPHANOUS - But you would also in the case of the prisons have to guarantee a certain number of prisoners in the cells, wouldn't you?

Mr MAGUIRE - We won't be doing that, but obviously if the accommodation is provided and **[with the annual data] [This text to be checked]** we maintain the right standards, we will be committed to actually providing those payments for that particular service.

MrTHEOPHANOUS - You have to pay for the cell even if there is no prisoner in it.

Mr MAGUIRE - It is just like building it ourselves, if we maintain a prison and look after it.

MrTHEOPHANOUS - The answer to that is yes.

Mr MAGUIRE - Yes. County Court is a bit different because there is actually a facility that exceeds government's requirements at the moment in County Courts, and the government actually has some options to use additional court rooms in the future, and we are paying nothing for that option, it is part of a structure that pertains to government, so that is another example where there is some flexibility in some assets. It is properly a low risk there.

I have spoken to this briefly in a slide or two back. Assessment of value for money: the PSC is just one of the elements we look at in assessing value for money, because that simply relates to the cost of the private party providing the contracted services and the PSC measures the cost of the government providing those contracted services. Obviously if you are doing a prison or a hospital, a lot of the services are simply done by the government, so the impact of the design submitted by the bidder needs to be taken into account.

The third point I have spoken to already. So the value for money is not just a public sector comparator; although that is a very important element.

Risk allocation and management. Sufficient risk allocation is one of the key value-for-money drivers in seeking optimum not maximum risk transfer. One of these documents provides the very detailed allocation of risk issues. The Risk Allocation of Contractual Issues guide is in here with a matrix summary at the end. That has been used as a basis for all Partnerships Victoria projects in risk allocation. The next slide. We have listed the major key risks as we have categorised them. The red ones are the ones the government would primarily bear; the green ones are the ones we are more likely to share, and the blue ones are much more likely to relate to the private sector. They would vary from project to project, obviously, like market risk; if you had a tollway project - and I would certainly have to have a look at the books - but that would be taken up by the private sector primarily. If you had obviously a hospital project or a prison project, the government takes the market risk, so some of these risks will jump around from project to project.

Mr RICH-PHILLIPS - Why does legislative government policy risk rest with the government rather than private sector; why is the government setting the legislation?

Mr FITZGERALD - That is, I guess, the reason why government from the private sector's perspective, is in control of its own legislation and policy, and particularly the regulatory regime and issues, so the government can always determine what impact through legislation it might have on a project going forward.

The CHAIRMAN - And if it fails to adequately address the contract of issues in the legislation.

Mr FITZGERALD - That is right, then it is a risk for the contractor, so he has no control over that.

Mr RICH-PHILLIPS - I am surprised it is not out as a high risk to the private sector and a low risk to government rather than a high risk to government.

Mr FITZGERALD - The risk to the project - well yes, from the private sector's perspective it is high; if they have to bear it, it is a high risk. We are saying that this is a risk that government has to bear predominantly.

Mr RICH-PHILLIPS - I see that is what you are saying, but I would argue that government does not bear sovereign risk because government creates sovereign risk and government controls sovereign risk because it sets the regulatory agenda, the legislation. The sovereign risk is a risk to the private sector partner.

The CHAIRMAN - But here we are also talking about identified risk, aren't we?

Mr FITZGERALD - That is right.

The CHAIRMAN - And what we are talking about is that a contract has been entered into which specifies that the government will ensure certain things as a result of that contract. If the government fails to ensure those things, then --

Mr FITZGERALD - In the contract the government says, "Yes, we will take risks to the cash flows of this project in respect to legislative risk". If government halfway through the project says, "Look, we are changing the regulation or the legislation" and that impacts adversely on the private sector's returns, we are going to have to make that good because we took that obligation on through the contract.

Ms DAVIES - That is where you get the idea of not being able to improve your public transport, because a government has said you are going to make this much money from City Link. So in fact the risk – the public transport improving - was a risk for a private contractor of City Link.

Mr MAGUIRE - I think we can speak generally. There is a material adverse effect to the contract. If the government changes the parameters, it does have to address those to the owners of City Link, yes. The allocation for government risk – the government can usually most efficiently bear that risk, I suppose is the point we are trying to make.

Contract management is a very important issue for government as well. We can't just ignore these things once they have been signed. We actively manage the contracts once they have been signed, and we have certainly put increased focus on that at the moment to assist agencies to do that, and also protect the Treasurer's exposure as well.

This is the last slide. Certainly in the case – perhaps not so much in Victoria but certainly in Australia - there has been a focus on economic infrastructure of roads, water treatment plants and rail projects; there is certainly a growing focus around the nation on social infrastructure, its needs and whether we can provide them under the **[structural] [text to be checked]** arrangements. Certainly there will be a growing need for social infrastructure in aged care and hospitals, et cetera, and if we are to get value for money out of this type of arrangement it needs to be looked at very closely.

The CHAIRMAN - While we were in the early 1990s we were pretty much out on our own with this stuff. There is a fair body around the world now which has been built up in various places, doing things like building public interests or comparators, those sorts of things. Are there any places that you looked at or people you were in touch with, or anything worth learning from?

Mr FITZGERALD - Certainly the UK, in developing these policies and guidelines we did look very closely at the UK experience, which is probably the deepest market. We do maintain constant contact with developments in the UK. We look at the projects that have been developed and learn from that. But we are also in close contact with other states, with the commonwealth and with other jurisdictions such as Canada which is also developing similar policies.

Mr MAGUIRE - Internationally, Holland and Ireland have taken up this area - certainly in the last four or five years only - but they have pretty robust approaches as well which are worth looking at.

Mr FITZGERALD - We don't see this policy as being set in stone. With 12 months or two years experience, it needs to be reviewed and improved, and I think that is critical.

The CHAIRMAN - And I guess one of the things that you have been saying throughout is that this is actually evolutionary.

Mr FITZGERALD - It is, absolutely.

The CHAIRMAN - Perhaps that is a reasonable time to stop. Thank you for your time. We certainly look forward to the detailed submission from you. We believe, as you do, that it is a very interesting area of public activity and one in which there is a great deal of interest both from in the parliamentary scene and from within the general public. We look forward to the submission. Thank you for your time.

Witnesses withdrew.

CORRECTED VERSION

PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

Subcommittee

Inquiry into Private Sector Investment in Public Infrastructure

Melbourne – 30 April 2002

Members

G. K. Rich-Phillips	Ms S. M. Davies
T. C. Theophanous	T. J. Holding
R. Clark	

Chairman: Peter Loney, MP

Staff

Executive Officer: Michelle Heane
Research Officer: Caroline Williams

Witnesses

Russell Walker, Assistant Auditor-General, and

Steve Mitsas, Director, Statewide and Central Agencies, Victorian Auditor-General's Office.

The CHAIRMAN - Can I welcome Mr Russell Walker and Mr Steve Mitsas from the Victorian Auditor-General's Office to this Public Accounts and Estimates Committee briefing on Private Sector Investment in Public Infrastructure.

All evidence taken by this committee is taken under the provisions of the Parliamentary Committees Act and is protected from judicial review. However, any comments taken outside the precincts of the hearing are not protected by parliamentary privilege. All evidence is recorded. Witnesses will be provided with proof versions of the transcript early next week. I would like you to feel free to make any remarks you would like to.

Mr WALKER - I have put forward a detailed submission to the committee. It was mailed yesterday.

The CHAIRMAN - What we are doing today is more in the nature of a general background briefing.

Mr WALKER - I would like to outline a number of points. The key element of the work undertaken by our office over the past decade has been to examine major PPP arrangements established by the government with a view to assessing and reporting to the Parliament the impact of such arrangements on the state's financial obligations and future financial commitments, the key risks associated with the arrangements, and the integrity of process is followed in relation to project evaluation approval and contractual selection, engagement and management. The nature of these arrangements, including the risk allocation between the public and private sectors has substantially evolved over the past decade. This reflects the increasing development and maturity of private investors and their willingness to accept certain levels of risk.

It would be true to say that the first generation of PPPs involved the allocation of substantially less risk to the private sector than later arrangements, as reflected in the provision of substantial guarantees and indemnities by the government to the private sector.

The CHAIRMAN - Where do you date the first generation of PPPs, because we have just had Treasury and Finance appear – just to see if we are consistent?

Mr WALKER - Late '80s, early '90s would be the first generation.

The CHAIRMAN - 1990 to 1992.

Mr WALKER - Yes. As investment markets deepened and the prevalence of private sector involvement in the provision of public sector infrastructure worldwide increased over the past decade, the sophistication of such arrangements has increased, so too has the risk allocation. Investors are now more willing to accept operational and demand risk than at any time in the past.

The key challenge of the arrangement is to establish appropriate risk allocation, effectively manage and adequately oversight the arrangement to ensure that the public interest is protected. In the establishment of such arrangements it needs to be recognised that irrespective of the mode of infrastructure provision / funding certain risks associated with public infrastructure are difficult, and in some cases inappropriate to transfer to the private sector, such as the government's duty of care, reflecting the public sector's underlying responsibilities associated with public sector service provision.

In relation to the benefits and disadvantages to the community in relation to such arrangements, the experience of the Victorian public sector in relation to the PPPs has been mixed, in part reflecting the key drivers behind the specific projects established. Our reports to Parliament, which are outlined in our detailed submission and the references thereto, have identified that in many cases comprehensive cost benefit analyses have not been completed to support the decisions to proceed with the selected PPP models.

A key driver for earlier projects was to facilitate off-balance sheet and purported cheaper financing of public infrastructure through the structuring of arrangements to achieve these outcomes; in many cases via tax-effective structures. With changing commonwealth tax arrangements and lower interest rates, the outcome for the state from a large number of these projects was adversely affected, with the projects becoming more expensive and required to be terminated in a number of instances.

MrTHEOPHANOUS - Can you give an example?

Mr WALKER - The early arrangements would be the World Trade Centre, National Tennis Centre, and accelerated infrastructure program, which was involved with the construction of court houses, police stations, the Werribee Public Hospital.

MrTHEOPHANOUS - Thank you.

Mr WALKER - Later PPPs, such as Latrobe Public Hospital and the Metropolitan Women's Correction Centre, were established in a competitive environment with tenderers participating in the tender process with a view to entering the market and submitting lower cost proposals incorporating aggressive assumptions regarding available cost efficiencies. In such cases substantial financial difficulties by the private sector operators forced a return of the service provision and associated infrastructure to the public sector.

While the original arrangements placed considerable risk on the private sector and allowed the government to walk away from such arrangements in the case of poor performance by the private sector operator, in each case the government decided to take over the facility principally due to the underlying obligations to provide the related public service.

Given the differing characteristics and profile of each PPP, assessments of the benefits and costs can only be taken on an individual basis. However, it needs to be understood that even though there may be changing technology and community needs and expectations, such arrangements can commit the state to specific delivery models over a long period of time and restrict future policy options.

In relation to the legislative and policy frameworks, the framework associated with PPPs in Victoria is set out in Victoria's Partnership Victoria policy which was published in June 2000. The framework is similar to that adopted in the United Kingdom, and has been used in the development of frameworks in other jurisdictions in Australia. Our assessments of the framework indicates that it provides a sound platform for the development of PPPs. However, given our assessment of PPPs over the last decade, have shown that key elements of effective project evaluation have not been followed; optimal outcomes from new arrangements will not be achieved unless all elements of the framework are observed. As you are aware, to facilitate transparency over contracting arrangements the government in October 2000 also released a policy statement entitled Ensuring Openness and Probity in Government Contracts, which requires the public disclosure on the Web of certain contractual contracts.

Ms DAVIES - Are you making a statement there that the government's current policies that are currently published, if they are all adhered to, they will be sufficient? Is that what you just said, or that they are not yet sufficient?

Mr WALKER - We believe they are, but it is going to be very important that all aspects of them are implemented.

Ms DAVIES - So they are only sound if all aspects are implemented. Are there aspects which you believe should be incorporated which are not part of that?

Mr WALKER - No, I think it would be fair say at this stage we have not identified any issues that we believe ought to be incorporated that are not already in the framework.

In relation to protecting the public interest and value for money and risk allocation, the key elements of the Partnerships Victoria framework include the conduct of cost benefit analysis of all proposals, public interest assessments, taking into account issues such as consumer rights, affected individuals and security and privacy, the development of a public sector comparator which facilitates comparisons of private sector bids with public sector provision and risk allocation based on value-for-money considerations, and the principle of risk should be managed by those best able to manage them.

The adequacy of these assessments and risk allocations are key determinants of the outcomes achieved by the state from PPPs. Based on our discussions with counterparts in the United Kingdom, where public sector comparators are also utilised in PPP assessments, caution needs to be taken from a number of perspectives, including comparator analysis should not be seen as only a means of supporting decisions on whether to proceed or not to proceed with PPPs; rather they could also be used to drive better value for money from private sector bids by focusing on individual elements of the bids that could be approved. Data and assumptions incorporated in the comparator analysis are subject to substantive uncertainty and volatility, and therefore care needs to be taken when assessing the results from the comparator.

A single comparator analysis can provide a narrow view compared with the determination of multiple comparator values based on various scenarios, and limitations associated with certain costing systems within the public sector may restrict the availability of suitable data and therefore also restrict the results of the analysis.

The other important issue is to ensure that decisions to proceed with such arrangements are driven by value-for-money considerations and not whether the arrangement will be recognised off balance sheet.

MrTHEOPHANOUS - That's a tall order, isn't it? How do you determine that, where the tendency of governments is to want to get things off the balance sheet?

Mr WALKER - It may be, but it is our view that it should be driven from a taxpayer perspective, and that is value for money. Whether it is on a balance sheet or off a balance sheet at the end of the day is not significant from a taxpayer perspective.

MrTHEOPHANOUS - Your role is not to defend the taxpayer.

Mr WALKER - We audit and hopefully report to the Parliament, and the Parliament here is hopefully representing taxpayer. So what we would look at, like any arrangement, is to assure that best value for money is obtained from whatever project the government enters into.

MrTHEOPHANOUS - So if City Link was publicly built for $2 billion, have you worked out how much it is going to cost the public over 35 years in tolls and whether it is value for money for the public, or did you simply go and do the analysis of whether it is good to have $2 billion off the balance sheet?

Mr WALKER - No. I would have to go back into the report. Out of all the arrangements we looked at I suppose it does not necessarily spring to mind. The details will come out of our review, but one of the key issues we found was that a detailed cost benefit analysis was not undertaken to support the decision to proceed with that project, and that was one of the findings we had in our report to Parliament.

Mr MITSAS - At the end of the day the reporting of arrangements is quite secondary to – if you are looking for value for money, the fact that you have something on balance sheet versus off-balance sheet should be irrelevant as to what is the better component to proceed with. Taking into account all the pros and cons, if the project proposals -

MrTHEOPHANOUS - I think that is a very naive approach, isn't it? In relation to the sale of the electricity industry, which you were involved in to some extent, there was a very big advantage to government - if you are looking after what government is doing - there is a huge advantage to government because they got such a high price for the electricity industry. But it might not be necessarily a huge advantage to electricity consumers who might finish up paying a hell of a lot more for electricity over the years. That would not have been a concern of your office; is that correct? Your office would have been concerned with the finances of the state, the state government, and in that sense it was a good deal.

Mr WALKER - We looked at it from the perspective of did the taxpayer get the best return, and the probity of the process - the proper process was followed through the privatisation process - and did it result in all the necessary steps being undertaken to ensure to the taxpayer got the best return.

MrTHEOPHANOUS - But not the consumer of electricity.

Mr WALKER - Well probably at the end of the day, in the longer term the benefit will come back to the taxpayer, and that is something that will be very difficult to judge over the short term but will be something to look at over the long term.

MrTHEOPHANOUS - I just think your public interest thing depends whose public interest you are talking about. If you are talking about the government's interest, and even if you are talking about the taxpayer's interest, it might not be the same interest as the interest of electricity consumers who are the public in that sense as well, but there are different ways of defining the public, and your analysis does not take that into account; it is not part of what you do. Is that correct?

Mr MITSAS - I guess that is right in a sense that we are precluded from commenting on policy, and I guess the coverage of government is a matter of policy.

The CHAIRMAN - I was going to make a similar comment. I would have some of the same queries and questions as Theo, but I think your charter is somewhat different.

MrTHEOPHANOUS - I am not criticising it; I am just saying that's your charter.

The CHAIRMAN - I think this whole issue of public interest is one that is not just being argued out here, but is being argued out in a number of places, and places are dealing with it quite differently, and it is to me different to the public sector comparator, which is basically about the financial arrangements more than anything else.

I want to ask you, Russell, in relation to that, when I spoke to the NAR about 12 months ago and was talking about them about the public sector comparator at that stage, they were indicating some reservations about it and they actually gave me an example of what they were talking about - a $75 million project that had been assessed through the public sector comparator as having a public benefit.

When the audit office actually queried what the public benefit was, it had been assessed at £100 000 in a £75 million project, but when they looked further they had not taken into account the costs that the consultants used to provide the advice, et cetera, to the department which ran into about £600 000. So they were saying some of those sorts of things around the way the public sector comparator in England is being used were of concern. Now you've spoken to them, I think, more recently than I have. Are they still talking about those sorts of things or is that being worked out?

Mr WALKER - The issues I have just outlined, those four concerns, were the issues that were raised through discussion with the UK. But completeness of data in any analysis is a key risk. It is picking up, or ensuring you are picking up all the costs associated with the private sector as well as ensuring you have accurate costings in relation to the public sector provision. What we are saying is that, it is not really the end, but clearly this is one of the factors that should be considered as part of the selection process.

Mr HOLDING - Do the shortcomings cut both ways? Is that what you are saying? Or in relation to identifying all the costs has there been any ability to identify all the private sector costs or is it accurately identifying the case of a public sector comparator actually identifying all the true costs to the public sector providing the service?

Mr WALKER - It is probably more the latter, because the private sector should be covered in the tender arrangement and the bid. Of course, as we know with some of these arrangements with experience, these are extra costs that come back to government, which is a risk; but it is ensure, like with any comparator, that all the data is considered.

The CHAIRMAN - I think what they were indicating to me was a bit further, that also once you've got that and you've got the data, even though you are confident and make sure it is all right in the case of this one - £100 000 in a £75 million contract - does 0.1 per cent or thereabouts benefit, does that actually constitute a reason for going ahead? That was the sort of question I think they were get go to.

Mr MITSAS - I think the issue they raised with us was that in using the comparator we need to recognise its limitations in the sense that it is developed in the context of quite a bit of volatility and uncertainty. So what you have is an assessment of hard private sector bids, which put the money where their mouth is, and you have this other, if you like, artificial comparator which projects cash flows, sometimes out into 20 to 30 years, and with multiple assumptions with, if you like, are highly sensitive. So a little movement could actually make a big difference.

I guess the lesson for them is the comparator is a good tool to use, but you need to use it with caution; and that's why that brings into relevance the comments that Russell raised, that other considerations should be taken into account. For example, perhaps it might be more useful for multiple comparators to be developed based on different scenarios to provide, I guess, a more informed basis of decision-making. For example, given the sensitivity of the assumptions, also another interesting issue they raised was that while the comparator at the moment is used to, if you like, support the value for money argument, there are greater uses that could be put to it in the sense that the public sector going into an analysis of what the public sector provision cost could be, they could actually use that analysis to increase the benefit of public sector comparators; it might point out certain components of certain bids that could be further developed. So to use that in a more interactive way, and they are the general, I guess, lessons over there.

MrTHEOPHANOUS - I think the point I was trying to make before is that there are two types. There is what you might call a closed system, like as in prisons, where the provision of the services to the government; ultimately, the customer is the government in that instance. And your role then is a lot easier, because what you are doing is looking at a closed system, how much is it costing ultimately? Is it value for money to keep the prisoners which the government is paying for? But that is different to say public transport, where you look at the taxpayers interests and the government's interest and you might come up with a certain answer, but that might not be the interest of the commuters. The commuter’s interests might not be served by that examination. The commuters might finish up paying a higher price, even though the government is getting a deal which is somehow better, it has reduced its debt or it has done other things. And I am very interested in that aspect of those two different types - the closed system and the not-closed system, if you like. If you can get any information in relation to that, I would be quite interested.

The CHAIRMAN - Thank you. Continue.

Mr WALKER - In relation to the management of PPPs, the effective management and monitoring of these arrangements once established is critical to the overall outcomes achieved. Typically, as larger PPPs are developed specific project teams are established drawing on both internal and external expertise to work through the emerging issues associated with their effective creation. However, once the arrangements are established and operating, these teams are generally dispersed, with a resultant loss of detailed knowledge of the arrangements.

A further issue that emerges from the long-term outsourcing arrangements is that over time there is a loss of expertise in the effective oversight of the arrangements given that the state may no longer be involved in areas similar to those subject to the PPP, and therefore individuals responsible for oversight functions may not fully appreciate the associated management issues. This represents a major issue impacting on the effective ongoing oversight of the arrangements. This is a similar problem that is experienced in other jurisdictions, including the UK. Therefore, it is important that effective strategies are developed by the public sector to mitigate these risks. This is particularly important, given the public sector's ongoing duty of care associated with key aspects of public sector service delivery.

Finally, in relation to accounting and accountability: a major issue associated with the arrangements is whether the arrangements can be recognised as part of the state's assets and liabilities, that is on-balance sheets, or as part of the state's commitments, that is off-balance sheet. Early arrangements were similar to finance leases, and under the tests outlined in the accounting standards were required to be recognised as part of the state's assets and liabilities.

Later arrangements have been developed so that they don't meet the tests in the standards relating to finance leases, and that the accounting standards do not specifically deal with these arrangements. However, the standards require that all transactions be reported in accordance with their substance and not their legal form. In addition, the concept statements issued by the profession provide a broad framework for assessing whether the assets and liabilities may be created under these arrangements. It is our view that given the complexity of the arrangements, the substance of the individual components of the arrangement need to be individually assessed; that is separating the supply and the financing elements, with reference to the underlying rights and obligations of the respective parties to determine whether they meet the definition of an asset or liability, and the associated recognition criteria. In this regard consideration is given to a range of issues, including demand risk, residual risk, obsolescence, penalties for underperformance or nonavailability.

The adoption of this approach by our office has resulted in the recognition of a number of Victorian PPPs on balance sheet, including the public sector motor vehicle lease arrangements, the accelerated infrastructure program and the St Vincent's Hospital redevelopment. This approach has also contributed to the provision of additional disclosure within the government's annual financial statement, where the level of financial commitments associated with off-balance sheet arrangements have been disclosed.

In the United Kingdom the accounting profession has developed a standard known as FRS5, which was issued in September 1998, which provides a standardised approach to determine the appropriate reporting of such arrangements. While there is some conceptual differences between the frameworks in Australia and in the UK, in broad terms the approach adopted in FRS5 is relatively consistent with the approach adopted by our office in the past in assessing these arrangements.

As a final comment: the Partnerships Victoria policy is relatively new, and we look forward to assessing new arrangements developed under the framework which will better place our office to provide feedback to the Parliament and this committee on the effectiveness of its implementation and the resulting outcomes.

The CHAIRMAN - To go to a couple of things: for this inquiry, in your view, where are the key areas for the future on which an inquiry of this nature should focus?

Mr WALKER - I suppose there is the potential advantages and disadvantages of such arrangements. I suppose clearly understanding them, ensuring that there is a framework in place that we believe will drive obtaining the best provision of infrastructure for the government, and ultimately at the end of the day; and ensuring that the possess is followed, I suppose resulting in appropriate risk sharing, innovation, and able to benchmark public sector performance against private sector performance, and I suppose overall cost efficiencies. But I suppose at the same time recognising that entering into these arrangements also leads to reduced policy flexibility, because the arrangements have got long-term lock-ins.

Mr CLARK - At this point in relation to the aspects that you will be looking at, the PPP process, will you be looking at issues of timeliness and therefore value-for-money or service delivery to the public in terms of how well the process delivers projects, how quickly projects come on line, whether there has been value lost through delays in getting projects running, whether the PPP process unnecessarily complicates the provision of capital assets or whether there is something flawed in the way it is actually being administered?

Mr WALKER - We always review projects in relation to the established timelines and costs that have been agreed with the private sector provider, and report against how the government is progressing in implementing against the respective time lines. As I said in my opening comments, the various issues we have looked at is the key risks associated with the arrangements, whether we understand them, who's managing them, the integrity of the process followed in the project evaluation and approval and the selection and engagement processes.

The CHAIRMAN - I think it is an interesting point Mr Clark makes and where the appropriate comparison is in relation to delayed timelines and so on, and whether that comparison is to completely a public project as how that might have developed as a timeline or a project in the private sector and as to how that might have developed, so the basis of comparison is also particularly important, just what you are actually comparing timelines to I think is important.

Mr WALKER - I suppose one thing you have to be careful with is that if you develop a comparator and a decision is made to proceed with one way versus another, I think it is then wrong to go back and say we are now implementing the private sector arrangement and then comparing it with what the public sector would have done, because you've made that choice based on cost efficiencies and time efficiencies, so hopefully you are saying "I have taken that choice because I am going to be able to implement that a lot quicker" or at less cost. So therefore it is important then to say "I have made that decision; the decision has been made on these criteria" and you then need to benchmark the performance against those established criteria, because that is why you have made that decision.

Mr CLARK - Assuming that is the right decision, or are you saying it is a policy call by government and therefore you are not going to question whether or not it could have been done better as a public project.

Mr WALKER - That is the analysis we would be looking for in the decision-making is, to ensure that those issues have been worked through in the decision-making process, to say has there been a proper cost benefit analysis undertaken to support the decision. If there is not, we would report to the Parliament and say we don't believe there has been a comprehensive one done, or yes the process was valid.

Mr CLARK - The issue I want to raise is in relation to on-balance sheet versus off-balance sheet. I hope you are familiar with the County Court project, for example, which I understand has a mixture of availability fee and a facility fee. I want to get the labels right, but one is a sort of flat fee and one is based on how much of the facility is actually being used for court hearings. I am trying to work out what the difference is between that and a long-term lease of a serviced office accommodation, or quite arguably essentially a financing transaction or a service delivery transaction; how do you go about assessing whether or not a project like that should be on or off-balance sheet or whether it should be classified as a long-term lease or a PPP?

Mr MITSAS - The audit assessment, I guess, at its basic level firstly involves identifying what the risks and obligations of the various parties are and allocating them to where they sit; and then making a call in terms of whether any of those, if you like, collectively give rise to an obligation, an asset or an obligation. I guess one of the criteria that is used is what is in the accounting standard AA17, which deals with finance versus operating leases, and they have some criteria there about the extent of useful life that is tied up in the arrangement and also the cash flows. For example, if the non-cancellable cash flows are greater than 90 per cent, then it is a financing arrangement.

In terms of the County Court example, my recollection is that there are provisions within the arrangement whereby, the government only commits to a certain percentage of the accommodation with the private sector accepting a level of risk associated with the assets and the facility. I can't recall the actual detail, but in that case on balance we believe that the private sector were at a substantial risk in terms of demand risk in terms of that asset, and therefore it was inappropriate for the state to recognise that asset on its balance sheet. It is a detailed assessment, but it really does involve consideration of things such as demand risk, the residual risk, what happens to the asset at the end of the term, is the public sector required to acquire it or is the public sector then left with the demand risk, the operating risk, et cetera? It is to do with obsolescence, it is to do with risks associated with operating costs, and on balance there is an assessment of the substance of the transaction.

Mr WALKER - My understanding of the Country Court arrangement was that there was a percentage of the building that was going to be occupied not by government but by the private sector and therefore the demand risk on balance did rest with the private sector. Now whether that actually happens once it is opened will be a different thing.

MrTHEOPHANOUS - Is it the case that we are talking about BOOT schemes, which is similar to the City Link scheme, is that a risk at the end of the period when the transfer occurs back to the public sector; does that become part of the factored-in risk in that sense? I mean, it has to come back and be run by the private sector; isn't that a risk?

Mr MITSAS - It is. The arrangement needs to be called at a point in time. The question, for example, with City Link is; is there an asset and liability to be recognised by the state and once you go into the accounting standards, and the accounting framework, there is a definition of what an asset is. In term of an asset, we have to have a present entitlement. In the case of the City Link it is undoubted that at the end of the concession period the state will gain control of an asset. The question from an accounting perspective is quite technical; it is whether at the moment the state controls an asset, whatever you may call it. I guess, having a look at the arrangements, which are quite complex, we concluded that there is no present obligation by the state in relation to the financing and there is no current entitlement to an asset, so on that basis it is off-balance.

MrTHEOPHANOUS - It is off-balance sheet.

Mr MITSAS - Yes. There are definitions in the accounting framework, and there are certain criteria that have to be met, notwithstanding the substantial judgment that is involved in making those calls.

MrTHEOPHANOUS - Whereas your office made the call on the trams, the financing arrangement in relation to the trams some time back, that that was in fact a financing arrangement and therefore should be on-budget.

Mr WALKER - The key reason for that was that the government had issued a guarantee or an indemnity back to the financiers so therefore the risks actually sat back with the state and not with the financier.

Mr MITSAS - I believe in that case also there were quite restrictive termination clauses so that, if you like, the state had a right to termination, but if they did there were quite prohibitive costs involved, so in reality it was never an option. And in fact that is what happened; at the end of the day the state made the residual payment and kept the stock.

Mr WALKER - A lot of the more current arrangements have got more structured walk-away provisions in them. So in other words if the financier is struggling financially the government can either step in, run the facility, while it constructs another facility and then walks away or can actually take over the facility as we saw with the Latrobe Hospital and the corrections centre.

Mr MITSAS - The reality is the risk sharing model has shifted quite substantially in the last 10 years. As Russell commented, the early arrangements were established to avoid the legal classification as finance leases, but in reality the private sector risk was actually quite low, so in reality those guarantees and indemnities provided the means by which that risk remained with the state; but as these arrangements have become more common around the world, the private sector is now honestly willing to accept more risk, and that is reflected in the type of arrangement, such as the prison arrangements.

MrTHEOPHANOUS - Where is the risk in the prison arrangement if there is a guaranteed price for the cell, irrespective of whether there is a prisoner in the cell or not; where is the risk?

Mr MITSAS - Are we talking about the supply risk or the asset risk? In terms of the asset risk, my understanding of those arrangements is that if the required services are not delivered to quality specified in the contract, subject to certain cure processes, at the end of the day the state has the option to actually terminate the arrangement and walk away.

MrTHEOPHANOUS - Is that why it is off budget?

Mr MITSAS - Is it one of the considerations.

MrTHEOPHANOUS - Putting it off budget?

Mr MITSAS - Off balance sheet, yes. The residual risk is quite substantial in determining where these arrangements are reported.

Ms DAVIES - You talked about the earlier arrangements, there were very prohibitive clauses that effectively prevented a takeover possibility, and you mentioned City Link as being one of those.

Mr MITSAS - No.

Ms DAVIES - Which projects specifically have you identified as being the arrangements within the contract were so prohibitive that you wouldn't have a Latrobe Regional Hospital situation?

Mr MITSAS - In terms of the first-generation arrangements that were prohibitive – and I guess in a sense forced the government of the day to pick up the assets on termination - are the likes of the World Congress Centre, the initial transport leasing arrangements, the accelerated infrastructure program. Monash Medical Centre, automated ticketing.

Ms DAVIES - Have you got a full list there?

Mr WALKER - In our detailed submission we have provided a complete list of all the projects we have examined and the references to our reports to Parliament.

The CHAIRMAN - Thank you for coming in this morning. Just one final question, Russell: you've spoken about the UK experience, and I think we are also aware that Canada has a fair body of knowledge; are there any other areas that you are aware of that are doing detailed work on the sorts of issues in PPPs that we have been talking about today?

Mr WALKER - I think it is a worldwide development. I suppose we took the opportunity when we were in the United Kingdom to look at this issue, plus we looked at accounting and performance reporting, so it was an opportunity to look at what the issues they were grappling with, I suppose, in that jurisdiction. I think it would be fair to say that these developments are spread out throughout the world and I am not sure which jurisdictions --

MrTHEOPHANOUS - Can I just ask you a question about China, which comes from a different perspective, but which is in some respects involved in the biggest experiment ever of public-private partnerships with a massive amount of partnerships being let out that are kind of semi-public; do you have any knowledge about what is happening in China?

Mr WALKER - No.

MrTHEOPHANOUS - It is becoming one of the biggest economies in the world, and a lot of it is based on partnerships with the public sector where the private sector and big multinational companies and so forth are coming in and doing those partnerships; you have no knowledge of that?

Mr WALKER - No, I am not aware of the breadth of the projects happening in China.

The CHAIRMAN - I thank Russell Walker and Steve Mitsas for their attendance here this morning. We certainly look forward to receiving and reading your submission on this issue and no doubt we will get back to you at some time in the future.

The witnesses withdrew.

CORRECTED VERSION

PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

Subcommittee

Inquiry into Private Sector Investment in Public Infrastructure

Melbourne – 30 April 2002

Members

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T. C. Theophanous
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Witness

Dr Raphael Arndt

The CHAIRMAN - I welcome Dr Raphael Arndt. All evidence taken by this committee is taken under the provisions of the Parliamentary Committees Act and is protected from judicial review. However, any comments made outside the precinct of the hearing are not protected by parliamentary privilege. All evidence today is being recorded, and as a witness you will be provided with a proof version of the transcript early next week. Would you like to make some comments?

Dr ARNDT - Thank you to the committee and Mr Chairman for the opportunity to present today. I have done my best to respond to the issues I was sent by you, and it has been a bit difficult in some areas, given my background, but I have done my best to address them, and that's the overview of the briefing that I will give today.

I guess the majority of what I am going to say, if you look over the page, are my personal views. All the views are my personal views, and I just need to say they do not reflect the views of my current employer, Hastings Funds Management, or any other organisation, but they do refer substantially to the work I did in my PhD at the University of Melbourne, which was focused on risk allocation and followed closely by the Victorian Treasury and some of the work on that. I should point out that the thesis is available on the Internet, and I have given at the back of the presentation a number of the references that I will use. I have provided information about where you can get those documents from, and if any member of the committee wants to contact me to chase up any of these things, I would be more than happy to provide further assistance.

It is important to say why governments should look at private investment in infrastructure and public services at all. Some of the work I did when I was doing my PhD looked at current spending, and it was very clear that total public spending on infrastructure is actually falling in real terms and relative to GDP. The ABS statistics, which I have indicated on the left, showed that at least up until 1996, 10 years before 1996 as a percentage of total infrastructure spending - as I said, acquisition spending - private spending as a proportion of total rose from only about 7 per cent to almost one quarter. And unfortunately the ABS stopped collecting those statistics in '96. When I contacted them, one of the reasons they gave for that was because it got too hard to distinguish between public and private sector infrastructure provision. So I think it would be useful if Australia's governments put some pressure back on the ABS to collect these statistics, but nevertheless I am sure that percentage would have increased since '96.

It was also clear that governments throughout the developed world have shifted emphasis from capital funding to recurrent funding over the last generation or so; it is not a short-term process, it has been a very long-term trend. At the same time the community at large – and this is not restricted to Victoria by any means – is demanding quality services. People in regions are looking at service delivery in cities and saying why can't they get the same quality services. The community is increasingly educated as to what is going on internationally, particularly through the Internet, and if there are better services available somewhere else then local communities want to know why. So it is incumbent on governments and parliaments to spend money wisely and to seek value for money, and I quote here from the Institute of Public Policy Research, which did a very interesting review of the private financing initiative and PPPs in the UK, where they basically said: "Getting public-private partnerships right is vital if the quality of the UK's public services is to meet the expectations of the British public over the next decade". They see PPPs as an essential way to deliver decent public services.

In terms of definition of public-private partnerships today, I thought I would use the definition that AusCID, the Australian Council for Infrastructure Development, developed: "A public private partnership is a partnership between the public and private sectors for the purpose of delivering a project or service that is traditionally provided by the public sector. It often involves private financing and management, with the government overseeing the objectives and running of the project. Unlike privatisation, PPPs usually involve the creation or construction of a new asset or facility."

So it is important to distinguish between PPPs and privatisation, which is actually the selling of an existing asset; whereas PPPs involve the creation of a new asset and service.

Obviously public and private sectors work together and divvy up their responsibilities. It is important to say, I guess, that in all cases, in my view, the public sector should be responsible for things like strategic planning, regulation, identifying and funding community service obligations, planning and facilitation and consumer protection, and in some cases what is now termed core service delivery - and that is a different issue that I will get back to. But the government's role should be limited wherever possible, because I think it is more appropriate that private investors accept business-type risks rather than governments; that's not what governments are set up to do, and that approach allows government to focus or core issues to government and the community. I was asked to comment on the benefits and disadvantages of Victoria's public-private partnership experience, and that is quite difficult to do. Victoria does have extensive experience in this field, and certainly has the most experience of any Australian jurisdiction, and probably would be close to the most experienced jurisdiction in the world for an economy of its size. As far as I am aware, the only comprehensive review of Victoria's recent experience was the Audit Review of Government Contracts, which was the Bill Russell report commissioned by this government, and its executive summary said: "From a financial and economic standpoint, the contracts brought very substantial benefits to Victoria."

The important feature there is obviously from a financial and economic standpoint. There are other issues I will come back to. Otherwise projects need to be considered on a case-by-case basis, and there is varying information to enable academics like myself to come to these opinions. Although I did do quite a complex comprehensive analysis of the risk allocations in the City Link project, which is published on the website, and to quote from that:

> **"The City Link agreement is a significant improvement on previously private funded roads in Australia due to a greater degree of risk shifting to the private sector and a related reduction in contingent costs to Victorian taxpayers. There is greater symmetry in the risk allocation, which should result in greater efforts to avoid potential risks and to better management of those risks which do arise."**

In other words, from a risk allocation point of view it was what I considered as an academic to be a successful project.

The CHAIRMAN - Before you we had the Auditor-General's Office here. I think the widely held view in the development of these in early days is that you've had a risk of this public sector being confronted by an enterprising private sector, et cetera. The Auditor-General's Office was actually saying that in the first generation PPPs view, there was a private sector that was risk averse, so what was the shifting point?

Dr ARNDT - In some cases the private sector is risk averse; it depends what risk you are talking about. But in this particular paper I was analysing urban toll roads in Australia, so I looked at the Sydney Harbour Tunnel, the M4, the M2, the M5 and the City Link, and of those examples the City Link was by far the closest to what an academic would consider --

The CHAIRMAN - So this project is related to a comparison to similar sorts of projects, not PPPs generally.

Dr ARNDT - PPPs in their current form didn't exist.

Mr HOLDING - Why? What were the features of City Link that made it superior from your perspective?

Dr ARNDT - The private sector accepted far more risk than other projects, and in my view it was risk they were capable of managing. That included things like the sophistication of the model that looked at the surrounding transport network; there was an agreed road network model which linked to an agreed financial model, and there was a basis set up that allowed the government policy flexibility, but at the same time recognised the need on the investor side for certainty, and really dealt with that in what I think to be quite a successful manner. That has been demonstrated since then, I think.

Ms DAVIES - Successful manner from whose point of view? From the public point of view; from the government point of view, or from the company's point of view?

Dr ARNDT - I think bearing in mind the competing interests of all those groups it was a good outcome for everyone in that without the level of certainty that financiers and investors require, the project would not have gone ahead in its current form, and it is unlikely that it would be there today if it had not gone ahead in that form.

From the government's point of view it gave certainty to the extent that it allowed flexibility in changes to policy, although it recognised that redress of varying forms would be payable to the private sector if those changes were made, but it gave certainty into how those calculations would take place. From the public's point of view, it ensured that - particularly the design and construction risks, as it happened - but other risks were passed onto the private sector and didn't come back to the taxpayers. Again, I am talking here about the economic and financial factors, not the broader community factors which I don't feel qualified to discuss particularly.

The CHAIRMAN - I don't want to dwell on this overly, because we are on short time, but on the comparison, if you like, I suppose if your comparison is between this project having been built and not being built, you would almost say there has been a public benefit because you have the infrastructure; but is that the appropriate comparison?

Dr ARNDT - The appropriate comparison is if the government decides that this project is necessary, or is economically beneficial to the state – and I take the broad definition of it – then what is the best way to deliver it, and that will involve a range of options which I will actually come to. The question that should be asked is what is the best outcome for the community out of all those options.

Just to the flick over to the benefits of PPPs more generally - and these have been expanded in my thesis, which is available - but there is some literature on these around the world now. Particularly reduced risk to taxpayer and earlier service delivery from the point of view of the efficiency of private sector construction techniques, but also avoiding public sector budgetary funding constraints, which unfortunately tend to influence the rollout of public projects when in theory they shouldn't. There is a quote from the UK National Audit Office from a review last year which actually looked at publicly delivered projects in the UK and found that on average 73 per cent were delivered over budget and 70 per cent were delivered late, and I have the reference to that in the back. That is quite damning evidence, I think, of the history in that country, and I don't know whether similar figures exist for Australia or Victoria, but it would be an interesting comparison.

Access to new technology - because bidders for these projects tend to be large companies, often multinational - if you compare, for example, a rural or regional water authority which might have two or three small plants, obviously they don't spend too much money on R & D, nor can they afford to, but if they bring in an operator who operates 150 plants around the world, they may well spend 10 or 20 times the total water authority's annual budget in R & D.

Customer focus - and there is a caveat on that. If the government gets the contract right and gets its output specification right then the private sector will be sensitised to focus on the customer. For example, in the public transport franchise here in Victoria it is very clear in the contract, as I understand it, that the private sector has to look at congestion, graffiti, on-time running, cancellations, things which are in the forefront of the customer's mind. I am not sure that it is as successful as it could be or not, but as far as I am aware, that focus didn't exist under government ownership, or at least it was more cloudy as to how that focus translated into senior management within the organisation.

Similarly, the private sector can act as a change agent in certain circumstances where there is entrenched delivery of services, and there might be a better way to deliver those services and governments might find it difficult to push through that. Private sector has access to broader funding than government. Government basically can do things from recurrent expenditure, accrued cash flow or debt. The private sector can take a more sophisticated approach basically to chopping up the risks of the project and allocating them to the people who actually want to bear those risks with a view to making them long-term, take a whole-of-life approach. There is no separation between capital and operating budgets in PPPs, there is in traditional funding and that can be an issue. If a project is delivered as a PPP then it is clear that that service will be delivered to the contracted standard for the life of the contract. I will come back to that, but that has been quite popular with public sector employees in the UK and increased efficiency. By that I have another quote from a different report from the UK National Audit Office, which found that 81 per cent of public bodies involved in PFI projects believe that they are achieving satisfactory or better value for money from their contracts.

There is another study by Arthur Andersen which I will refer to; it may have been already mentioned. That found on average 17 per cent savings over public sector comparators. So there is some detailed evidence that these things can be delivered.

Finally, no white elephant projects. By that I mean if there is no demand for the service, if funding is not available and if the private sector is asked to take those risks, that will become very clear very quickly to the procurement agency. Similarly, the government cannot hide its calls on operating budgets going forward in this sort of deal because it is very clear and it will be reviewed by the Auditor-General.

The point I want to leave you with is these issues are not unique to Victoria or Australia. They have been supported by various Auditors-General here and the Audit Review of Government Contracts but also strongly pushed by the World Bank. PPPs in some form or another have been adopted by over 140 countries, 450 projects have now been signed in the UK. And just for interest, there is, for example, a knowledge centre for PPPs in Holland; there are similar centres in Ireland, the UK and other places.

I was asked to comment on costs, or what you might consider are downsides to public private partnerships. I would like to make the point, as I said earlier, that the issue is not is this a perfect procurement method but is it better than whatever other options are available. And yes, there are some issues. One is transaction costs, which tend to be larger than they are both for government and for bidders than traditional procurement methods, but evidence has shown that those transaction costs will reduce with experience and particularly with clear and consistent policy, so I support Partnerships Victoria; it was a good start on that road.

The UK has been quite successful in reducing transaction costs by developing clear policy and standard contract documents.

The issue of externalities refers to what economists call the things outside that won't be considered by financially motivated parties, the welfare benefits and environmental benefits and other things. And it is clear that there is a role for government to identify those issues and either fund them through subsidies or direct funding, if that's worthwhile based on the community assessment point of view for the benefit of the project. I guess the point to make that is that if the government has to put some funding in that does not mean the projects is not worth doing. The analysis to make is if the project is worth doing in which way is the community better off? There has been criticism, as you mentioned earlier, about inadequate risk transfer.

MrTHEOPHANOUS - Can you make a distinction between the community being better off and the government being better off?

Dr ARNDT - With an academic's hat on I am assuming the government will act in the best interests of the community and will be accountable to the voters over time and be delivering value for money.

MrTHEOPHANOUS - Big assumption.

Dr ARNDT - I don't think I am qualified to get further into that discussion.

MrTHEOPHANOUS - The distinction we made earlier - and I would be interested in your comment on this again - in the case of City Link, it might have been a worthwhile project; a government enters into that contract, but from the point of view of the government's interests, it has been able to put what would have been a sizeable debt off its balance sheet, so there is a government interest involved in it, and it has a project and a service which is there, but from the point of view of the community, the motorists --

Dr ARNDT - Because it is user-pays.

MrTHEOPHANOUS - Because they are paying for it. You can use the same analogy for electricity, public transport. The using public, if they have to pay for the service, it seems to me has a different set of interests than might be the government interests.

Dr ARNDT - That is quite right, and it is a good observation. In my mind that is an issue; that is a critical policy issue that the government of the day will have to address and will be accountable for, and the community will judge the government on.

In some cases I think the community is quite happy to pay user-pays charges to get services, otherwise you wouldn't have however many people you have there using City Link every day. I am sure some people choose not to use it and maybe no-one is happy to pay money for something, but at the end of the day people do make the decision to use it, so in a similar way to publicly provided services like water people pay to use those services. That is not an issue I sought to address; it is something too complicated for me, and that is why I suppose things like Parliaments exist and why an inquiry like this important.

The inadequate risk transfer I will come back to, but it is clear from the research that is no longer the case; it may have been in early days but not any longer.

Mr RICH-PHILLIPS - On that point, Treasury was in this morning and indicated that with the second-generation projects there may have been a trend to excessive risk transfer, that is, the focus is let's get rid of all the risks rather than allocate the risks sufficiently, which is the theme of your thesis. Have you seen any evidence to suggest – I mean, you picked up on City Link as being a good example of risk allocation – but have you looked at any other projects that were undertaken in the second generation?

Dr ARNDT - I have. Maybe I will leave that until the next couple of slides and come back to that. Distributional effects – effectively both costs and benefits of PPPs are not necessarily evenly spread across the community, and I will return to that. But I guess the point is that those distributional effects also occur for publicly funded projects as well as privately funded projects. The politics of PPPs need to be addressed, and clearly for politicians, such as yourselves, there are issues related to that.
I thought it would be useful to put up a quote from the British Prime Minister, Tony Blair, who speaking on PPPs said last year:

> **"Of course, there will be opposition to change. Change is seldom popular. Every reason, good or bad, for resisting it, will be given: safety, practicality, unfairness to the workforce; the spectre of rail privatisation will be mentioned every time a proposal for reform is made, so that people are too scared to consider on its merits the change being asked."**

The outcome is that there is a need for politicians and for government, if it believes in the benefits of PPPs that it appears to do, to actually sell those benefits to the public at large.

The CHAIRMAN - But to go the other way there, aren't considerations of safety, practicality, unfairness to the workforce issues of considering a project on its merits?

Dr ARNDT - Absolutely. The point is that all things should be considered critically, but also logically and not blown out of proportion.

The CHAIRMAN - I suppose what I am saying is that Tony Blair may have been using his own rhetoric.

Dr ARNDT - That may be right. The key point I am trying to make is that politicians have a responsibility to sell to the community at large the benefits of the policies that they adopt.

Some case studies on some current projects I thought would be useful: I have said a few times the question should be is the community better off by a service delivered under PPP or by traditional means? The current examples - well, the City Link, I think, was delivered on budget to the taxpayer, maybe not to the investors; it certainly wasn't delivered on time. The question is would it have been delivered on time if it was a publicly procured project. There are a couple of existing road projects in Victoria: the Eastern Freeway Extension, the Geelong Road.

The CHAIRMAN - Can I ask you a definitional question there, because I would not consider the Geelong Road a PPP.

Dr ARNDT - No, these aren't PPPs. I am trying to compare different delivery methods.

The CHAIRMAN - I am sorry. Right. It is just the way it is headed.

Dr ARNDT - The question marks there indicate that it is too early, as far as I am aware, to know the answers to those questions, but it will be interesting to observe as these projects are rolled out how they compare relative to the other procurement method.

MrTHEOPHANOUS - It does raise the question of definition; do you have a definition that you can give us of what is a PPP?

Dr ARNDT - I did that. County Court and Federation Square, similar metropolitan projects; Berwick Hospital, which should be delivered as a PPP, and the Austin and Repatriation Hospital which is not, and it will be interesting over time to compare how they perform.

Moving on to protecting the public interest. In my view, the public interest is in obtaining services on a value-for-money basis, all other things being equal, and of course the 'all other things being equal' is an important statement.

In Victoria I did some quick research, and as far as I can tell, Victoria spends around $2 billion a year on capital procurement out of the budget papers. That is a lot less than what it used to be because of the privatisation programs of the past, but nevertheless it is still a substantial amount of money. Clearly, this is based on achieving service delivery rather than actually building assets, so there is no need for the government to own assets, and that is recognised in the policy. The public interest in obtaining those services efficiently on a value-for-money basis - and there is a quote from the Arthur Andersen report there, which I will not read, but it shows on average a 17 per cent saving as compared to the public sector comparator.

I have included a quote from Paul Boateng, the Financial Secretary to the UK Treasury. There is a typo; it was a quote from last year not this year. He said:

> **"There are those who claim that the private sector is making a profit at the expense of Government, front-line delivery and public sector staff. This is not the case: bringing in the private sector adds value, helps deliver better services, and in many cases enhances the experience of working in the public sector - at all levels."**

While not judging the content, this is the sort of statement that helps to sell a government policy to the community.

Ms DAVIES - This view, that there is no need for the government to own its own assets, I see that as being very value laden judgment; where does your assessment of that come from?

Dr ARNDT - I suppose it is a philosophical question about what the role of government should be.

Ms DAVIES - It is a degree of faith.

Dr ARNDT - I don't think it is a question of faith, as long as the government enters into good contracts. But my interpretation of that comment is you are saying it needs to have control, or more control, of the service delivery than what it might get under these contracts, and I will come back to that.

Ms DAVIES - No, not just that. There are a whole range of reasons why it is often better to actually own the assets rather than do these other things, but I am just interested where your perception of that comes from, and you've just said basically it boils down to a question of faith.

Dr ARNDT - I think it is more a question of what the role of government should be. In my view, the role of government should be to deliver essential services to the community where those services cannot be delivered in another way that is acceptable to the community, and to deliver other community obligations that couldn't be delivered by the private sector. That is a very economics-laden definition, but that is essentially where this view comes from.

Ms DAVIES - So it is a sort of item of faith, the economics.

Dr ARNDT - It is more than faith, because implicit in that statement is the government is still responsible for the service delivery. If it chooses to get a third party such as the private sector to deliver an asset that it needs to deliver services, then it will actually develop a contract that is enforceable, that will force that third party to deliver the service or the infrastructure for the service in a manner that the government requires. So it is more than faith, because there will be legal protections built in.

Ms DAVIES - Again, that boils down to a judgment that people are capable of putting down all the necessaries onto a piece of paper that becomes a contract, which again we have seen is subject to error.

Dr ARNDT - Yes, that's true.

Ms DAVIES - And, change and didn't foresee and can't think about and didn't see at the time.

Dr ARNDT - There is always scope for human error. I suppose there is scope for human error in publicly procured projects, too. The issue is how we move forward and learn from the extensive experience we have had this area, and I guess that is what my PhD was about, looking at what had been done over the past decades, saying where are the lessons and how can we go forward to get better outcomes for the community?

The CHAIRMAN - We have about five minutes or so left of our allocated time.

Dr ARNDT - I will skip through.

Protecting the public interest: the factors that are built into the policy, and the factors that are or may be in the public interest test but I am not aware of - sharing benefits and costs, and I have talked about the distributional effects; step-in rights for the government are very important - and the point that has just been made - are essential to ensure the community actually gets the services in all eventualities they have been demonstrated in Victoria to be effective in projects like the Deer Park Prison and the Latrobe Hospital, where whether you agree or not with the quality of service, the government has certainly demonstrated it has step-in rights and it could exercise them.

Public sector comparatator methodology if applied well will always ensure value for money on the basis that if you agree with the basis on which it exists.

MrTHEOPHANOUS - Do you have a view there?

The CHAIRMAN - Do you have a view there? Let's assume that is right. Do you have a view of is there a level of benefit, if you like, so it can simply do it cheaper there is a 1 per cent benefit, a 10 per cent benefit?

Dr ARNDT - That is a project-by-project assessment.

The CHAIRMAN - No, that was not the question I was asking. I was asking about whether there should be a trigger or a benchmark to say well that's an appropriate level on an individual project in which the market --

Dr ARNDT - The benchmark should be all things being equal if you are delivering the same services and benchmark and assuming the same base case for risk assessment and you compare the bid on a risk-weighted basis, it should be $1, in my view. And transparency obviously is built into the current policy, and I won't go into that. I will skip the next bit because I am sure that Treasury has covered that. I think the policy and clear approach of policy is very important and needs to be to be supported by Parliament, industry and community because it increases transparency and certainty. It will reduce transaction costs; therefore, it will encourage better tenders. It ensures public accountability and it will guarantee value for and money if it is implemented. So there are some pretty strong reasons as to why the policy should be supported. I will skip the next slide, which talks about risk, and the next slide, which talks about the types of risks in projects.

On risk allocation theory, which is coming back to my thesis: Basically, based on an economics analysis, risks should be allocated to the party which has the best ability to influence a risk occurring or the size of the risk or can mitigate the risk better.

That is essentially what economists call the moral hazard problem, avoiding that problem. The survey that I did in collaboration with Treasury found that actually that what you might call rational risk allocation is somewhat quite far down the tree of how practitioners judged things were actually happening, and that is the quote on the left there. They found:

"Commercial returns and government bargaining power were the key drivers --"

in those contracts. And that is something, referring back to your comment earlier, that there is evidence that there was excessive risk allocation in some projects compared to at least what the private sector thought ought to have been optimal. This approach based on economics over the page would tell you that there are cases on the left of the graph where the government would not transfer enough risk to the private sector, and the private sector could have managed those risks better and therefore the government may end up paying too much if those risks materialised; and similarly, if the government transfers too much risk to the private sector that they can't control or pay too high a risk premium and there is some optimum in the middle.

My thesis was based on actually defining that optimum, and Partnerships Victoria to a large extent picks up on a lot of that work. I did a number of case studies - seven projects in all from public information - and that is all available. There were three Victorian projects: City Link I have spoken about, and the Latrobe Hospital, and the Men's Metropolitan Prison, the Port Phillip Prison. The quote on the prison is worth making:

"One key observation flowing from an analysis of the Men's Metropolitan Prison contract is that it is important for the government to structure the industry and regulatory system in a clear and fair way prior to going to the market with a PPP deal."

In other words, the government has to get its output specification right and structure the contract in such a way that the private sector can invest on a known basis. The private sector can't solve the policy issues for the government. The government needs to do that first before it asks the private sector's opinion. There is some discussion about some of the harder risks to allocate which I will not go into. In practice what this meant was that some very large risks become unquantifiable and lead to long negotiations.

One approach for dealing with that is adopting a standard risk allocation. Sir Malcolm Bates did a review of the PFI in the UK and then did a second review, which I have quoted there, which basically says Treasury needs to adopt standard approaches to these things; the agencies need to take up those standard approaches and that way we will get better outcomes.

In summary on the current policy: Partnerships Victoria has essentially adopted a theoretical approach; it is designed to deliver optimum risk transfer, it will result in a benefit, and it is based on sound research.

The CHAIRMAN - There is a photo of the survey report, the Arndt and Maguire as the authors; is that Glenn Maguire?

Dr ARNDT - That is. That report is available on my web site as well. Future trends, finally: In my view, Australian governments are reconsidering PPPs at the moment and moving to 'protect the public interest'. I think this means that the government wishes to retain control of services in cases where economics suggest those risks should be transferred. That raises a question of how to ensure efficient risk transfer and scope for innovation in those cases. I have put in a quote from the Infrastructure Investment Policy for Victoria, which was the last government's policy and the current Partnerships Victoria policy, which reflects on this change in approach to risk allocation.

To flip over the page, what this really means is that governments are moving back up the line now. There is more government involvement and less risk transfer. The question arises, while that may be important from public policy grounds for various reasons, it raises economics questions, and those issues need to be considered in these cases, and I am not sure that the current policy has made a coherent argument on why in some cases the government wishes to retain core services and in others it does not.

The CHAIRMAN - Is it not that that is a clash of two different types of risk, and the, if you like, aligning of that; and that is on the one hand, and certainly the early generation ones, economic risk or financial risk are the key drivers, but as they have developed there has also now been enough practice to suggest that political risk is a key factor, and that might be why you are getting back to these sorts of things?

Dr ARNDT - That may be the case, but I think the way to address that is to deal with the political issues separately because the risk exists that you end up with a contract that is not structured in a way to achieve optimum outcomes, so the taxpayers end up with a suboptimal outcome.

The CHAIRMAN - But surely the whole idea that the person who holds the risk should be the one who manages that risk. Government will also hold the political risk.

Dr ARNDT - Sure, and there are other ways of protecting that through step-in rights and other things like that, so there are value-for-money considerations.

The CHAIRMAN - I am not arguing; I am just suggesting that perhaps that is the debate that is currently going on.

Dr ARNDT - It is a debate, and it is an important debate. I am not for one second saying these issues are not important; all I am saying is that they start to cloud the economic consideration.

To finish, risk bearing actually changes the actions of the parties involved. For example, on the Melbourne City Link everyone knows the Burnley tunnel had some construction problems. In that case the parties, Transurban and Transfield Obayashi joint venture actually agreed to defer litigation until after the project was completed to get revenue happening. An open question I have is: What situation would have occurred if that was a government project, would the parties have acted in the same way?

Ms DAVIES - Who would have done the suing?

Dr ARNDT - I think everyone would have sued everyone, and it would have been unclear; but I guess the key issue is that it may have held up the project delivery and from the point of view of motorists that was not the optimal outcome. From the point of view of motorists people might be suing each other now but they don't really care because they've got the road and they are using it.
To again quote Tony Blair:

> **"Where the private sector can help lever in vital capital investment, where it helps raise standards, where it improves the public service as a public service, then to set up some dogmatic barrier to using it, is to let down the very people who most need our public services to improve."**

So in conclusion, I believe the benefits of PPPs are too great to ignore. There is bipartisan support for this approach, both in Australia and globally; the approach is being adopted all over the world. Victoria is not unique at all. Having said that, clear policy delivers better outcome for taxpayers for the community and for investors. The main benefits derive from risk allocation and innovation, although there are other benefits that I alluded to. Partnerships Victoria's approach to risk allocation is based on sound research.

Finally, the exclusion of core services could reduce the benefits of delivery unless managed carefully and that is an open question. The next page has some other references the committee might be interested in looking at further.

The CHAIRMAN - Thank you. You talk there about global adoption of the approach, and that is clearly the case, that it moved from a situation where Victoria was almost on its own back in the very early '90s to now where there is very widespread use of PPPs. Outside of the UK, where everyone talks about, where are models or actions or research, et cetera, going on that my be instructive to this committee?

Dr ARNDT - I think Holland, Ireland, to some extent Japan, although the situation there is a bit different to what it is here. There are probably models in the US that might be of relevance, although again they have this more black-and-white view of public-private delivery. The French model is more blurred, but there are certainly models we can take away from that. In terms of other places where there is significant delivery going on, though, I am not so sure the policy is so clear you would want to use it as a standard, but in terms of development of projects, Hungary, Romania, the former Soviet Union, Chile, Argentina- Chile has done more PPPs than Australia - Mexico, and the list goes on and on - most of South-East Asia, parts of Africa, South Africa.

Ms DAVIES - Do you exclude Canada?

Dr ARNDT - No. Canada has done some projects, but I think they have had some problems there in developing some cohesive policy as well, and I don't know of many projects. They have delivered sporadic projects, but I don't know of a significant rollout they have achieved. Maybe my research is getting old in that I haven't updated it for a year or so, and these things move quickly. But when I was doing my PhD and I was looking as hard as I could for other academic research on this topic, there was very little to be found anywhere in the world, which was a bit of a frustration but also an opportunity, I suppose.

Mr CLARK - Can I ask: You have a very simulating assessment of some of the conceptual issues involved in PPPs; overall how do you think the private sector is viewing PPPs as a potential investment opportunity at the moment, say in Victoria, and more generally in Australia?

Dr ARNDT - It is hard to answer that question clearly. I think certainly there has been a lot of talk about PPPs in the new form. There has been a fair bit going on, particularly in the road industry in New South Wales; there have been a number of projects in Victoria that have been announced will be developed and will use PPPs, including a few in the market at the moment. And I think the private sector probably thinks it is early days that the policies that are starting to come out - and Partnership Victoria's is certainly the most comprehensive - have been very good policies and have been supported by industry by and large, but it is really too early to say whether those policies have been tested on local projects.

Mr RICH-PHILLIPS - In one of the papers you published last year, you state the industry is pretty cynical, and you quote Partnerships Victoria, the degree of government commitment to the policy; can you expand on that?

Dr ARNDT - That was a paper I wrote for my former employer, AusCID. I think at the time - the policy came out in the middle of 2000 - and I think that paper was written around the middle of last year, June, July.

Mr RICH-PHILLIPS - Dated October last year.

Dr ARNDT - At that time I am not sure any PPP projects had been released into the market in Victoria at all, and there was some debate happening here in Victoria on, for example, how prisons would be delivered, how the Austin Hospital would be delivered, and the government seemed to be taking its time in making those decisions, and so having generated a lot of interest there was some scepticism as to how the government would make tough decisions. Now I think there are a few projects starting to be deliverered, although again it is only a trickle compared with what could be done, and I suppose the industry will not make its final decision for some time yet. In other states, particularly New South Wales, I think, projects have been more slow to come to the market, with the exception of the roads in New South Wales.

The CHAIRMAN - You are saying Victoria is actually ahead of New South Wales.

Dr ARNDT - In terms of social infrastructure. The New South Wales government has schools; I don't know of any others. In terms of roads they have two, one out to tender and one coming.

The CHAIRMAN - We had better wind up there. Thank you, **Dr ARNDT** for your time this morning. We are happy to take up your offer should we have anything further that we might like to expand on, to come back to you.

The witness withdrew.

CORRECTED VERSION

PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

Subcommittee

Inquiry into Private Sector Investment in Public Infrastructure

Melbourne – 30 April 2002

Members

G. K. Rich-Phillips
T. C. Theophanous
R. Clark
Ms S. M. Davies
T. J. Holding

Chairman: Peter Loney, MP

Staff

Executive Officer: Michelle Cornwell
Research Officer: Caroline Williams

Witnesses

Nick Morris, Chief Executive, and

Andrew Wade, Economic Consultant, Tasman Economics.

The CHAIRMAN - I welcome Nick Morris from Tasman Economics, and Andrew Wade, economic consultant, to this Public Accounts and Estimates Committee briefing on Private Sector Investment in Public Infrastructure.

All evidence taken by this committee is taken under the provisions of the Parliamentary Committees Act and is protected from judicial review. However, any comments made outside the precincts of the hearing are not protected by parliamentary privilege. All evidence given today is being recorded. As witnesses you will be provided with proof versions of the transcript early next week.

Mr MORRIS - I am very pleased to be here, and thank the committee for giving us the time to talk to you. The involvement of the private sector in infrastructure investment, is something that I have spent most of my life worrying about, mainly because I was involved from the late '70s in the United Kingdom in working on the early stages of privatisation policy, and then during the '80s and '90s on the implementation of privatisation and then regulation.

In the slides I have given a quick summary of my own background. I began my career as a civil servant then becoming the first employee of what is now the UK's main microeconomic policy research outlet, the Institute for Fiscal Studies, and then to found London Economics, a consultancy which did a lot of the privatisation work in '80s and '90. I moved to Melbourne with my wife and family about 18 months ago, and I am now an Australian resident. I am also a visiting professor at the City University Business School, and I have worked quite extensively over the last couple of years on infrastructure projects in Australia and Asia.

Your invitation to meet with you was to the Tasman Institute, so I thought it was helpful to explain the new structure, because we have brought together three bodies under the heading Tasman Economics: the old Tasman Institute, which is explicitly policy-oriented, and a nonprofit organisation; Tasman Asia Pacific, which is a consultancy that deals in infrastructure; and London Economics Australia, which is the subsidiary of my London-based company.

If we now think about what we mean by infrastructure, I think this is quite a good definition: we are talking about the tangible physical assets that are used by Victorians and which contribute to the economic welfare of the State of Victoria. I find that quite helpful. But in terms of what we might think of as examples, they are things like transport systems, utility systems and public services such as hospitals, prisons and schools.

If we look at what has happened in Victoria, we have a slide here of what has happened to capital investment as a per cent of GSP. You will see it has had a slightly bumpy ride, with a decline in the early '90s overall; but the bottom part of the chart shows there has been a significant decline in public investment, the public part of that capital investment. That is a common trend, if you look at other countries. The next slide shows you the equivalent for the UK, and that is a common trend worldwide. There has been an unwillingness of governments to pay for investment in infrastructure, and a hope that the private sector can help.

The CHAIRMAN - Just on that, we were given the information before about the decline in public investment in infrastructure. We were also told that the ABS up until 1996 kept figures on private investment in public infrastructure but now no longer does so because of a difficulty they say in defining which is which.

Mr MORRIS - That is correct. The figures given here are for a much more aggregate measure of gross domestic fixed capital formation, so it gives the pattern. But the ABS has had difficulty measuring infrastructure investment, as have governments everywhere. The UK's statistics office has the same problems of measuring exactly what one means by infrastructure.

The CHAIRMAN - Is that a problem of an accepted definition?

Mr MORRIS - I think it is mainly a problem of resources and the ability to extract data. I don't have a conceptual difficulty in the definitions of this. Most statistical departments worldwide have been reducing the amount of measurement they are able to do.

There are a variety of beliefs that the private sector has helped in addressing this problem. In the previous two slides I highlighted the various needs that Australia has to invest in roads and schools and hospitals, and again it shares this with the rest of the world. But there is a crisis in many countries, and I think it may not be as bad a crisis in Australia but there is certainly a need in Australia to look at how we are going to fund the next 10 or 20 years of infrastructure investment. There are beliefs out there that private financing is a very valuable thing that can help with this, and I have included a couple of quotes on this slide from the EPAC Private Infrastructure Taskforce.

Ms DAVIES - Are you sure that it is that governments can't provide, or that governments choose for philosophical reasons not to go into debt?

Mr MORRIS - Governments choose for philosophical reasons not to go into debt.

Ms DAVIES - So it is a choice, not an inability.

Mr MORRIS - If we get into what has happened in politics in lots of countries, there has been a tendency in the last 20 years to believe that what the voters and taxpayers want is constrained taxation and less expenditure by the public sector.

Ms DAVIES - Which has been driven by a sort of economic theory rather than any change in reality.

Mr MORRIS - Yes, the monetary school.

Ms DAVIES - It is a sort of a philosophical belief.

Mr MORRIS - Yes. It is the current economic trend, if you like, it will not necessarily exist forever, but it is what we do at the moment. What the figures show is that this actually goes for a longer period than just since the '70s; this is a trend that has been going in the UK a little longer than that. After a post-war boom in expenditure from about the mid-60s and the Wilson government, from then onwards our investment in public infrastructure has been declining.

Mr HOLDING - But it is a function of an ageing community; it is more sophisticated than simply saying it is a philosophical decision on the part of governments not to spend money on public infrastructures any more.

Mr MORRIS - There are many other needs.

Ms DAVIES - It could also be based on the fact that after the Second World War, which was a period of incredible destruction, there was a need for the incredible building-up of infrastructure, if you are taking a really long-term view of it.

Mr MORRIS - Certainly in the country I know most about, which is the UK, we under-invested more than we should have in things like roadways and sewers and that sort of thing. One of the things which the privatisation program of the '80s did was that it introduced private investment to solve some of those problems. In some cases they were not solved as well as they might be; but it certainly introduced investment which helped with some of those issues, particularly in the sewers.

If we look at the types of private sector investment that are possible, I have put in for the committee three slides, two of which I have drawn from other places, to think about, because there is not a single thing that is just private sector investment. There is a whole spectrum of ways in which the private sector can get involved, ranging at one end from being involved in the management and running of infrastructure, building them, up to the other end to actually ownership in the long-term. In the middle there is a whole variety of mechanisms whereby the private sector could choose to own and operate in perpetuity, own and operate for a period and then transfer back to the public sector, own and operate and then lease back, or design, build, fund and operate but never own. So there is a whole range of different things that can be done.

Mr RICH-PHILLIPS - Do you classify PPP as different to those models?

Mr MORRIS - No, I tend to use the term to embrace everything.
Mr RICH-PHILLIPS - Including privatised?

Mr MORRIS - Yes. On the slide – they may be in the wrong order – but on the slide, the one after the table, there is a spectrum, and the spectrum is defined. This is actually not my work, but taken from UNDP, but I find it a helpful diagram. It is the one white on a blue background. That gives you a way of classifying all the various ways in which the private sector can get involved in public infrastructure ranging from fully public sector across through frameworks, service contracts, joint ventures, passive public investment, but mostly public, all the way across to fully private sector, the full privatisation model. Most definitions of PPPs stop short of absolutely full privatisation, so I suppose one could have that as a distinct category.

If we go to the next slide of the claimed pros and cons of private involvement, down the left-hand side I have just put some of the main headlines about what people say. First of all, it is clear that the private sector does have capital available and that the international investor community is willing to invest. That is not saying anything about the price at which they are willing to invest, but there is capital available for infrastructure in countries where the governance and political systems are relatively stable. There are some problems with private sector interest in investing in some of the countries I am working in at the moment, like Indonesia because there is rightly concern about political risk. But in countries like Australia it is clear people are very happy to invest in everything providing the return is there.

There is a helpful transfer of risk; there are some things where the private sector is willing to embrace the risk of which the public sector may not wish to. In the early days of PFI - private finance initiative - in the UK, I think the public sector did not quite understand what it meant by risk and so many of the early PFIs, I think, were inadequate in their responsibility to transfer risk so they were paying quite large amounts to the private sector while keeping quite large amounts of risk held in the public sector.

The CHAIRMAN - That is one of the key questions we are looking at, the ability of the public sector to be able to assess risk in the first sense and then allocate and manage in the later instances. So from your experience there, what have you seen as a result of that in the building of that expertise within the British public sector?

Mr MORRIS - Gradually the departments have got a bit better; they don't make the same mistakes more than a couple of times.

The CHAIRMAN - But have they actually attempted to get that expertise within the public sector coordinated in a cohesive way?

Mr MORRIS - There has been a very strong attempt to, in inverted commas, 'modernise' the British ministries and give them a corporate structure, and try to attract good people to them. It is very difficult in London, as it is here, I think, to attract people because the alternative employment for such people is merchant banks particularly, at triple the salary, so it is very difficult. In my own experience, observing these PFI-type deals – and I have been on both sides of them - sometimes the public sector will hire consultants to assist them to understand. The fire power available to the private sector in terms of risk analysis and so on is way in excess --

The CHAIRMAN - That really is the question I was coming to; it still exists in that way?

Mr MORRIS - I am afraid so.

The CHAIRMAN - And whether that in itself is a risk.

Mr MORRIS - It is. In the UK the market matures, and on both sides people have an awareness of the needs of the other, so it does not actually in the longer run do the investor community any good to invest in projects that are seen generally as rip-offs to taxpayers. So there is a limit, however clever the private sector is, to how far they can push the envelope; but there is a general issue, and it embraces not only this but regulation as well, that there is a lack of expertise within the public sector to handle these things. This has been particularly true in the attempts of the various regulators in the UK to control utilities, because they have just not been able to get the right staff, and the private sector has been able to – people like me tend to be employed by the private sector and not by the public sector, for example.

The CHAIRMAN - Thank you.

Mr MORRIS - The third pro is that public borrowing is reduced. Now personally, I think that was a very important force in the development of the UK PFI story, because people were very, very concerned about the public sector borrowing requirement; it was almost the number one goal of policy. And to my mind that was misplaced, that was an overreaction. But certainly the vagaries of public accounting have driven this, because the public sector has been determined to get things off-balance sheet and reduce its debt. Put more positively, if you don't have to spend more money on infrastructure, you can spend it on people, schools, and hospitals, and so on, and that is positive. So if you do feel yourself to be budget constrained by the political system you operate within, then this is a way of increasing your ability to spend on other things.

Finally, and I have put it at the bottom, but to my mind it is one of the most important: there is a whole raft of ways in which the discipline and indeed the expertise of the private sector, increases the efficiency both of operation and of choice of investment.

The cons that are claimed, I am about to come back to what I regard as a myth, which is that the government can borrow more cheaply. On the face of it, Australia and Victoria have Triple-A ratings; they can go out to the market, they can borrow quite a lot of money if they wish to and they can get that money at a much cheaper rate than they can borrow it from the private sector or get investors in the private sector. If you don't mind, I will come back to that one, but from my comments you will see I don't believe that.

There is a con in that taxpayers are in a position to accept risk, and maybe the public sector is a better holder of risk than the private sector, and that may be true of some risks. So in looking sensitively at PPPs, it is very sensible to think about who is most able to bear risk and therefore what is the most efficient, and it is not necessarily the case that all risks should be transferred.

The CHAIRMAN - Was that an earlier view?

Mr MORRIS - Certainly in Britain, with the early PFIs, there was a feeling that the public sector really shouldn't be worried about anything. To my mind, the third dot here on the con side is probably the most important argument. I will come back in a moment to where things have gone wrong, where the private sector has taken over and then we have messed up regulation. If we don't get regulation right, and the public sector doesn't work out the legal and regulatory framework properly, we can get into a terrible mess, and I will refer in a moment to California Electricity and UK Rail Track as examples of that. The other con is if the public sector is well run, there is no particular reason why some of the efficiency gains, which I had in my first column, can't be mimicked or achieved in the public sector. The corporatisation experience of Australia is actually an example of some quite impressive efficiency gains being achieved without transfer of ownership. My own views have evolved, having lived through privatisation and seeing its flaws as well as its gains, and I think one should be very careful about the difference between the need to transfer ownership and the need to introduce efficiency improvement. And I think we in the UK might have done better in some of the industries we sold if we had actually corporatised. In many cases we sold the assets for a third of their asset value because we were so desperate to actually sell, and we wanted to get shareholders in, for example. I am thinking particularly of water, where the numbers were roughly £5 billion raised and £15 billion value, and that transfer of value from the public purse to the private sector was not obviously, to my mind, sensible; although it was obvious that we needed the investment and we needed the efficiency, there may have been other ways.

If we come to the myth of cheaper government borrowing, I have put a quote in here from Ian Little: he very conveniently wrote something in the *Australian Financial Review*:

> **"It's a myth that governments have access to 'cheaper' finance to undertake projects: a government's ability to borrow more cheaply is purely a function of its capacity to levy taxes to repay borrowings."**

To understand what is going on here, I think it is helpful to think about the processes that both the private sector and the public sector go through in making a decision to invest. In the private sector it is virtually impossible, unless possibly you are BP Amoco and it is a relatively small investment, to borrow or to introduce equity except on the basis of the risks of the project itself. So every single piece of project finance I have been involved in, the project itself is what we are assessing, and unless the project stands up in terms of generating the rate of return required for the investors and the lenders, we don't do it.

Mr HOLDING - Because you can't get the money.

Mr MORRIS - Because you can't get the money. I mean I might want to, but I am in a straightjacket, to my mind correctly. In the public sector I can do all kinds of things, if I want to, providing I meet whatever public sector controls there are; but getting the money is not the issue, so providing that the Treasurer will let me have the money, or Treasury will let me have the money or I have the money in my departmental budget or something, or in some cases I am the Prime Minister and I happen to want to push something through, I can invest in anything I feel like. There are examples – and I have listed from the UK, Concorde, the Millennium Dome and AGR Nuclear reactors – the last one might have been done by the private sector - I doubt it in the later stages, but the first two there is actually no way they would have been done by the private sector. To my mind, the Millennium Dome was a colossal waste of £1 billion.

The CHAIRMAN - They are interesting projects, because in some ways I put the Millennium Dome in the same basket as putting a man on the moon in the next decade, but they go to the national ego. I don't know how you deal with those sorts of things. In some sense governments are expected to do those sorts of things, but you are right, you will probably not find a private sector person.

Mr HOLDING - Only someone who has never been to the Millennium Dome could invest in national ego.

Mr MORRIS - I did take my family there once, and I was very disappointed! If we look at the Victorian experience, and the committee will realise I am a newcomer here, and probably my opinions on Victoria are less valuable than other opinions. I was involved to a certain extent in Project Victoria and the early reforms, and it does seem to me that Victoria gained from these reforms. There were a variety of ways in which, first of all, the sale of electricity assets assisted in the reduction of debt and the corporatisation process led to efficiency improvements and so on. So my own personal view is that one can give the Project Victoria process a tick, and that the financial situation Victoria was in in the late '80s early '90s was improved by that process.

I enjoy using City Link; it seems to me that that is an example, and the next slide looks at the pros and cons of City Link. Clearly there have been examples of the ability of the private sector to assist in infrastructure, which clearly the city has benefited from.

Ms DAVIES - Can I ask for a quick definition of efficiency, as you use it.

Mr MORRIS - I tend to see it as either capital or operating efficiency, so I have two thoughts: First of all, have we invested in the right things; and secondly, are we operating them at best practice? And then I think about technical efficiency, and when we are doing what we call benchmarking we tend to try to look at a world best practice at operating something and then look at where we are relative to that best practice frontier.

Ms DAVIES - So you don't take into any consideration issues of equity and social justice.

Mr MORRIS - Equity is another issue, but I tend to separate efficiency from equity.

Ms DAVIES - So your evaluation of all of those projects would be on the basis of economic efficiency as you define it. Is it limited to that?

Mr MORRIS - No, if somebody asks me to do a policy evaluation of anything, I will have both equity and efficiency considerations.

Ms DAVIES - But here, when you say 'successful' you are talking about in terms of efficiency.

Mr MORRIS - I am not here addressing any of the distribution consequences. So I am very focused on that issue, but that is to say that I am not interested in equity, but in this case that is all I am limiting my evaluation to. (I think, given the time constraints, I will just table that analysis about City Link.)

If we look internationally at what sort of experience there has been, I have mentioned earlier the experience in the UK with PFI. I have to say that was mixed. In some of the early PFI projects the returns which the private sector achieved were quite high, and much of the risk was indeed left with the public sector. I think the recognition of that over the years has come, and today's PFI, or now PPP projects, are getting the right balance, I think, between public and private interests, but certainly the early ones were almost a licence to print money.

The CHAIRMAN - One of the things that was raised with me in the UK was that there was concern – and it goes back to what you were saying about the ability to borrow – that there was a windfall being gained through rapid refinancing on a number of PFIs, and that there have been no addressing of the sharing of windfall. Are you up to date with that, whether there is anything going on in relation to that?

Mr MORRIS - Yes. There has been a lot of concern, particularly focused on hospitals. Just to give a very casual interpretation of what happens: we do a deal with you for a hospital that currently has no patients, and we evaluate that based on the risk of whether we might or might not have some patients. So of course, because of that risk, we need quite a high return to get the equity of debt. A year down the road we have signed a contract with you to have some patients. Now then the project is totally different.

The CHAIRMAN - You have a changed risk.

Mr MORRIS - Yes. So then I can refinance and I don't need as high a return. Then obviously that return stays with the private sector. So in the early evaluations - the public sector is becoming more savvy and it is beginning to realise this occurs, and therefore it is trying to bring the initial story down because it is saying your upside is bigger.

Mr RICH-PHILLIPS - Is it a question of proper risk assessment.

Mr MORRIS - Yes, and that is part of what I meant when I said the public sector's ability to understand these things is limited. There have been several articles in the UK recently about this in relation to hospitals, and there is quite a lot of concern which is being looked at at the moment about exactly that issue.

I have had some experience in Canada and elsewhere on this. In some cases access to the final income stream helps reduce risk. For example toll roads are a easy one to do because there is a guaranteed income stream that is very likely to happen; so it is not that difficult to get somebody to invest in it. It is other places where the income stream is more dependent on things that the public sector might decide, they are actually rather harder. I have just listed a few of the countries, and my own expertise is in water and electricity in particular; but in water, for example, there have been a number of cases – and these are some of the countries where it has occurred – where really quite bad water systems and problems for public health and inadequate sewage and so on have been solved in a way that is regarded as positive by the introduction of private sector.

If we turn quickly to some problems I perceive with this. At the top of my list of the things that go wrong is badly designed regulation. The two glaring examples of this recently were Californian Electricity and the UK Rail Track. In the Californian case the regulator intervened to prevent a variety of things that might have happened in the markets, and that then caused some severe problems with subsequent investment which then caused power shortages. So that was the issue in California. It was nothing to do with – well Enron follows on, but this is pre Enron, this is last year's problem.

The UK Rail Track is an example of inadequate thought being given to all the stages of the regulatory regime. In the UK the operating companies purchased the rights to run trains along the rails, but what was ill-defined was the responsibilities which we placed on Railtrack, and the maintenance and signalling responsibilities and indeed the access charging regime which led to that. Some of UK rail problems go back to the fact that it was a bad network, badly invested in over many years; but some of this is that we didn't give enough thought to way in which rail tracks should interact with the train operating companies.

Ms DAVIES - Would you say that was set up in a parallel way to the way the Victorian rail access network has been set up?

Mr MORRIS - No, it is different and there is a rather different story.

Ms DAVIES - There are still problems?

Mr MORRIS - Yes.

Ms DAVIES - In Victoria?

Mr MORRIS - In Victoria.

Ms DAVIES - But they are not related to the same sorts of reasons?

Mr MORRIS - No, the UK ones were very much about the inability of the train operating companies to have a dialogue with Railtrack about bottlenecks and congestion points and so on, and they were also rather specific to the UK in that we ended up with 70 different companies doing the administration and maintenance and so on, so the coordination issues were very severe and I think that is not so much a problem.

Ms DAVIES - Sounds a bit familiar, doesn't it!

Mr MORRIS - I should say, I am unwilling to talk too much about that because I am working on the Victorian rail access regime myself at present.

There is an example which I don't personally know a lot about, but I wanted to highlight, but in some cases specialist knowledge resides in the public sector, and it may be that that specialist knowledge does not get transferred to the private sector when things are taken over, and I understand that there was an issue of this kind in the Victorian prisons.

Perhaps the most important is that there is a game that goes on here about over-optimistic projections, and people on both sides actually try to convince themselves of the demand forecasts and so on which turn out to be a long way off the mark. That is certainly what happened in the Channel Tunnel case. I didn't put that on my previous list because that was not really a public investment. The people who lost there were French shareholders, but I understand there were the same sorts of issues with the Sydney airport rail link.

The CHAIRMAN - The Sydney airport, in my view, almost had a incentive for failure in the contract.

Mr MORRIS - Finally, this lack of public sector experience is quite severe. We talked about the inability of the public sector to be as sophisticated in risk analysis, but there are also issues about what I call assymetric information, that if you are dealing with a computer supplier, it is very, very hard for the public sector to know enough about what you are being offered, and many of the NHS's problems have been about computer systems which have then failed to deliver what they were expecting, even though the American software suppliers say yes, they did, and there is a mismatch between what the public sector thought it was buying and what was delivered.

The CHAIRMAN - And then there was some argument about what the specifications were.

Mr RICH-PHILLIPS - Is there something that has improved in the UK, because from our body of evidence, how it is managed, can it be drawn from these projections?

Mr MORRIS - I don't know. I hadn't seen it at the stage I left the UK about two years ago. It was still an endemic problem. All I can say is that the public scrutiny is rising rapidly, and England's public accounts committee is now looking at it very carefully and the auditor's office is very concerned. So it is much harder to get away with it than it used to be.

Mr RICH-PHILLIPS - Is the problem more one of not being able to adequately assess and manage the risk, or is it more a lack of knowledge about what the public sector reaction requires in a partnership in terms of delivery of service?

Mr MORRIS - I was distinguishing between the two things. There is an analytical expertise shortage in the public sector, the inability to adequately analyse contracts; and the second part is a lack of the knowledge and experience of things like computer systems, but it goes wider than that, it might be scanners and things we are investing in. We just do not have the level of knowledge of what this product is in the public sector that the private sector has.

Mr RICH-PHILLIPS - A lack of knowledge as to what you actually want or what you are seeking?

Mr MORRIS - Yes. What ought to happen, in my view, is that some sort of intermediary should emerge that is capable of helping the public sector with this decision. The problem is with the way we structure our finance and so on; most people have an incentive to make the deal happen. It is actually quite hard to find, so even if you hire your own consultant it is quite hard to make them not interested in you because you probably will not get the expertise unless they are interested in you, so there is an issue about independence of advice in these cases.

Ms DAVIES - You were very quick to point out the inadequacies of the public sector in not understanding the sort of deep and meaningful technicalities of this type of thing; do you also see a superficiality as to an unwillingness in the private sector to understand issues beyond the superficiality of economic efficiency, that there are a whole other range of values which the public sector has to know about and understand which the private sector is rather blind to? The intermediary, might it not be a bit of cross-fertilisation both ways? You are pushing it very much that there are all these inadequacies in the public sector.

Mr MORRIS - I am sorry if I am coming across as an uncaring technician.

Ms DAVIES - But again you do acknowledge that it is more than the technical.

Mr MORRIS - And the role of government is very much to deal with the equity, social, political issues which are above what we are talking about now.

Ms DAVIES - And which might be of integral inadequacy, and the private sector has to keep a very narrow focus.

Mr MORRIS - As a policy analyst, I find the level of analysis that people are willing to do is, beyond just the immediate financing, weak in the private sector. People have very short attention spans and they don't have the time to think about the things in the public sector.

The CHAIRMAN - Isn't it also cultural on both sides? I mean that's the way you would be doing it if you were doing a fully private operation, and that's the way you would do doing it as a fully public operation, and what we are talking about is the interface between the two.

Mr MORRIS - At its best government should do what it does best and vice versa.

Ms DAVIES - And if they are going to be in a partnership, they need to understand each other.

Mr MORRIS - Absolutely, and that is a challenge.

Mr HOLDING - In relation to page 12, the slide that was headed The Myth of Cheaper Government Borrowing. Could I get you to explain the relationship between the quote and the dot points underneath it. I understand the point you are making about private sector investment and that it is driven by this notion of return and that is the way it is assessed, whereas public sector borrowing does not have the same discipline on top of it, but how does it relate to the cost of government sector borrowing?

Mr MORRIS - In most markets countries are rated, or indeed states are rated by ratings agencies. The ratings agency will take a view of the risk of default. The possibility of us (Victoria) defaulting, at least at the moment, is low. There have been times in our history where it has been more likely, and most sovereign governments would have a Triple-A or a Double-A rating. There are exceptions, and Argentina at the moment is an issue. But in most cases, most countries are treated by potential markets as if they are quite unlikely to default.

Of course, if one goes on and on and on investing in project after project that should not be invested in by normal standards then one puts that rating in jeopardy and the cost of borrowing rises; and indeed, if the financial community notices that you are behaving like this, then things may happen to your exchange rate or maybe people are less willing to trade with you, or maybe people are less willing to invest in your country. So there are a variety of ways in which the financial markets can exert a certain amount of discipline on governments, but it is slow to come and it certainly doesn't occur, except with absolutely massive projects on a project-by-project basis. It occurs because of profligacy over quite a long period. It is perhaps wrong to call it moral hazard, but it is like moral hazard, because there is an issue that the decision I make today will affect my state or country's ability to borrow in a few years time if it comes alongside other decisions like it, but I won't observe it today because the ratings agencies will still treat me as Triple-A. That is the issue; we are being rated on something different, that is, our overall likelihood to default rather than a specific project.

Mr HOLDING - But all things being equal, the government borrowing, is that effectively at a cheaper interest rate than the private sector borrowing for the same project?

Mr MORRIS - Yes, the government can borrow at rates that will be lower than it can borrow on the basis of the risk of an individual project, if it wished to.

Mr HOLDING - So all things being equal, it is not a myth to say that the government has access to cheaper finance; what you are really doing is putting a qualifier on is saying that there are other costs.

Mr MORRIS - Yes, and if you took all those costs into account properly you would actually find the markets work and that the rates are the same, but those costs are incurred over a much longer time frame.

Mr CLARK - I accept completely your point on that as a general proposition. The question whether in a federation such as Australia commonwealth tax effects on the state alter that outcome, that is, the private sector provider is subject to commonwealth income tax the public sector is not. Does that upset the equation, or can you demonstrate the point ultimately that the commonwealth holds the tax regime?

Mr MORRIS - I am afraid I can't answer your question off the top of my head. I think it probably does, but I would need to go away and think about that.

Mr CLARK - If you are willing to give it a bit of thought.

Mr MORRIS - Yes, certainly. Obviously there are some distortions in the Australian system, including the Commonwealth Government Grants Commission which impacts on this, as well as the tax regimes, but it is a bit more than I can do now to work those through.

The CHAIRMAN - I don't wish to be responsible for you missing your flight out of here.

Mr MORRIS - That's fine.

The CHAIRMAN - We might conclude at that point so that you can get away. Can I thank you for your time this morning. I think it has certainly been an interesting session for us, thank you, and we look forward to you perhaps coming back to settle any matters we may wish to pursue in the future.

Mr MORRIS - And I will certainly follow up on Mr Clark’s question.

The witnesses withdrew.

CORRECTED VERSION

PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

Subcommittee

Inquiry into Private Sector Investment in Public Infrastructure

Melbourne – 30 April 2002

Members

G. K. Rich-Phillips
T. C. Theophanous
R. Clark
Ms S. M. Davies
T. J. Holding

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Witnesses

Associate Professor John Wilson, Chairman, Institution of Engineers;

Mr Ken Mathers, National Vice-President, Institution of Engineers and Principal, Ken Mathers and Associates; and

Dr Colin Duffield, Senoir Lecturer, Faculty of Engineering, University of Melbourne.

The CHAIRMAN - I formally welcome Associate Professor John Wilson, Mr Ken Mathers and Dr Colin Duffield from the Institution of Engineers to this Public Accounts and Estimates Committee briefing on Private Sector Investment in Public Infrastructure.

All evidence taken by this committee is taken under the provisions of the Parliamentary Committees Act and is protected from judicial review. However, any comments made outside the precincts of the hearing are not protected by parliamentary privilege. All evidence given today is being recorded, and as witnesses you will be provided with proof versions of the transcript early next week. Professor Wilson, if I could invite you to make some opening remarks.

Assoc. Prof. WILSON - Thank you for the opportunity on behalf of the Institution of Engineers to make a presentation today. We were advised to give a written presentation and speak to it, so I apologise in advance, if you were expecting a Power Point presentation, we will just talk it through.

I am the state chairman of the Institution of Engineers here in Victoria for 2002, and my two colleagues here have a long history in infrastructure. I start with Ken Mathers, who has had 30 years involvement with infrastructure delivery, initially with Vicroads and then heavily involved with the City Link Authority with the City Link project. Dr Colin Duffield has had over 20 years involved in infrastructure procurement, and in the last 10 years has been heavily involved in the researching side of the very nature of what we are talking about today, the public and private partnership side of things. I think at question time you will be well serviced by our members here.

The Institution has had a long history and involvement with infrastructure. You might be aware of this infrastructure report card which the Institution put out in 2001, which comments on the state of infrastructure in this country. Essentially, the state of infrastructure in this country is not good. We have rated it from A through to E, and a lot of our infrastructure is rated C-minus, D and E, which is not good. A lot of money is required to at least maintain that infrastructure, and not only that but actually build on it; we are talking about in the order of $150 billion worth of investment in the coming years needed to at least maintain and develop our infrastructure.

We are very strong on the fact that strategic expenditure infrastructure, privately or publicly, can actually underpin new economic development. The Western Ring Road is a good example of that, and that investment there followed by a lot of new industries that are forming out in that region.

The increasing focus on private investment reflects several changes in the nature of skills of government. Firstly, government is very much trying to reduce debt right now; that is just one issue, we want to get the private people on board. The other issue is that government has been downsizing, going back to their core business, and a lot of the technical expertise within the organisations is no longer there, and therefore partnership with the private organisations is a good way of tapping into the engineering, financial and managerial skills which a lot of the public sector in some ways can lack.

The benefits and disadvantages to the community of major infrastructure projects that involve private sector funding: certainly the Institution of engineers strongly supports private sector investment in public infrastructure, and whether be that for full privatisation, BOOT schemes or the public private partnerships that have been used extensively around Australia, and particularly in Europe. There is a range of hard infrastructure, such as buildings, roads, and rail services and also the soft social infrastructure, including public health, education and prison services.

The Institution recently released this publication here on “Public investment in infrastructure: Justified and effective”, and I will leave a copy with you of that. It talks about the government's need to not only consider the level of public debt, but also the condition of public assets. I am leaving this documentation here to demonstrate the issues around the topics, and some of that information might be useful for you in your deliberations.

In some cases, such as toll roads and expansion of electricity generation, the private sector has been able to provide new infrastructure; in other cases, the private sector has taken over existing infrastructure like the airports.

A couple of observations we make in respect of privately funded infrastructure conceived in the last few years: firstly, in general the private sector will only invest in the public infrastructure where a strong business case exists, and for that we mean a reliable income stream and the appropriate level of return on the investment. Essentially, if that's not there to start with, well it is going to be very hard to get a partnership happening. Another observation is that over the last 10 years there have been delays in the tendering process, maybe due to delays in tendering or significant changes to the tender brief or changes in government policy. Any of those things which bring a delay to the procurement of infrastructure is going to slow down and detract from private investment; essentially the private investors want to get in there and make the dollar, get the business happening. So that for any delays obviously there are going to be costs to them, and it does not make it so attractive.

Social equity issues have been raised. In some areas people have a user-pay facility, and in other areas it is provided free by the government. Those social issues have been raised but certainly have not been solved, so they are some of the challenges we have. The provision of private investment in public infrastructure, I believe, needs to be carefully marketed to the community; if it is not marketed correctly to the community there will be some bad perceptions at the very start, which is hard to correct once they are in place.

The second part we are very strong on is having a body such as the infrastructure planning council, that sort of body; but maybe a body a little bit stronger than that body, to actually plan the infrastructure requirements for this state in not only the short-term - which we call less than five years - but also medium term - which is five to 15 years - and also long-term, getting up to 50 years. We see that as a very, very necessary body to provide that overview of what the infrastructure requirements are. We need to address a number of issues. One of the ones is what the population of Victoria is going to be over the next 50 years, which is obviously a large driver for infrastructure requirements. Certainly associated with that infrastructure planning council would be the preparing of a triennium infrastructure scorecard, like we have here, looking at our assets and where we are going. We believe the makeup of the council needs to be expanded to include representation from ministers, infrastructure owners, constructors, users and community representatives. A certain part of that is addressed now on the council, but we need a little more of the business and technical expertise on that council.

We come to public acceptance of private investment in infrastructure. The main one we see there is transparency. We think the more in-confidence negotiation that happens the less confidence the public has in the agreements, so we are pushing transparency forward where possible in those negotiations and in the final documentation. It is a partnership between government, business and the community. Only when all three are comfortable with them will private investment been seen as a long-term solution rather than just another government fad.

Improving infrastructure project risk management is another key area. We certainly believe the Partnerships Victoria goes a long way to addressing a number of the issues associated with risk. I mention a few of the principles which we believe underpin project risk management for infrastructure. Firstly, risk allocation must be negotiated and sensibly allocated to the party best able to manage the risk. I think that is a fundamental rule of risk allocation. If we get to a situation where we try to offload risk to a party which is not able to properly manage it, well, it might be good in the short-term but eventually it will come back and bite you and result in disputes and additional costs and delays.

We believe risk management is critical to all projects, and will determine their structure, contractual arrangements and outcomes. As we state in the paper here, there is no single optimal risk allocation of risk management process for all projects, it is unique, project-by-project basis.

We raise a number of ways one can overcome the risk side of things. One is to have better risk management managed by multidisciplinary teams, which should include professionals with legal, engineering, financial, environmental and social backgrounds. A realistic amount of time must be set aside for risk identification, allocation and analysis, and that may be several months for major projects. It is of fundamental importance for us to get that sorted out at the very outset and to negotiate the risks adequately. We advocate a risk management matrix development to allow for project officers to determine which contracting approaches - whether we go for the more traditional design and construct, alliance, or public-private partnership at the outset to be used. So we see that as a important part of the inception of any project. When it comes to future trends one of the things we are very keen on seeing is that government builds and maintains the expertise as an informed buyer and regulator. There are certain things the government can certainly outsource, but we believe if you completely outsource your technical expertise you will be left a bit vulnerable there when it comes to needing a good review of the projects.

The main principles we mention is that an informed organisation has the skill to understand their cost, benefits and risks of proposals. The public sector organisations invariably need to grow expertise from graduates as the limitations on public sector pay for middle-level technical staff and hence large-scale lateral entry of experienced staff. We are advocating to acquire a certain skill base in government in technical expertise. The Institution is recommending that the government agencies should ensure they have access to the appropriate level of technical expertise so they can be an informed buyer of engineering, information technology and other technical goods and services. To do this a possible model would be to examine the goods or services to be procured to determine the level of technical expertise required to be an informed buyer.

It will also be necessary to evaluate the relevant existing level of in-house and external technical expertise available; undertake a cost benefit analysis of in-house versus contracted expertise at each stage of the contracting process, and obtain where appropriate the required expertise. We are certainly not advocating to go back to the days of the state instrumentalities where they look after different assets, but we are suggesting that we maintain within the organisation some level of expertise so that the infrastructure performance can be judged with a fair amount of knowledge.

If I can briefly sum up now. Private sector investment in infrastructure is becoming increasingly important, and it is certainly becoming a lot more of a mature mode of delivery, both nationally and internationally, and that has been happening over the last 10 or 15 years. However, it will never replace public investment completely; we know there is a huge amount of investment required in infrastructure. This means that considerable public investment will still be required for many decades. To achieve value-for-money outcomes using private sector investment, long-term infrastructure planning is required. We are really pushing this infrastructure planning council and broadening the terms of that council, having quality risk management practices for both industry and government agencies, and recommending that government agencies be informed buyers. So that in a nutshell is where we are coming from, but we more than happy to answer any questions you might have. We have another 15 minutes to get through that.

The CHAIRMAN - Thank you for that. I think that is a terrific presentation addressing the issues that we really want to go to. As you were going through it occurred to me that maybe much of what we have seen as PPPs to date, or mooted as such, probably flow from the fact that our infrastructure is not in great shape and there is an immediate need to look at some of these things. What I was wondering about was your view of, in those areas where you may not have that immediate need but there is a need to ensure that 10 years up the track the infrastructure is still in good shape, how do you shape a PPP that may not show a return for, say, six, seven, eight, 10 years?

Assoc. Prof. WILSON - Sure. This was the challenge we were talking about before, when the private partner comes on board the fundamental thing is to have an income stream, a rate of return for that investment. It depends on what margins they are working with; are they working to a return of investment in the next year, five years? And that is really on a case-by-case basis. Colin might have some thoughts on that.

Dr DUFFIELD -If I hear you correctly, you are starting to tap into how do you maintain the service outcomes in a long-term strategy given that if you look historically between 1990 and to date the early projects were based around construction rather than based primarily on service, and in truth the ones based on service like Latrobe Hospital were not great successes. There were gaps in the knowledge base. I think in the marketplace, when the Victorian government has gone to the PPP policy it has gone to much more to serviced outcomes and to public interest tests up front. I think the outworking of the private rail system here in the metropolitan region has gone some way to identifying how to scope and specify service outcomes on a long-term basis as opposed to just around a construction as a operating business that has the need for upgrades and the like as you go on. I think that has been the first example that I have seen where a sizeable bite has been taken out of an ongoing business, and as we read in the press there are ups and downs in it, but overall it seems to be moving forward.

The CHAIRMAN - That probably takes you through where you are talking about scoping contracts, those sorts of things, to another threshold issue, and that is the expertise available to do that scoping risk analysis and so on, particularly within the public sector - and you address that partly in your paper - but taking that further when we were speaking informally before: if there is a different view of what the risks are in the public sector and the private sector, how do you work towards getting trained people who actually understand the risks across both, and do the current training institutions actually talk about things like public perceptions of risk as well as what risk is in the private sector?

Assoc. Prof. WILSON - It is covered there in the presentation, but if you really want that between the government and the industry you really have to get the two talking, and you probably have some personnel swapping sides from government to private as well.

The CHAIRMAN - Yes, trying to get back, if you like, to slightly before the crossover, how do you ensure there are people on each side who actually understand the requirements, if you like, of the other?

Dr DUFFIELD - I may be able to unravel it into a simplistic framework. I think when we do PPPs, take government's perspective, there is a commercial responsibility to state; there is a servicing of the community interest; there is regulation long-term, and there is an aspect which I would call stewardship, which is the long-term management of the state's asset. I have a personal view, it is not the IE's view, but to separate some of those functions it allows the right people with the right expertise to step up to the plate. If you separate out the commercial issues - and of course you can get good commercial people in government to go head-to-head commercially with the private sector, and you can work through other assets. So I think there are people in the marketplace with the skills, but I think to expect one individual or group of individuals to be all things without separating them out is a tough call. So I think there needs to be a little bit of thinking about how it should unravel and how it should be put on the table, but I think the expertise is there given a bit of refinement.

The CHAIRMAN - What do you see as the balance of the private sector to hold that sort of expertise internally as against buying it in? Particularly, say, when later the criticism might be that you buy it in for this project, but the person you are buying it in from on the next project could be working for the private sector, and so is there a view that may be clouded because they are essentially working in the private sector and are coming in just on occasion to advise?

Assoc. Prof. WILSON - On the technical side there is not necessarily gearing up for full mode of delivery within the public sector, but it is having enough people there who understand the technical procurement requirements of infrastructure so you are coming from an informed buyer's position.

The CHAIRMAN - The technical aspects in the some sense are the easier ones to deal with, aren't there?

Assoc. Prof. WILSON - You are quite right there.

Mr MATHERS - I think it has been beneficial for the government to maintain its expertise in this area, but I also think it is very beneficial for both sides of industry, both the government and the private sector, if you do have these risk management experts who come in on one particular project; they might be working for the government, but on the next project they are working on the other side of the fence. I think that is good because that just broadens their knowledge. They probably have a greater appreciation for what the government's view is on certain risks when they are working for the government and they can go back into the private sector; so I think it is just a broadening of knowledge, which is a good thing.

Mr HOLDING - Peter has very much touched on a question I wanted to ask. The part of your presentation I found most interesting was this question of how government retains or obtains the relevant technical expertise, as you call it, for being an informed buyer or regulator. I would be interested in soliciting your view on how government is going in terms of maintaining or obtaining that expertise. This is a relevant to a different inquiry that we are doing, but from your perspective as engineers and practising in that field, to what extent is government able to anticipate and plan for what its skill and expertise needs to be in this field in terms of contract management and PPPs? To what extent is it able to say, "This is what our needs will be in the future and this is how we are going to plan to meet them", or is it just complete adhockery at the moment?

Assoc. Prof. WILSON - A case-by-case basis; the roads system is different to the power system, for example.

Dr DUFFIELD - We are very well serviced in Victoria for roads; they have a good expertise and a good skill base. My background is more in the contracting sense rather than working in PPPs. To me there is a gap in what we have at the moment in terms of the long-term contract administration of the arrangements that are established after long protracted discussions to make sure that as the projects run down stream that one party - usually the government - is not weakened by its expertise moving off somewhere else on to the next project and people forgetting what has actually been agreed and thereby the commercial advantage being whittled down over time. That is one area where expertise does need to be built up, and there is quite a lot of knowledge required.

Mr HOLDING - You are saying that the expertise in that instance is not lost to government, it is just lost to the management of that particular project.

Dr DUFFIELD - I am saying if you take a more global view, government, in my view, needs to protect the interests of the state by having people very familiar with the contracts that they are dealing with over the long-term, which is what these contracts are as opposed to only come in for say the procurement phase where everyone jumps into it and rattles it out, because these contracts obviously run much longer, so the expertise and the knowledge basis is required over the longer period. And that, in my view, requires more training and some tailor made expertise in respect of the agreements that have been struck and how to work with them, because they will have to be change and be dynamic, and that is quite a challenge.

Ms DAVIES - I really appreciated your presentation. In fact I see the perspective you are coming at is much wider than a narrow economic efficiency perspective. I also appreciated your comments about what your association relates to it, and that there are values there beyond straight economic values.

The comment that you made about governments need to be assured that the organisation delivering essential services infrastructure is sustainable, that echoes a bit in view of the difficulties that there have been with some contracts. When you say that sort of a statement, does that mean that you believe that that straight competitive approach is not appropriate because it is not able to fully recognise the long-term sustainability of particular bids?

Assoc. Prof. WILSON - There are two parts to this. One is the commercial position; the other is that longer term, the other benefits that go with that particular project. We would like to see, I guess, both being judged whenever you award a tender for that sort of work, rather than being on a purely commercial basis, or up-front costs for that job. If you look at the more long-term, maintenance costs that go along with that, it maybe a cheaper solution to start with, but if it is going to cost you a lot more money down the track, that sort of costing needs to be brought in so that you are comparing the tenders on a level playing field to start with.

Ms DAVIES - One of the key issues it seems to me is that the whole workability of the particular project might depend on the ability of somebody at a very early stage too list sufficient relevant factors that need to be taken into consideration, and that need to specify everything rather than to have a broad understanding of what your duty of care is, which is a much wider concept that the public sector can deal with; do you see that that is an inevitable problem? Is it possible to foresee enough, to have enough expertise, to list all the different elements that need to be considered in a contract?

Assoc. Prof. WILSON - Certainly the less you list the less you get.

Ms DAVIES - I see that as an incredible inhibitor in the workability of it, because if you have to specify everything and you don't get it unless you specify it, then you are inevitably going to have holes.

Dr DUFFIELD - In the engineering technical discipline there has been a major shift from specifying things in terms of being prescriptive to taking a performance-based type of approach. If you get a building today or go for a design and construct, say on a road, the specification is we want these outcomes but we are not telling you actually how to lay it down.

If you can be specific enough - and certainly around the table we have a view that you do have to be clear about how you scope your project - but if you can be clear and specify the performance outcomes clearly, okay, the actual way you do it over time will change, but if the performance outcomes are clear then at least for a window of time in the medium term you should get that right. And I think in the longer terms things will change; new technology, changes will emerge, and we will have to move with that. So there has to be scope with these arrangements to continue to change and be managed.

The CHAIRMAN - Can I just follow through that, and ask for an example on the type of infrastructure we are looking at. If you have the building of a major new piece of freeway, what would you give as an example of a good outcome that could be applied to that that would then determine that all of the outputs that you might otherwise have specified are actually met?

Dr DUFFIELD - You start to get down to the detail, and of course you get into the subtleties of are maintenance responsibilities part of the package that you've asked the contracting entity to undertake; because if there are you may well specify whether you want this facility to be 100 per cent operational meeting these particular service requirements in 20 years, and it is your responsibility to make sure they are, and if they fall below a certain level within a time frame you can specify to the users it has to be fixed up, or whatever.

The CHAIRMAN - The outcome is that you must maintain a piece of infrastructure that will allow a maximum of half an hour's travel time between these two points; that type of thing?

Dr DUFFIELD - Yes, that's the type of thing.

Mr MATHERS - But I also think with public infrastructure, you've always got to be aware that when you are building it you are building it for the long-term, and that there are important urban amenity design and aesthetic requirements that you have to think very carefully about as well. It is not just a process of being out there and building a piece of hard infrastructure that is functional, but it also has to look right in the city and it is there for all time.

The CHAIRMAN - It is interesting you raise that, because in one city I spoke to someone who had carried out a major public private partnership in infrastructure project, and when I was talking to them afterwards and said was there anything they would do differently, they said the one thing they would not do again was retain the design, for those sorts of reasons.

Mr MATHERS - Yes, but you can specify your design outcomes and urban design and aesthetics without you defining exactly what you want; you can think of performance requirement but it is essentially up to the private sector.

Assoc. Prof. WILSON - And as part of the tender assessment as well.

Mr RICH-PHILLIPS - One of the issues you touch on in your paper that was released last month *Public Investment in Infrastructure* is the issue of solvent risk, which is something that seems to have been of particular interest of late in Victoria with partnership privatised services, the rail access regime, the retail price caps for electricity which seem to have created some disquiet in those industries. Given that we do have falling investment in infrastructure, how much of a factor is sovereign risk to the potential participants? Is it something you are getting a feel for that is of major concern or is a major disincentive?

Dr DUFFIELD - Sovereign risk in Australia is different to some other countries. I have worked on projects throughout Asia and even in Germany – I haven't worked in South America! – so our governments and the democratic processes we have here are robust, and I think that comes through in all of the business we do, so I would like to say that up-front. Particularly for these projects where sovereign risk comes into play is where projects are delayed beyond what the marketplace wants or is desiring by way of commercial outcome.

If I go back in time and look at some of the early projects that were done there is a great learning curve. The Collie Power station in Western Australia is a classic example of where the solicitors went to and fro trying to negotiate themselves to death; after five years the project did not proceed. Similarly, in Victoria, on change of government, there have been delays to projects, which of course make the marketplace a little unsettled; and I think the County Court is an example where caught in the midst of the change of policies - and not that that is a bad thing - but it is the aspects where it delays the project and people then start looking at the assumptions we have made for commercial outcome, are they still valid, and have we lost the opportunity to actually make a commercial deal.

So when you say sovereign risk is it a concern, we say yes, in terms of the ability in the marketplace, the desire, to know what people are entering into. There is a lot of money involved in doing all the background work, tendering for these projects and doing the necessary research to get your cards on the table. So if you think the process is going to change in an ad hoc fashion, or every time a change of government comes in and someone wants to put their own stamp on the way business is done, then I would say yes, it does have an adverse effect.

The CHAIRMAN - Taking away the change of government, which can always affect these things. What is the level of understanding in the private sector that dealing with these sorts of matters within the public sector that the largesse of public money may in fact alter the sorts of time lines that would be normally applicable in a straight private commercial transaction? There may well be other requirements that are about accountability, transparency, probity, assuring the Auditor-General, all of those sorts of things that can give you different time lines to if you were pursuing a project purely as a commercial entirely private sector project? What is the level of understanding that that time line – and I am not saying that that justifies the sort of thing you were talking about in Western Australia - but there may well be a longer lead time into the project than if it were purely a private sector commercial project.

Mr MATHERS - I think there is a level of understanding out there that there can be these sorts of changes when you have changes of government, and the private sector can manage it. But I think there can tend to be an increasing level of frustration when projects are excessively delayed.

The CHAIRMAN - That's the question I am asking about. It is not about on change of government; it is at normal time, and there may be a view in the private sector that, "This is an excessive amount of time. If we were doing this project ourselves, we would have had this done six months ago".

But on the other hand in the public sector they may be saying, "Well this has actually been a pretty quick time line for us because we have had to go through all these processes and again it is that interface between two sectors that only until recently had not come together yet.

Dr DUFFIELD - I have a view that the market place will price what is put before them, so that if a firm time line of process is put before them, that's what they will price. If that time line stretches way beyond what could have happen - and, of course, everyone states, "Yes, we really didn't think it would have taken this long", that is when the frustration gets beyond just, "We are getting a bit annoyed with this" to "Hang on, is this a good deal for us to be in?"

Assoc. Prof. WILSON - And there are always some unforeseen delays occurring.

The CHAIRMAN - And I guess we are still at the place where we are building a body of practice for people to look back to in one sense.

Ms DAVIES - Can you name particular projects that you think have been delayed too much beyond what the market is happy with at the moment, where there is a degree of frustration evident?

Assoc. Prof. WILSON - I think there was a degree of frustration with the fast rail, for example, getting that whole program moving. That is what I hear around the place; people feel that has taken a long time to get moving.

Ms DAVIES - Are you aware of any reason that has been given for the delay?

Mr MATHERS - It is a tremendously complex project. Various franchise holders that have a role to play in the development of the fast rail project. I don't think it is easy, by any stretch of the imagination. I think the private sector is frustrated with that but also realises it is not as simple as it looks.

The CHAIRMAN - It is an interesting project, and it comes back to what we were talking about earlier, about what expertise exists internally in order to be able to pull that thing together, because there you have a huge project in its own right, but it also has so many stakeholders involved before you can even get it into the marketplace.

Ms DAVIES - It seemed to me that City Link got off the ground very quickly, and yet there were problems that resulted from it happening as quickly as it did, even though it was a relatively limited project.

Mr MATHERS - What were the problems?

Ms DAVIES - The engineering problems with the tunnel and the problems with the E tag. I mean, all of those were problems that happened because the project happened more quickly than it should have done. Is that the way you see it?

Mr MATHERS - Being involved with the project, no, not really. The state tried to kick that project off back in 1992, and then we had the change of government. The project was subject to a review for 18 months, and being involved in that process, my personal opinion was that it was entirely appropriate because we ended up with a better final outcome for Victoria and Australia with that approach to City Link, because within government we refined it and we got it to the point where it was a lot better than when it started off.

Ms DAVIES - So you see it as having been delayed rather than being a project that got off the ground very quickly.

Mr MATHERS - There was a delay to the project because we had a change of government, but there was a delay with the technical side of things and the commercial operation; and also with respect to the foreign technology, because in 1992 we didn't have the kind of technology in Australia that we had with City Link. City Link probably leads the world in terms of tolling technology.

However, I think with City Link and the problems the builders had, I am not so sure that if the project had gone any slower those problems wouldn't have arisen anyway. When people are trying to design and build a thing, they are trying to do it to address every known problem they are likely to encounter, and in this particular case things went wrong. You have to bear in mind that when you are talking about a technical problem Melbourne's geology is about as complex for building a tunnel as you can get anywhere else in the world, and a lot more difficult than our brothers in New South Wales or Sydney have to put up with, where it is pretty good going.

The CHAIRMAN - Were you saying you were involved with that on the government side?

Mr MATHERS - Yes.

The CHAIRMAN - And you saw the 18-month delay, or whatever you want to call it, as a good thing in terms of the ultimate outcome?

Mr MATHERS - That is right.

The CHAIRMAN - Can I ask you the reverse question to that: How did the private sector see that 18 months delay, because that is what we were talking about before?

Mr MATHERS - They were quite frustrated, but I think they realised that this was, at the time and still is, the largest BOOT project in Australia, and that it probably was necessary. When I was in VicRoads in those days we thought we had the project pretty right, but we still thought we needed an external review and that is what the Ronaldson review did; it did a lot of things for the project in terms of the financial aspects to make it more attractive to the private sector to take the risk and invest in it. I think if you ask the private sector, and obviously some of these people will be coming to see you, I think their response would be pretty vocal at the end of the day, that it was a very worthwhile time to review this massive undertaking to make sure we had a better outcome.

The CHAIRMAN - I was just interested because it actually goes to that perception we were talking about a minute ago, of the two sides, if you like, and the perception of the time lines.

Dr DUFFIELD - To give you another example, so some of your early Docklands work, there were cases there where particular parcels of the project were let or put to the marketplace – in fact one I recall was put three times – it was a large Malay investor very interested in that piece of action, but for the third time having bid and lost their bid and spending over $1 million to get them in the position to get around the table, and they got a bit tired of it and there was a lot of money wasted. If you delay the process you can actually waste the private sector's money on that sort of concern.

The CHAIRMAN - That is right, and it is another issue of whether they are tender costs or bidding costs.

Mr MATHERS - If I can add to what Colin is saying, in the past in government we have not had a real appreciation of how much it does cost to put some of these tenders together, and even for design-construct projects for roads that are around $40 million it will cost each of the private sector parties at least $250,000 to bid for those things, and in the big, big projects you are looking at costs in the millions of dollars.

The CHAIRMAN - So if you don't win one regularly --

Assoc. Prof. WILSON - You have to stay in business and make it up with the next one.

The CHAIRMAN - Thank you very much for your time today. We look forward to your further involvement in the inquiry.

The witnesses withdrew.

CORRECTED VERSION

PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

Subcommittee

Inquiry into Private Sector Investment in Public Infrastructure

Melbourne – 30 April 2002

Members

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T. C. Theophanous
R. Clark
Ms S. M. Davies
T. J. Holding

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Witness

Professor Graeme Hodge, Director, Centre for Privitisation and Public Accountability, Monash University.

The CHAIRMAN - I welcome Professor Graeme Hodge from the Centre for Privatisation and Public Accountability, Monash University, to this Public Accounts and Estimates Committee briefing on Private Sector Investment in Public Infrastructure.

All evidence taken by this committee is taken under the provisions of the Parliamentary Committees Act and is protected from judicial review. However, any comments made outside the precincts of the hearing are not protected by parliamentary privilege. All evidence given today is being recorded. As a witness, you will be provided with a proof version of the transcript early next week. Would you care to make a statement to the committee, Professor.

Prof. HODGE - Sure. I had actually done a bit of preparation for today, so I am happy to hand around some material. I won't go through all of this, but you will have heard that anything that is possible in the private sector and it is pretty rosy and it couldn't get better! However, I want to present an independent view of public private partnerships.

A number of people will be aware I have done some work in privatisation and have achieved some pretty positive results on contracts, and I do hang on fairly steadfastly to my independence in these views. Just to remind ourselves of the differences between things like PPPs and traditional contracts, there are several differences in my mind; and I will talk about the promises they make and have a look briefly at the evidence and finish up with the issues as I see them. I will go across these briefly.

PPPs to some people are the new frontier, or the latest chapter of the privatisation book. I don't think that is wholly fair. I think it is something different, but it is certainly a long-term relationship; they are significantly different to traditional government contracts because of the points I will present. There is some sort of joint decision-making for outputs; it is not only government of the day deciding the infrastructure that is to be built, it is a joint process. They have much longer-term implications than traditional contracts, there are huge financial flows involved, and there is a much greater capacity to share risks and rewards.

When I make presentations on partnership issues my colleague from a famous bank talks about risk sharing, shafting and shifting, and I think that there is an element of truth there. I guess for us as part of government, we have to decide what we are doing, whether risks are being shifted or shared or we are being shafted. Partnerships obviously do have an element of capacity to share risks and profits and other things. The main issues that I will get to later are the need for long-term accountability and the need for transparency to avoid short-term political expediency.

What are the promises that PPPs make? There have been traditionally two. The first one is that there was a claim made that they reduce pressure on public budgets. That claim has been so for several years, and that is now widely believed to be false. To an extent, I guess, public funding initiatives turn a capital requirement into a long-term recurrent or annual requirement, but they certainly don't reduce the call on the public budget if government pays for them. That is largely now seen as a false claim.

The second claim is a reasonable one, and that is that they can provide better value for money. So it is a reasonable claim on which we should have a look at the evidence. When you have a look at the evidence, I guess the big finding there is that the evidence is sparse. You can go back to the original reports from Arthur Andersen and the London School of Economics in 2000 that talked about analysing 29 business cases and they say if you do that you will find 17 per cent savings. I notice that this is in the Treasury and Finance documents, and that it was done on the basis of business cases which you might regard as somewhat flexible.

The National Audit Office in the UK at the same time looked --

The CHAIRMAN - Are you saying there that the Arthur Andersen stuff was not on delivered projects?

Prof. HODGE - It was on business cases. The National Audit Office looked at seven PFI actual projects, and they reckon that you get cost savings of between 10 and 20 per cent, so that does deliver some semblance of veracity to the earlier claim; it seems to be reasonable. A couple of other academics have looked at this. Hall in the UK looked at some of those early projects, and he said of the four roads projects he analysed there was an overall saving; although two of them were better done through traditional public funding, and two of them were better done through private fundings. He looked at two prisons that overall gave a 10 per cent saving. All of those savings came from one of those contracts and there was a 10 per cent actual estimated saving overall. And the National Insurance Recording System talked about a 60 per cent cost saving, again from this academic.

If you go to the UK nowadays - in fact I have just come back a couple of weeks ago - they now talk about that cost saving having been subject to some considerable reduction. In part, that is because the government agency that was specifying the project changed their mind part way through, but there were certainly significant cost savings.

In Australia, a couple of academics from New South Wales, Bob and Betty Walker, talk about partnerships as accounting trickery. They liken it to the kind of Bond Corporation ethos, the heady days where he hid things off his balance sheet. So they don't regard them particularly well. They talk about the feasibility study that was done for Sydney Airlink, that BOOT project, predicting a 21 per cent return to private investors but giving a 2 per cent return on equity to government. I guess that starts ringing bells in my head saying, "Hang on, is this reasonable?" and it does not look good, 21 per cent compared to 2; but I would have to remind you that in some ways it depends on what risks have been taken on. When I insure my house, I pay someone else to bear the risks for me, so it will cost us money, but it does seem that 21 per cent for the private side and 2 per cent for the government side does not look very flash, certainly from that feasibility study. The M2 motorway was expecting something like a 24 per cent return to the investor.

Walker and Walker talk about the evidence of returns to private investors as being pretty glowing; it is a good deal to get in on. So I guess you would expect an industry to be building up, promoting partnership projects. In the US there was only one study done, and they talked about a particular correctional facility in Massachusetts costing 7 per cent more than it would have through government and as being wasteful. Now that is the evidence that I have seen that has informed the view of journalists; there may well be other evidence around from accounting companies or investment companies which I have not been able to review, but that is the evidence that is out there in the public domain.

The other side, I guess, we ought not forget is that the Department of Transport recently in the UK looked at London Underground's history and said if you look at the history of the London Underground it has always been over budget and late. The Jubilee line was six years late and 30 per cent over budget. If they lined up, as they did indeed, 250 London Underground projects completed between 1997 and 2000, the estimate from people involved in those projects was that they probably came in around about 20 per cent over budget, with the public sector of course managing those works.

On the private side there is not much evidence around, and if you look at the public side, it is not too flash either. So as far as I am concerned, it is a bit of an open slate; the claim is unproven to me. If you ask managers in UK organisations, as the UK National Audit Office did in their survey, 81 per cent of the managers would have looked you in the eye and have said, "The private finance initiative projects that we have been doing have either been excellent, good or satisfactory; they are okay". Six per cent said excellent, 46 per cent good, 29 per cent said they were satisfactory. So 81 per cent of public managers in the UK government agencies were saying that they were fine.

Having said that, I think I am yet to meet a manager who is willing to admit they have been making mistakes and have basically been messing things up, so we do need to recognise the conflict of interest involved in that survey. But it still gives us some information. So that is the evidence from overseas; not very flash.

Everyone around the table would have watched City Link in Victoria, and would be aware of the information that is available on that. Certainly we did deliver in Victoria under the previous government a large complex project. It was delivered more or less on time and met government objectives at the time. The Auditor-General said in 1996 that the choice of consortium was fair and equitable, so I guess there was some element of reasonable competition there. If we observe particularly things like construction risks and so on, there were huge risks that were transferred into the private sector, and the governance of that project was effectively achieved through the Melbourne City Link Act, some 231 pages long. There is a 34-year lease for the tollway; there was no public cost benefit ratio undertaken before the decision, although various versions of that came out afterwards. The contract is for up to 54 years if consortia profitability is low, and you do have this obvious issue of “lock-in” by the government. We are locked in for, I think the lowest point is 27 years and the highest 54 years, depending on profitability. There does not appear to me to be any provision for consumer protection in the scheme, which is of concern; and at the time the government of the day was able to override normal due process concerns in building that infrastructure.

My bigger issue with City Link, however, is that in looking at the documentation - even the Audit Review Committee report of Russell, Waterman and Seddon, my big issue is that the deal is not clear, and it ought to be clear. I understand you can put contracts on the Net, but unless we have a two or three-page summary of deals such as this, it is never clear. In fact, I was involved in another session this morning about accountability, and someone was saying they don't know anyone in Australia who can coherently summarise the deal that has been done in transport in Victoria. Partly it is a complex deal. There are many, many deals; probably three or four dozen deals. But as a citizen I would have to say it is a concern to me that no-one knows the deal. I presume the bankers know the deal, and the previous government knew the deal, or its lawyers did, but I would like to know the deal as well.

Ms DAVIES - That worries me, that whole business of the complexity of the contracts that may or may not be put on the Net; do you believe that it is technically feasible to have a three-page summary of a particular deal that would contain the essence of some of those very complex arrangements?

Prof. HODGE - Without hesitation, yes. I guess the issue is that we are used to sending out work; (we are bureaucrats - as I formally was) - we are used to sending out to Parliament two or three-page summaries of very complex issues, like how you value future transport accident losses on the road. If you can do something as complex as that, surely you can make a two or three-page summary for Parliament, and hence that can be put on the Net.

I guess the other side of that is that if we can't summarise it in three pages, we need to figure out a process that makes it transparent and go to those people who do hold that information so that we all know the deal. When you speak to bureaucrats about that, I am sure they will say, "It is too difficult to put this in", but it is possible, I am convinced.

Ms DAVIES - I have been following a contractual dispute down in my area between a private operator and the government, and it seems that the actual contract was so complex that nobody who signed up to it actually understood the commendations they were signing up to; and in fact there are things in the contract that contradict each other. Do you think if you were talking about the transport deals, the transport contract, do you think there is the same problem, that they are so complex that they can be mutually contradictory at some point.

Prof. HODGE - I suspect that is true, yes, I guess because of the way they have been put together. And when a contract comes up every exception or every question that is asked the typical answer is, "We will just add another clause in", so you do end up having the risk that contracts are both long and contradictory.

Ms DAVIES - So you think public interest would be better served if you had more transparency in more simple summaries of contracts?

Prof. HODGE - Absolutely. I think the only way the public interest is served is that if both sides understand what the deal is.

The CHAIRMAN - What, in your view, would be the key elements for the short summary of any particular deal? What are the key elements? Price, those sorts of things.

Prof. HODGE - I guess it comes down to the sense of what is the government's expected rate of return; a very simple thing to ask. Why not have it in that two or three-page document? It used to be in past decades we would expect water and roads organisations to do cost-benefit ratios, to tell us what the rate of return was. Why can't we do it for these sorts of projects? I think they can, but things have to be clearer than they are at the moment. At the moment what happens is, I believe, that we all get a view of a specific project, we hear the theory, or the idea, I should say - the theory that the risks are borne by this sector or that sector and contracts are drawn up but we are never too sure who is bearing what risks with these things, because it strikes me the government bears a lot of risks depending on the political temperature of the day, depending on the four or five decades that follow after the contract is signed. So a rate of return on government funds would be very sensible; what risks are born, and the expectations of those risks are also sensible. In the calculations that people do on risks for construction and maintenance and various other types of risks – there is actually a diagram in today’s session handouts – demand, operating, financial, sovereign/political and so on, all of those risks are valued as part of the contract. I might take an aside to say how they are valued. The figures are in there, it is just that the no-one has the desire to bring them forward to a two or three-page summary. So I think it is a question of desire. On the valuation of risks, I might say I laboured under the assumption that when you are doing risk calculations you go and talk to your insurance companies and actuaries, until I heard a fellow in the UK say how it is done. It is actually done in a room, and you ask those in a room what sort of risks are involved in the project, and what do you think would happen if worst came to worst? How much would that cost? So the risk numbers or matrixes, as far as I am concerned, are made up.

Ms DAVIES - By whom? Which particular people are sitting in the room?

Prof. HODGE - In this particular case, the UK example, I believe that it was the government agency people sitting down in the room, the local authority - I think it was public and private, to be fair - experts dealing with the schools that they wanted funded. When I say 'made up', that is being a little frivolous because any of us can do back-of-an-envelope calculation estimates. It is one point better than guessing, but getting a dozen people to guess is really of not much benefit. It is certainly not hard, scientific empirical evidence as I would expect from an actuary. If you ask an actuary a question like that they will come back in three weeks and you will get quite an accurate answer, and an insurance company ought to be able to do that.

Mr HOLDING - Are you saying that is true of many, many, PPPs or just the one you saw in the UK?

Prof. HODGE - The honest answer to that is I don't know. I have heard one example of how it is done in the UK. It may not be true of bigger projects. I don't know.

Mr HOLDING - What sort of a project was it?

Prof. HODGE - I can go into the homework if you want.

Mr HOLDING - It is just an extraordinary observation. If it is true, I would expect that whatever assessment of risk was done for a project of say the scale of City Link you would presume that all of the data would be collected and all of the expert advice would be sought before any assessment would be made of what the various risks were and what they were valued at.

Prof. HODGE – Yes. And can I just add to that. I would like to agree with you, but I am not sure that is the case. And the reason I say that that is if you look at the annual concession payments that are due to the City Link project, in the separate agreement the master security deed, exhibit W - first amending deed clause 3.1 something - if you look at that, at the bottom of the contract it says there is an annual payment from the consortium to come to the government but we can change that into a concession note which is then deferrable until the end of the project; and it is not clear what the real value of that end note payment actually is, firstly.

Secondly, you only need to make those annual concession PPP payments if private investors earn more than 10 per cent, and then if the consortium has enough cash from the previous year. It is a great deal that has been negotiated, and I suspect that some of the risk transfers that I am talking about - not having done the homework on it - I suspect some of those you can afford to overlook and take the short cut route if you can negotiate a deal that says, "We are going to take more than 10 per cent on this project". But I don't know the answer to whether that is the process that is used on all partnership projects, that's true.

Forget the politics, let's just go over to concerns. As I said, I would like to see the deal that is done becoming more transparent and clearer, particularly to citizens and interested observers, firstly. Secondly, I would like to see some empirical work done on who actually bears the risks. The idea of risk transfer is all good theory, but until you can go to a large project and look at the risks that have occurred and document who has borne what at what price, and so on, you really don't know whether or not the theory of risk transfer has been risk transfer or risk sharing or risk shafting, and I don't think empirical work is being done at the moment, aside from saying some of the obvious construction risks on City Link were borne by the private sector.

Who steers the state in future when government signs partnerships? The paper I presented in the UK actually had this euphemistic title, *Who Steers the State When Somebody Signs up on a Project?* In the end I guess the conclusion we come to is that governments don't steer - not subsequent governments anyway - the contract steers, or the Melbourne City Link Act steers the state for 50 years, because governments would prefer not to break contracts. I don't think that legally they can't - they can - but markets take a very dim view of that.

Mr HOLDING - But certainly you can see a contract without breaking it? It is the government's role to manage the contract in accordance with the act. Whilst it may involve disagreement, dispute, whatever, but breaking the contract is the only option available to the government if it is dissatisfied with some aspect of performance.

Prof. HODGE - That's true, and I guess the question there is “do governments break contracts”? And what I am saying is that I suspect they don't, so there is no steering; the contract steers the state.

Ms DAVIES - From the submissions we heard earlier on, you need to have manageable opt-out clauses in your contract because that gives the state more capacity to steer if there is an unsatisfactory outcome. If I understood it rightly, they were saying that the City Link one, for example, the opt-out clauses were so onerous that no government would ever do it, but some of the later contracts were not, and therefore we have been able to have the example of the hospital, the prison where the opt-out clauses have been enacted. Have you seen an evolution over time of the government's capacity to put viable contracts in that will not leave them powerless?

Prof. HODGE - Well, I guess my answer to that would be I am still learning about the area, and if you are telling me that there are now opt-out clauses then that would reduce some of the power of arguments that I have been putting.

Ms DAVIES - If the government were able to take over the hospital and the prison, then you would assume that the contracts were different than, say, City Link.

Prof. HODGE - And we may well have been learning as we go along. That may well be true, which would in the end strengthen the argument that the contracts need to be totally transparent, including the summary, because it then becomes a proper business partnership between government and business, (leaving out the citizen’s concerns). If that is indeed the case, that we are learning as we go along and that there are opt-out clauses, there is an even better reason these things have to be transparent, including profit sharing arrangements. Otherwise, how do you know who to trust in this whole thing?

One of the issues in the UK was that there is a sense that partnerships or private finance initiatives was a way of getting around the government budget, okay; because it was not annual expenditures, it was really giving someone the right to 20 years of future government flows - tolls from motorists. It did not need to go through the formal government budget project process; it was kind of an off-budget structure. And there is still a concern about the way of getting things “off-budget”, as it were, and I don't think that is reasonable at all. We have to develop smarter ways of figuring out what governments have signed up for, in exactly the same way as we used to do it through capital expenditure with schools and hospitals and so on; you have to force them to go to parliamentary committees, put in works programs and so on. I understand that is slow, but it is one of those things that should not proceed without scrutiny

How can parliamentary oversight of partnerships and committees be improved? - which is the issue I have just raised: how do we get things that have run off budget back on budget somehow to be part of the parliamentary process? It could be as simple as needing to table documents and deals, summaries and so on, in the Parliament, and putting them on the public record. Is there a need for accountability mechanisms independent of the government of the day? It comes back to this question of who steers the state once we have signed up. All governments will typically be confident of the deal they signed yesterday, but when there is a change or two or six or 10 changes, there may well be a case for having a look at more accountability mechanisms to authorise these things. We probably wouldn't want to get the Auditor-General to check over contracts, for a whole lot of reasons.

Ms DAVIES - Why not?

Prof. HODGE - Because I think we would then be confusing who is accountable for what.

Ms DAVIES - The Auditor-General surely is responsible for the accountability of public funding. If there is some public money going into it, surely part of the Auditor-General's role is to oversee the spending of public money.

Prof. HODGE - I think he is responsible for overseeing systems and for putting checks and balances in place, but I think he would be uncomfortable with him having to sign all the expenditure for partnerships.

The CHAIRMAN - Are you saying early stage involvement in the AG?

Prof. HODGE - All I am saying is that there is a question there about confusing who is accountable for what. When any government enters into a partnership on an infrastructure deal, they are accountable for what they do. A separate question though, and a general one, is how transparent is this and what figures are being reported to whom?

Ms DAVIES - Well if he is not going to do it, who else is going to do it? Are you suggesting that there should be another body set up?

The CHAIRMAN - On the other hand, if you use the AG as a contract vet, if you like, you are exposing him to a lot of pressure down the track.

Prof. HODGE - And he would then probably have a series of visits from commercial bankers!

The CHAIRMAN - But there is a risk to the AG, if the contract does not work out in the way intended, if he signs off on it early.

Prof. HODGE - That is the signature on the deal. But we certainly want a lot more than we get at the moment, which I think is an accountability vacuum.

I guess the last touching issue is there appears to have been a purchasing ethos. If you look at the Treasury and Finance purchasing guidelines for PPPs, it is as if we are purchasing stationery or a building - but these are up to $2-billion projects. I think there are huge public policy issues in here, political issues in here, as well as purchasing issues. The way it has been written up at the moment, it is literally just as simple as, "Do we buy this in or do we buy that out?" and I think it is grossly oversimplified. That is a process concern I have over the guidelines that are out from Treasury and Finance. That covers most of my issues.

The CHAIRMAN - Thank you for that, Graeme. We will conclude on that note. Thank you for your time and preparation and the issues you raised for us. Hopefully at some stage we might be able to speak to you again as the inquiry goes on.

Prof. HODGE - Thank you.

The witness withdrew.

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PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

Subcommittee

Inquiry into Private Sector Investment in Public Infrastructure

Melbourne – 30 April 2002

Members

G. K. Rich-Phillips
T. C. Theophanous
R. Clark
Ms S. M. Davies
T. J. Holding

Chairman: Peter Loney, MP

Staff

Executive Officer: Michele Cornwell
Research Officer: Caroline Williams

Witnesses

David Shepherd, Business Development Manager; and

Hans Fischer, Executive General Manager, Project Development, Transfield Pty Ltd.

Necessary corrections to be notified to executive officer of committee

The CHAIRMAN - Welcome Mr David Shepherd and Mr Hans Fischer from Transfield Pty Ltd to this Public Accounts and Estimates Committee briefing on Private Sector Investment in Public Infrastructure.

All evidence taken by this committee is taken under the provisions of the Parliamentary Committees Act and is protected from judicial review. However, any comments made outside the precincts of this hearing are not protected by parliamentary privilege. All evidence given today is being recorded, and as witnesses you will be provided with proof versions of the transcript early next week.

Mr SHEPHERD, **Mr FISCHER**, would you care to make a statement to the committee.

Mr FISCHER - What I have in front of me is a letter of 18 April inviting us to assist the committee to gain an overview of the issues. The subcommittee would appreciate a briefing from Transfield on the issues. Is it okay for me to continue? Is it an interactive process?

Ms DAVIES - Certainly; sometimes too much!

Mr FISCHER - Transfield has evolved from a construction company in the '70s to a substantial organisation delivering projects in the more complex delivery mechanism, which we currently describe as build, own and operate, or on a Partnerships Victoria basis. It has followed the trend, which was basically instigated by I would think governments and public sector in particular. In the '70s we had big projects in front of us, like Loy Yang in Victoria, and I vividly remember the torturous task of getting this project up, where the SECV, the State Electricity Commission of Victoria, was parcelling packages out for design and construction, or only construction with design done in-house; and of course that delivery mechanism came with excitement and despair. What followed was significant cost overruns and I think it triggered a move by the public sector from a hands-on approach of agencies as head contractors to a one step-removed position in saying here is a private sector who can take on the head contractor role.

Then it didn't take long to also invest into the private sector some of the other risks involved, like operator risk and patronage risk or market risk. One of the early projects where Transfield was involved was the Sydney Harbour Tunnel in New South Wales, where the private sector delivered the complete project. Basically without any cost to the taxpayer, following the user-pay principle where the car user paid a toll to cross the bridge or tunnell.

MrTHEOPHANOUS - But car users are also tax payers, though, aren't they?

Mr FISCHER - Sure, but the funding of the project does not come from a tax revenue generated by government. The money has to come from somewhere; it doesn't come out of thin air.

MrTHEOPHANOUS - Just like electricity consumers are also taxpayers.

Mr FISCHER - Sure, but it is a user of that particular facility who pays rather than the broad-based tax income spread over all the population. There is a small distinction. I guess that has triggered a number of projects, and in Victoria particularly at the time - the water project, Yan Yean - we were involved in the delivery of the Yan Yean project, and contemporaneously in Sydney the McArthur water treatment project, and they were two projects that were quite iconic at the time where the private sector took on the concession for delivering water, where the quality of the water was a determining factor of the payment to the contractor/concessionator. This started the move into a longer-term assessment of the performance of the contractor or special- purpose company in the delivery of that service.

Again, another quantum leap, I guess, was performed in the Melbourne City Link, where the size of the project surpassed everything done before in Australia, where the technology involved - the free-flow electronic tolling surpass everything in tolling done until that time. It was Guinness Book of Records stuff in the true sense. It also showed the pitfalls of this particular delivery mechanism, where the risk shift from public to private sector is more refined. I just describe it as the creation of a fire wall between the government and the private entity.

The performance of the Burnley Tunnel is very close to Transfield's heart. We took the risk of the design and construction sitting entirely with the private sector, with the constructor. There is an effective risk shield to government, and those costs overruns do not penetrate through to the government and ultimately to the taxpayers.

MrTHEOPHANOUS - But again the costs do penetrate through to the motorists using the City Link.

Mr FISCHER - The cost of the initial project assessment, not the additional cost which we incurred to rectify the Burnley Tunnel.

MrTHEOPHANOUS - So that came off the bottom line.

Mr FISCHER - Off the bottom line of Transfield.

Ms DAVIES - You will get that back ultimately.

Mr FISCHER - No. Transurban is the ultimate owner.

MrTHEOPHANOUS - Don't you decide the prices?

Mr FISCHER - No.

Mr SHEPHERD - Where Transfield is a shareholder of Transurban, which is a public company, we do not dictate how Transurban runs.

Mr FISCHER - The structure is: here is the government, here's Transurban; the owners of Transurban are a wide band of shareholders, and here is Transfield Obayashi as the contractor. The design and construction contactor had an obligation to deliver to Transurban, and if it did not deliver on time it was subject to liquidated damages. The liquidated damages would have paid the financiers over the period of the delay. In addition to that the rectification work which caused the delay had to be covered by Transfield Obayashi, so there is a clear fire wall between Transurban and the State, and a clear fire wall through the design and construction contract between the contractor and Transurban. The fill pricing regime has actually been set by the State as part of the concession.

Fundamental to the success is this shift in emphasis, I would think – we talk still about the same infrastructure - but a shift in emphasis, a greater role for the private sector, a changed role to the government, a proper focus on the outcome and performance , a clear definition of performance requirements by government.

MrTHEOPHANOUS - Had the project been constructed by the government on contract to Transfield Obayshi, that fire wall could still have been built, couldn't it?

Mr FISCHER - Experience suggests not. It is a hard case to answer really because we can't simulate it. If there would have been a design and construction contract the government would have had to negotiate, for example the allocation of geotechnical risk. In the case of the Melbourne City Link the unexpected behaviour of a 60-metre water head above the tunnel under the Yarra River, the unexpected XXX of the ground caused a change in the tunnel design that led to subsequent problems in the actual execution. I would have thought that that problem would have somehow from a contractor's point of view tried to be shifted back to the ultimate client entity. When I look at the contract, why can't the government write a similar contact and lock the contractor in? From experience, it just doesn't happen that way, and from my experience the government is not a good head contractor.

MrTHEOPHANOUS - The cost overrun on the Geelong Road, are you saying the government will probably finish up paying for it?

Mr FISCHER - It would be pure speculation for me to say that, but it is definitely clear to all of us that a contractor seeks some variation. I asked a fellow contractor in Queensland what is their expected variation from Main roads? Twenty per cent of the contract value. That is a big amount. It is a $200 million contract, a $40 million contract variation. The agencies can't help themselves, There is a big temptation actually to go through all delivery phases of the project rather than putting the fence around it and saying "We are not touching it any more" – this can be delivered by the private sector in its entirety.

The CHAIRMAN - So are you saying that, for example, had that been done as a purely public project - and we will say Transfield was still the contractor, but it was contracting direct to government as a purely public infrastructure provision, that the government would have ended up paying more money?

Mr FISCHER - More money.

The CHAIRMAN - No, would have ended up paying those extraordinary costs that came about.

Mr FISCHER - I am not sure if those costs would have been covered by contractual provisions and commitments and stuff like that.

MrTHEOPHANOUS - What you are saying is there is a tendency.

Mr FISCHER - There is a tendency; there is the experience generally, yes. We did another project in Brisbane, the Air train project, where we put a rail infrastructure between the city and the airport. And in parallel Queensland Transport put in the South-West Transit Way project. These are all public numbers. The south-west transit way project was scheduled or budgeted for $450 million, and they ended up with $750 million to 800 million, just purely by cost overruns. Our project had a construction value of $120 million. Not one cent went to government, because of its build-own-operate nature and this idea of the fire wall. By comparison, on the Melbourne City Link Project I think the parties negotiated about a $5 million or $10 million variation in a $2.4 billion project, which is quite extraordinary. In order to overcome the pitfalls of inadequate specifications, wrong XXX and interface problems we should look at partnership delivery mechanisms, look at bigger packages, look at outcome xxx delivery and specifications. Or at the operations side and performance criteria. A very good example was the Public Transport Corporation carve-up into franchises.

I was involved with the Yarra Trams campaign. What it brought home so clearly was that in order to be successful the agencies need a mirror in front of them and saying. “What do we really want to achieve and how are we performing; what are the performance criteria?" If I may say so, as long as it is a monopoly, these questions do not naturally come up. Again, when I look at Queensland, we had to procure Queensland rail services for the line to the airport. In order to fund the project, we require reliability of service. But we also require penalties, because if the trains are not on time it has an impact on patronage. The response from QR, “if you want to penalise us for not being on time we are not committing to reliability”. There has to be a mindset or paradigm shift. That is the hardest part; that the agencies have to come to terms with the fact that they are under scrutiny now from a competitor or from another operator that provides similar services, but under a very strict commercial regime. Our experience of a transition from public to private sector is that it actually enhances the service that is provided to the public.

Ms DAVIES - That is a very romantic and very positive view of what has happened under these schemes. You could equally say that given that there have been at least two projects that have had to be taken over by the government that there have been fairly grave errors in the private sector's ability to assess a likely rate of return on projects, and likely costs that they haven't been very good at assessing their likely returns and their likely risks. Like the electricity companies and the railway companies have all had to come back and say "We are sorry, our contract is no good, we can't make any money. I mean the railway, the public transport companies have had to do that.

Mr FISCHER - Here in Victoria?

Ms DAVIES - Yes. So do you think there is a very positive view of how efficient the private sector is? And I would say we have some overt examples of where they haven't been very capable of judging what is in their own ability at all.

Mr FISCHER - There are two elements. Let's see what can actually happen. First of all, there is an element of competition.

Ms DAVIES - I just wonder how you react to what I am saying, if as you would say there has been that desire to get in at the lowest bid, has that been a factor against the interests of both the public sector and the private sector; and that competition has been dysfunctional?

Mr FISCHER - Competition has the benefit of fuelling innovation; fuelling good ideas, attracting.

Ms DAVIES - Or fuelling unrealistically low bids.

Mr FISCHER - Fuelling unrealistically low bids, and unrealistic patronage assessments and growth expectations. The assessment of patronage as the driver for revenue is a tough one.

The CHAIRMAN - I just want to follow through Susan's question there, whether it is really that there are two different sets of skills that are involved: one on the public side in its traditional role of providing services and the other on the private side in its traditional role of commercial orientation. Both have built up expertise in their particular areas but not necessarily across the other's area, and so when you come to a project – I don't think so much necessarily a project like the delivery of a road - but if you take private prisons, this sort of thing, that actually involved a very direct service delivery as well that the risk analysis that goes with some of those performance criteria for the delivery of the service, they are not as well done as the financial arrangements about providing the prison, et cetera, the infrastructure.

On the other side, the public sector might well be able to outline what the performance requirements are and the quality of service in the field delivery, but it is not quite as skilled as working out the risks in the financial side as the delivery side. So maybe there is a problem there that either side is not fully skilled.

Mr FISCHER - Okay. My observation is that perhaps one of the core problems is the affiliation with the competitive process in some of the projects. Competition could distort the outcome by unrealistic assessments which, makes some of the people very unhappy. We have more than one construction company; we have debt providers, equity providers, and they have their own set of scrutineers, their own set of investigations. By the time a project which requires funding has been promoted to a bid proposal, all these stakeholders that have done their own investigation are comfortable. I mean, banks do not want to back a project that has no legs, and it is perhaps that scrutiny that is adopted from which one ought to attract comfort.

But in the case of the airport link to Sydney airport, it didn't have the desired effect; the patronage was not achieved, and the project went into receivership. But when you look at the services, the services are still there. So from a public point of view they get the benefits. Somebody gets terribly hurt, but it is most likely somebody on the private sector side, either banks, or in this case, equity providers.

The CHAIRMAN - But I would tend to argue that that particular one - and I think you are right about it - the contract there was a contract that actually seems to show up that neither side do the full detail of what it was trying to deliver - or was fully across what it was trying to do.

Mr FISCHER - That is right, the SRA couldn't ever deliver the services which they underwrote.

The CHAIRMAN - And on the government side, they wrote a contract that actually almost rewarded the operator when they failed.

Mr FISCHER - Yes.

The CHAIRMAN - So I don't think either side necessarily could take much comfort out of that one.

MrTHEOPHANOUS - We have a list that has been provided to us of projects where the government has had to come in and take over again, things like the World Trade Centre and the tennis centre and a range of other projects here in Victoria that have had to be brought back in, and that suggests that there may be some things that need to be done differently.

Mr FISCHER - It is hard to say. One thing again, coming back to this competitive element, is that there have been other ways of delivering projects - alliance, more cooperative style, providing transparency, - which in my view have a lot of merit because you can compete for innovation. But at some stage you have to sit together and translate the innovation into a design concept - the government agency and that party of the private sector - that moving together rather apart as in an adversarial tender process where every corner is negotiated.. So you have other possibilities of contractual relations in the future.

My preference would be an expression of interest to proceed where a proper capability is being produced by everybody who wants to participate, followed by a super selection on that basis; and then there are one or two who move forward through the project definition phase where there is much XXX and emphasis on transparency and understanding. This way we avoid the situation whereby two parties actually can negotiate for half a year and they talk on different planes and they never realise, because of probity constraints. Eventually you have to break the barriers down and get the parties on the same plain so the outcome can be owned by both parties.

The CHAIRMAN - How much of a difficulty do you see in that process? If you were delivering the same project through a partnership, would you actually expect that the one delivered through the partnership is going to take longer to get up because of some of the things you were just talking about, the probity considerations, the transparency, the different requirements in negotiations?

Mr FISCHER - Yes. The selection process generally and the whole gestation process to the fundamental decision can take longer, yes.

The CHAIRMAN - I hesitate to use the term 'delay' because it is not quite, but what is a reasonable time line for delivery of a public sector project in comparison with the same thing occurring in the private sector, given that there are different requirements around the public one? I understand with City Link that there was about an 18-month delay while it was being reviewed at one stage. I assume that caused a fair amount of frustration.

Mr FISCHER - Yes.

The CHAIRMAN - But on the other side the people involved in that said they felt from the public point of view they actually achieved better outcomes and a better project; now how do you get those things together?

Mr FISCHER - It is hard. In City Link there were two parties being pulled along, and a competing consortium and our consortium, and the government actually spent a hell of a lot of effort advancing negotiations with both parties, and that was a big achievement. I have seen it only before on the defence side, where the defence department traditionally had a problem getting into technical detail, because normally they buy advanced modern technology for which there is no in-house specification. What they do is say to the proponents: You give us your proposal, we XXX and negotiate the two proposals advance to a point where we have a clear understanding of the project definition, and we pay both of you but we select one which we want to move forward to contract award. And they maintain the ownership of both technical proponents.

MrTHEOPHANOUS - I think the issue that concerns me is that it is not just a value-for-money thing for government. I think the issue is broader than that. It is not even just taxpayers but ultimately consumers. If, as a result of a deal between the government and the private sector, the government gets a good deal and by extension the taxpayers get a good deal but the consumers are ripped off, well, I don't see that as necessarily in the so-called public interest. There is an acknowledgement that that has potentially occurred in relation to City Link and in relation to the electricity industry, and I remain to be convinced that it hasn't occurred, because just using the City Link example, when we first came into government we asked the question how much would it cost to buy back one toll? It was the one on the Tullamarine Freeway, because of the political issues associated with it. My understanding is that we were told the price of buying that one toll was around $1.5 billion, which was three-quarters of the cost of the original project. So somebody is going to be paying a toll on there for 35 years. Well, the government may be able to say we haven't added to state debt as a result of using a private second interest arrangement, but I would have thought governments have a broader responsibility than simply their own bottom line; and even the so-called taxpayers that pay money for them, there is also the question of their responsibility as a consumer.

Mr FISCHER - This consideration will always occupy us. It is very difficult to foreshadow. Who knew that the Transurbashare price would quadruple? If you and I had known, we would have invested in that and we would have been sitting somewhere else perhaps today.

MrTHEOPHANOUS - I should have guessed!

Mr FISCHER – In the case of NSW toll roads, the RTA make their own assessment, their own financial modelling, and it works out; they have got a pretty good idea on the construction costs and they work out a cap for the toll, and that's it. We will toll now on the Lane Cove Tunnel for $2 each way; we XXX. On the tunnel it was $2 . In addition to that, the RTA says "We want our development cost reimbursed" so they ask for a contribution of $54 million, user-pays. So the government has taken the next step in New South Wales of saying: If we do these projects we want our up-front costs reimbursed and we want the user to pick up fundamentally all our cost.

On the Western Sydney Orbital Road they do the same thing. They call it business consideration or up-front cost. What we are negotiating there is an amount of business consideration to pass on to RTA; and that is a deciding selection criteria. You make your own assessment on construction costs. Whatever is left over we hand over to the RTA. And that has XXX that capacity of the private sector to make super profits out of toll revenue. I think that is part of this evolution process we are seeing. Wherever we are seeing a little leakage or a little opening the next move will be sharper; stakeholders will move in to close it.

In 1991 when we negotiated Yan Yean, the banks took a conservative look. Today they are much more open, understanding and aggressive. This is all part of the evolution. It is hard to say what the position will be in 2050. What we are seeing here is a general shift of services which traditionally have been provided by government to the private sector. I don't think a new power station will be built in the same way it was in the early '70s and '80s, because it has proved to be insufficient. In addition to that, the government has lost the engineering capability in many areas. In many instances the agencies have lost the capacity to actually define projects. So we just have to work very hard on partnership. We like this partnership idea, because it suggests that neither party has got all the solutions, we have to work on the solutions together in the same way as we work on the implementation of these projects, an open transparent approach.

Ms DAVIES - Are you happy with the development of the partnership approach at the moment with this government? What pluses and minuses can you see in the current processes?

Mr FISCHER - First of all, it is still to be road tested properly. The latest version of the Partnerships Victoria framework, I think we have not had enough opportunity to look at. I understand that there will be an expression of interest coming out on the prisons where the partnership framework will be applied, where the private sector is to build the prison and provide certain services, but not the lock-up services. We are not getting the keys, I understand.

The CHAIRMAN - I think there are a number who have just go into or are about to go into the market.

Mr FISCHER - I think this is an interesting development in Victoria, which you don't see necessarily in other states - the emphasis on social infrastructure versus economic infrastructure. I think the economics work. There is a hell of a lot of effort on both parties to see if they get the right outcome, the right mix.

MrTHEOPHANOUS - Is one of the advantages that the private sector are better managers, that they are better able to manage a business - whether it be to provide a service or whatever it might be - in a more efficient, cheaper way than the public sector, or is the evidence the reverse?

Mr FISCHER - When we took over 750 people from Yarra Trams, we could see quite a shift. They are the same people, but they seem to have a different smile on their faces. I don't know why that is the case, but I could see that there was a market change. It was the same people who worked on the side of government, and on 8 August 2000 they started to work for the private sector. There was a change in attitude.

MrTHEOPHANOUS - Was there? Were you involved in Loy Yang B?

Mr FISCHER – We were involved in Loy Yang, but we failed.

MrTHEOPHANOUS - Mission Energy got it.

Mr FISCHER – We worked with SEI.

Ms DAVIES - Can you see some extra skills that government needs to take on board to manage partnerships better, that they haven't got at the moment?

Mr FISCHER - It is a challenge for government to maintain the outcome focus and the performance focus in this partnerships concept. Agencies have to spell out what they want so the private sector can actually perform accordingly.

Ms DAVIES - In a prescriptive way or in an outcomes way?

Mr FISCHER - At the end of the day defined in schedules which are attached to a contract or concession. The concession which controls the relationship between public and private sector, must be clear in what is expected, and that's, I think, the biggest challenge.

Mr SHEPHERD - But it is outcome focused, not prescriptive.

Ms DAVIES - Prescriptives don't work very well.

Mr SHEPHERD - No. And that's the intent of partnerships, to get the outcomes, and also as Hans said to get the government to understand the outcomes of what it is trying to achieve, not the methodology of trying to get there.

Ms DAVIES - They are the experts to work out the methodology.

Mr SHEPHERD - They have a range of skills that are more finely tuned in various areas than the government, because the nature of government is very broad; private sector is very based on buildings, roads, infrastructure.

Ms DAVIES - Can you see some extra skills the private sector needs that it does not have at the moment?

Mr FISCHER - Definitely.

Ms DAVIES - In what?

Mr FISCHER - The private sector didn't run trams in our days. The customer service focuses on new skills in areas where we haven't actually applied ourselves previously.

Ms DAVIES - In understanding things like the public interest, do you think that business has enough understanding of the concept of the public interest and broader social goals as opposed to economic goals?

Mr FISCHER - I find the private sector adapts very well to those requirements.

Ms DAVIES - Do you?

Mr FISCHER - Yes.

Mr SHEPHERD - I think one of the things the private sector has probably got to learn is to be a bit more open in the way it is doing business with government when it gets into this sort of relationship. We worked on a $450 million sewage project for Sydney Water. We had to form a combined team and move people in and out of that team because they were not fitting in. One of those things we were going through in that process was making sure we had the right people in that team who could work with the government to deliver a joint project.

Mr HOLDING - So these people would were moved out of the team didn't understand the openness.

Mr SHEPHERD - It was the culture of that relationship, which was not a hard dollar contract relationship. It is: We are working together to deliver this with Sydney Water so we needed a different set of skills to be able to be still commercially minded, but knowing that you've got a government partner working with you in delivering that project.

MrTHEOPHANOUS - What about with the unions? Was the relationship of Yarra Trams with the tramways union better than --?

Mr FISCHER - Absolutely!

Ms DAVIES - You appear convinced.

Mr FISCHER - We had the same trepidation, and enormous concerns about how to react: Are we exposing potentially the public XXX an unstable union relationship? And it didn't happen.

MrTHEOPHANOUS - Why is that?

Mr FISCHER – We worked hard to establish a good relationship and understanding with the unions and Lou Gregorio.

MrTHEOPHANOUS - He kept the trams in the middle of Bourke Street when they were government owned.

Mr FISCHER - It just occurred to me when we talked about this performance outcome, I would say the rate in which public sector business is being handed over to a private sector is very much determined by the ability to actually describe and define the outcome of the business and the performance criteria which you want to make and that factor, that it needs definition, "What we really want to achieve is that". You look at an immigration group sitting somewhere near the airport and say you want to privatise that service, try to define how do you want to describe to a private proponent what you actually expect from them because these immigration guys do not tell you to what ritual or what performance criteria they work, and that is where I believe the crux is. There could be more services put in the hands of the private sector if the measure of the performance is more clearly defined and the incentive and penalty regime is properly applied, which is a big driver for the private sector.

The CHAIRMAN - I thank you, Mr Fischer and Mr Shepherd, for your time here this afternoon. It has been very valuable to us. There may be something in the future that we would like to follow up with you, and we will be back in touch with you if we do.

The witnesses withdrew.

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PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

Subcommittee

Inquiry into Private Sector Investment in Public Infrastructure

Melbourne –30 April 2002

Members

G. K. Rich-Phillips
T. C. Theophanous
R. Clark
Ms S. M. Davies
T. J. Holding

Chairman: Peter Loney, MP

Staff

Executive Officer: Michele Cornwell
Research Officer: Caroline Williams

Witnesses

Andrew Haggar, Partner; and

Mario D'Elia, Director Project Finance, PricewaterhouseCoopers

Necessary corrections to be notified to executive officer of committee

The CHAIRMAN - I welcome Mr Hagger and Mr~D'Elia from PricewaterhouseCoopers to this Public Accounts and Estimates Committee hearing on Private Sector Investment into Public Infrastructure.

All evidence taken by this committee is taken under the provisions of the Parliamentary Committees Act and is protected from judicial review. However, any comments made outside the hearing are not protected by parliamentary privilege. All evidence is being recorded, and as witnesses you will be provided with proof versions of the transcript early next week.

Mr Hagger or Mr~D'Elia would either of you care to make a statement?

Mr HAGGER - I will introduce who we are, as there are a lot of people in PricewaterhouseCoopers around the world, and a lot of people in Victoria, so I will just explain what part of the PricewaterhouseCoopers practice we come from. We come from what's called the Corporate Finance and Recovery Unit, which gets involved primarily in financial advisory services of various natures. In particular, the group that I take care of here in Australia and also in Asia as well, and that Mario is a director of - resident here in Melbourne - is called project advancement and investment banking. That arm of PricewaterhouseCoopers takes care of things, particularly at the public-private interface, which includes things like public-private partnerships, concessions, and infrastructure advisory everywhere in the world, and privatisation. These are things primarily at the public-private sector interface. We would at this stage like to give a short Power Point presentation.

Power Point demonstration.

Mr D'ELIA - I have tried to follow the format of the letter as much as possible, but if I have not covered some areas and we have time at the end, feel free to ask questions. If, during the presentation, you want to interrupt, also feel free to do so.

In terms of stating our expertise and our experience, in Melbourne we run a team of approximately 10 to 12 people - who come from all different walks of life - in our group, but mainly have a financial background. Some come from financial institutions and have a banking background; others have an engineering financial background, so we have a wide range of expertise in the group.

We list the types of roles that we are currently doing in terms of PPPs working with Partnerships Victoria. We currently lead financial, strategic and commercial advisors to Victorian government on: Scoresby Integrated Transport Project; Spencer Street redevelopment; Berwick Hospital, and VicTrack Fibre Optics.

In terms of what that role is, we tend to work in all these cases developing a business case, which looks at the scope of the project, the affordability and how you get best value for money. We look at the delivery mechanisms that may be involved in order to give the best outcomes. We package that all up and we present that as outcomes for government to decide whether the project should go ahead, how it should go ahead, and how they should fund it. That's the first phase.

The second phase: If it does go ahead as a Partnerships Victoria project, then our involvement continues in terms of setting out all the expression of interest documents, looking to commercial terms, the financial structures involved there, setting up the evaluation criteria and going through the process of evaluating, selecting, negotiating contracts, down to financial closure, and contractual financial closure. So we are involved from the beginning where we have an idea of the project, developing what it is, how to best deliver it to get the private sector to contract and to deliver it.

The CHAIRMAN - Is your unit within the firm working purely on the public side of that, or are you also providing service to the private sector that may then wish to get into it?

Mr D'ELIA - The skills needed to be able to advise government on these projects is not just a government understanding, but that is an important part. The value we bring and the reason why are successful is that we also have quite a strong connection back into the private sector. Our work predominantly - if we had our optimal mix - is probably about 60 per cent work in government, 40 per cent private sector; and varies between 60 and 80, depending on various projects. But over a period of time it is probably 60-40. There are issues in terms of conflicts, so we tend to try to work in different areas and make sure we don't cross over. PwC has a lot of rules in terms of Chinese laws and traditions and things like that, so that's in Victoria. We are involved in most of the major projects. We also assist where a policy is being developed in terms of having our input in terms of what may or may not be acceptable on the private sector side so the people formulating the policy can actually have that input when they are formulating their ideas.

The CHAIRMAN - Does the converse of that occur? Is there someone out there who's working with the private sector and advising them of what may or may not be acceptable to the public sector in those sorts of cases?

Mr D'ELIA - That is the role we tend to play. In terms of when we advise the private sector, it is not only the financing structures of where the best capital market deal or lease deal is, but it is having an understanding of the drivers the government has - which is very different to corporate - and understanding the sensitivities, the privacy issues, the process of just getting legislation through and approvals; they are areas where there seems to be a bit of a black hole, and the private sector tends to not understand what is involved, but people like ourselves who have had people work in government and have been going through the process have a sensitivity and a feel for that so they can actually say, "Well no, that's wrong; you can do it a lot better and the meet the government's objectives if you just do it this way".

Lots of times the private sector does not have an issue with that, it's just that I have seen it many times, they just don't know, don't understand. They have people as mediators between the two and they find that helpful. That is the type of role we play.

Ms DAVIES - How many companies might there be who would be competent in playing that mediator role, in Victoria, apart from yourselves, who have the sort of experience?

Mr D'ELIA - I touch upon it slightly at the end of this presentation in terms of one of the issues in developing trends or in developing more of the project is to have people who lead the projects, either from a government side or private sector side, who actually understand both sides, and that is a shortfall. As more and more projects occur, there are more and more people learning, so from a standing start there aren't hundreds of people to be able to choose from and there has been a restriction, I think, in a number of projects because there haven't been the right people. There are some very, very good people, very, very good engineers, good financial people, but the people who have that experience of actually understanding both sides and are able to make that right balance, it comes as an outcome that is beneficial to both sides and that understand both sides is reasonably rare but it is developing. Some of these bigger projects are spinning off quite a few people in terms of being involved in the processes and learning from them, so there is a market now being built up for that.

Mr HAGGER - If you take a typical project and you think there are four or five bidders, overall I would say there are seven to 10 institutions that do this sort of thing very regularly. There are others who come in and out with various knee-jerk strategies. I am talking specifically from a financial advisory viewpoint; you generally come up with the same seven or 10 names in terms of advising a bidder or advising a company.

Mr D'ELIA - As I say, that is why that role of 60, 40 is quite important for us to make sure we refresh ourselves on both sides and not just tie into government or private sector because that knowledge of both is critical. In terms of our other experience, we have a national practice of over 30 people, both in New South Wales and Queensland, doing the same things, and we have a large UK operation, which has direct input. One of the things which I may leave with you is a presentation by our UK firm - it is a public document - which has been involved from basically day one with these types of projects in the UK, and they have done a lot of surveys and reviews of projects, and for background information you may wish to have that. I leave that with you.

In terms of benefits of involving the private sector in delivering infrastructure, I think we need to go back to thinking or understanding what it is that we are trying to do. The idea is not building or finding the best way to build an asset; it really is to find out what is the best way to receive some of some services. The asset can be varied in many different ways, but the service is the critical aspects of the government's purchasing for private sector. The difficulty at times we have is that people or departments have been living with projects for many years, and they get to a point where the project is ready to be funded, but it is very hard for people to go back and check and say, "Well, that was okay, maybe then, but in terms of services that we need today, will this asset still give us all those services? Is there is a better way of doing it? Can we rearrange that asset? Do we still need that asset or can we do it another way?" The most fundamental questions we get asked is something this process of Partnerships Victoria brings and drives benefits from.

So if we keep looking at it in terms of service delivery, the process allows people to look at the balance between the capital expenditure and the operational expenditure as a whole solution rather than, I think, the traditional way where governments went out for a design construct contract, they got something built but after one or two years whatever happened on the operational side once the thing was built it was never the problem of the person who built the asset. This process is to look, "Well, this asset is going to provide services for the next 30, 40, 50 years; is someone going to guarantee that those services are going to come out at that same standard, the right standard, for the next 30, 40, 50 years?" And someone has to make a call on the balance they spend. If they don't put enough capital into it up-front they will have higher maintenance costs, but if they put too much capital up-front they will have lower maintenance costs. That type of balance and taking the risk of that doesn't work, and they are going to be financially inconvenienced. It gives a whole lot of different drivers and different perspective as to how you come up with the solution. Quite often in these projects, two or three or four bidders may all come up with different solutions which all work; all have different costs structures but all have different ways of dealing with the service, and that is something quite important that comes out of it.

Coming out of it is also innovation. People with access to overseas technology, overseas ideas come in rather than a department having the best people locally but not having travelled as much or having had the exposure to new ways; and there are ideas, new innovations that can come to Victoria by having this open to more competition. Access to patented technology: If you go out and buy a particular asset from somebody they charge you the full cost of that, of all the technology, of the patents and the research they put in, but if they are going to own it and operate it for 30 or 40 years internally themselves you have a different pricing structure so you get the benefit of the access to technology at a cheaper rate.

We have picked up some benefits of tax structuring from the commonwealth government, which the state does not necessarily have access to. Risk transfer is something you can spend days talking about, but it is quite critical that if it is done properly the state bears risks that it is able to manage and passes through risks that it is not able to manage. And if you look at examples like the Melbourne City Link project, where you have a failure of the construction in terms of the tunnels, there was a lot of money needed to be spent, not only did the government not need to put more money into it, but very importantly, it was also removed from the litigation that was occurring between the different parties. So that risk transfer, that understanding, "This is my role, this is your role", without being involved and being messy is quite a critical aspect of it as well

Over and above all that, I think the real important part is that the whole process changes the way that the public service approaches investments in infrastructure. The process is a discipline where people have to start thinking about alternatives, they have to look at whole-of-life, they have to look at price risks, they have to ask people differently about what can be done, and that process has not necessarily been all the best previously. This actually has a schedule or a format, a matrix, which you need to go through and have all the questions answered. And I think that process of having a more commercial approach - not commercial as in revenue profit, but commercial as in what works and was does not work and how can we do it better - has been something that has been slowly introduced into the project management teams and how they look at the results. At the end of the day the process does not specify one particular outcome. The process in itself is the important part of coming up with the right way of delivery. If it is government delivery that comes out of it, well that's fine; if it is private sector delivery, that's fine because that is the way the whole process has come through. You evaluate all the benefits of doing it either way, and there are benefits of doing it either way. So it is a management tool that comes out of it which is something people would normally use anyway.

In terms of investing over a long period of time and having the capital up front, it allows government to better priorities its use of funds so it has more money to spread around and you can create new commercial enterprises by establishing new businesses.

Ms DAVIES – That is more a value statement surely than a factual statement, your statement that it enables government to better manage its funds: do you believe that so far there has been a proper cost benefit analysis of the projects that have happened so far and projects that might be coming up?

Mr D'ELIA - The point I was making was that rather than having the money paid up front, which takes a big swag of available capital out of the system, by paying over a long period of time the government has more time and more resources as the capital to be able to allocate the different projects, so that's not one that is eating up everything, and allows them to have more flexibility rather than maybe priorities and have the flexibility to choose a wider range of projects rather than just one.

Ms DAVIES – To re-emphasise the question: do you think there has been sufficient cost benefit analysis done on projects that have been done so far to see whether over the long-term in fact it has made more sense?

Mr D'ELIA - Each project must have in part of its business case a cost benefit side to it.

Ms DAVIES - Do you think there have been adequate cost benefits of the projects that have been done so far?

Mr D'ELIA - It is not an area that we provide a service in, so I could not comment on the abilities or not of others, but in terms of the process -

Ms DAVIES - Who would do them though? If you've been advising the government as parts of your service you don't do the cost benefit?

Mr D'ELIA - No, the engineering firms tend to look at those aspects – the SKM's of this world, and those sorts of people, would tend to do the cost benefit study. We provide the financial numbers and the inner structuring, but in terms of the raw data for what it is going to cost to build a bridge or what it is going to cost to build a water treatment plant, that is not our area. They would look at the different methods of reengineering that asset and what the flow-on effect would be. That is a detailed separate report, and in all the business cases that I have done, we are not the ones signing off on that bid. They are done separately by the engineering firms, who are reputable firms, and I would assume the -

The CHAIRMAN - We are probably a little at cross-purposes there on the question. That is, I think what is being asked is not a cost benefit projection but a cost benefit outcome, and have there been enough projects completed under this to really make a generalisation about whether or not the cost benefit actually exists in the way that is projected when the partnership is entered into.

Mr D'ELIA - The benefits that you predicted to be there, are they there?

Ms DAVIES - Yes. You are making a confident statement that this is a benefit, this a cost benefit; yet what I am saying is, is that just your statement of belief or have you actually got the evidence to show that that has been the case in the outcomes?

Mr D'ELIA - I suppose it is where you start from, because I think the previous government did do a range of these types of projects, and if you look at the UK experience, if you look at from Partnerships Victoria point of view this really has not been a project to say under this one process yes they are fine. But having looked at the nature of the projects and the process that that has involved, the project only goes ahead once you've gone out to bid, if someone comes in with a better result than what you predicted whether you could have done it for yourself. The trick then is, or the skill then is to translate that into a contract to be able to maintain that benefit, that people have promised in their bids. The results that we have got in terms of bids, it has been the case in most cases if not all, that on a like-for-like basis the bids from the private sector are less than the benchmark that the government has set for itself.

Ms DAVIES - So the only thing that has been evaluated is the benchmark or the pricing itself; nobody does any cross benefiting?

Mr D'ELIA - No, it is not just a financial benefit, because in terms of evaluation there are qualitative and quantitative. The qualitative are the benefits the government has seen in terms of flow-ons to communities; the effects on communities such as noise, environmental, and all those things are evaluated and once all put together they do give a better outcome than what the government has in its own benchmark.

Ms DAVIES - It depends on the quality of the original benchmarks.

Mr HAGGER - There are various levels where one can talk about cost benefit. I think through the process we are measuring the anticipated cost and the anticipated benefit based on the rigours of the process, sitting at a point in time having a benchmark and evaluating the bids against that benchmark. So there is a process that goes on at the point of the government deciding how to procure the project; that is a cost benefit analysis in that sense. From our vantage point, we have been involved in projects where that analysis happens. Obviously, we don't have a vantage point on the projects where we are not advising government. I think it is fair to say that because this is a whole-of-life project the scoreboard, if you like, remains on through the life of the project. So part of your question also comes out, “Have we had enough projects to be able to say has this delivered what we anticipated at the time we anticipated costs and anticipated benefits?”

As Mario says, under Partnerships Victoria we have not had projects coming through for long enough to be able to evaluate that. Just to put it into further context, the document that we are providing you with today, just for your interest, is a study that has been done in the UK on the public-private partnership process in the UK, which is further down the track. It is still not far enough down the track to be able to make a whole-of-life judgment, but it does look at projects that have got through the critical early stages of the construction risks and the early operational risks. It is by no means trying to be a scientific report with clear conclusions, but it has taken anecdotal evidence from various state bodies and current projects.

Mr D'ELIA - There are a range of people involved in the projects on the government side who can ask basically those questions in terms of issues that we have beforehand, ”Do you think it has been better or as good or worse?” and there are survey results in. We don't want to emphasise that too much because Australia is different, and we tend to use that as background information for our own guidance rather than to say, “Hey, UK, we have to translate that over here because we do things differently”. The behaviour of the financiers and the construction companies is different over there. They tend to be more commercial and be able to deal with risk a lot more than they are in Europe, which is a strange fact because they are the same banks, but they do have very different behaviour.

In terms of the issues, looking at these projects, one of the major issues is that in terms of the complexities of these projects there are limited at the moment, but it is developing, the range of advisers and people within government who can set themselves aside to deal with the project for 12 to 24 months and not be distracted, because people, if they are any good, are in high demand and they get called all over the place, and to actually allocate a person for a project tends to be quite difficult.

But the successful projects, the ones that have been easier to deal with, have tended to have very, very good project directors, people like government, whether it is internal or whether they have had special run-off, individual private consultants and it is their normal job. I think that for all states, looking at these types of projects, there is a high demand for these people and there could be at times a shortage of very good people and I think that may be something that could compromise a project. Some of these projects, some of the criticisms have been that once you set up a legal contract that the state loses flexibility in order to deal with the asset or the framework within which that asset operates. A way of mitigating that is by allowing for flexibility in the contract to make changes. There are costs involved, but by identifying the flexibility extent up front and by identifying up front the areas that may change so that the bidders can take that into account up front, can allow you to have an easier process down the track when things need to change. It is things like, for example, building capacity for an asset; but there are different ways of staging that asset; you may be able to ask for a certain capacity, but it is up to the bidder to decide when they put that capacity in so you then get a balance between the capital and when it gets put in, whether they need upgrades or whether they actually build it all upfront and take that risk,

But there are ways of dealing with that. I think a one-off approach to projects does cause problems, if we tend to do one here, one there, there is not the UK model where you do one hospital and then do 30 afterwards and so people become accustomed to all the issues and it becomes a bit of a blueprint and they run them off. We tend to have one-off projects, so people have to relearn: there are cost implications of getting people to do a one-off project rather than having continuity is difficult as well.

The project management after contract closure is an issue that has not come up as being a fundamental flaw, but it is something that needs to be looked at as these projects start coming in to close: how people are going to manage the project once the specialist-type people who put the project contract together leave. One of the things that we do is we make sure that there are a couple of people from the department or from the authority who are actually sitting with us as we go through, so we get a bit of a redundancy built in so there is someone there who actually understands what we know, or if they need something that they know exactly where to call for help, but that is a skill that needs to be developed, and some are doing it a little better than others I would say.

Future trends: If you look at the project, Partnerships Victoria's mission is to find the best value for money as the objective. We are really looking at identifying the best scope, the best delivery mechanism, the best risk allocation; and that really should be done for any project, any investment decision that we make. It does not mean you come up with the same solution; there are a myriad of solutions but it is a process. The process itself is something that should be encouraged and used and considered by people, so some departments do.

There is no reason why the process can't be used for a range of different industries. Accommodation tends to be quite a strong asset class that has been done elsewhere in the world, infrastructure for education, housing, hospitals, as is done here; roads is something with a lot of expertise. In terms of limitations where it becomes a bit more difficult to do a PPP-type approach is that there are costs involved in setting this up, so $10 million or above usually tends to be the minimum. There have been some smaller projects elsewhere but they tend to be one-offs. There are restraints in terms of policy; there are things that government wants to retain in ownership and they are things that need to be dealt around, like the operational aspects in some of the assets. In water for example, the private sector can own and operate the water plant because of the hi-tech and specialist-type nature there, whereas in hospitals there are social issues there so the operational aspect is not new. Then it is also the ability to manage the project, and the growth in demand for project managers and advisers is going to be an issue, if it does peak very quickly.

The CHAIRMAN - So within your issues, should government develop its own expertise in-house to the point where essentially it does you fellas out of a job?

Mr D'ELIA - In some ways. There are different models. The Victorian model is that it has a group of core skills within Treasury which it tries to build up in-house and tries to use those people as assistants to projects wherever they are, so they tend to have a knowledge base. Other states tend to have their own people within their own departments rather than have a centralised body passing on information. Whether it is through us or whether it is through a government body, I think the dissemination of knowledge is important. You will find the private sector bidding for a project will get the knowledge base for five or six different projects, and it is quite easy for them to try to reinvent or go backwards in some projects if there isn't someone on the other side who has seen what the standard has been in other projects. So the importance of having someone across the whole range, and not only Victoria - but to see what is occurring in other states and overseas to be able to say, "Hey there are improvements" is quite important to bring better value for money.

Mr HOLDING - You said the PwC practice has been to try to encourage people from different departments to be involved during the project development stage, if you like, or prior to closing the contract or signing the contract and proceeding on. How successful has that been? What do you take away from that issue?

Mr D'ELIA - The bigger departments tend to have the flexibility of putting people in to follow along. Some of the smaller ones don't have that flexibility. In two of the water authorities, because they have actually had to live with it for such a long time and people have had to be a bit more specialised in their jobs, whereas in departments you have to move around a lot more or have wider ranging responsibilities, they have been very, very concerned about what was going to happen once people like ourselves, or the engineering consultants, were leaving, so they made sure that there were at least two or three. Apart from the decision makers being the CEO, the CFO and the chief engineer, they have had people who were going to be dealing with the customer, the provider, on a day-to-day basis because you end up getting a contract maybe that thick, and just knowing the flow through of that is quite critical, so we encourage that. We run training programs later on for people who need it, because for us the success of a project is the long-term nature, not just that we have signed the contract; because the more and more people feel comfortable that projects are delivering value for money, the better it is going to be. So we try to put a bit more effort in to make sure people are comfortable throughout the whole process.

Mr HOLDING - Is there a workforce training issue there, or a workforce skill acquisition issue there for the public sector in terms of identifying people? This came out in the evidence we took from the

Institution of Engineers today. They said basically what happens in the public sector is that people who are involved in the contract move on to the next project. What problems then emerge? Because in a big thick contract there is not the corporate knowledge of people knowing all the nuances when it gets negotiated.

Mr D'ELIA - I agree. And when you look at some of the regional people where they find it difficult to attract good people, commercial people, expert-type people out into regional areas to start off with, they are going to have trouble having the right people continuing on. But it was interesting in some of the benefits that you actually get out of the project, the pluses and minuses. In a water project I was involved with in rural Victoria, there was an issue in terms of the water quality and an international water firm was running the BOOT project. The person running the plant was a chemical engineer who had been trained in the States and had been all around the world, but part of his process of promotion was that he had to spend a year or two out here in the a rural country town. To get actually someone like that with that expertise is nearly impossible, but they did it. They had a problem with the water regions. What he did, he passed those results to the US; they went to France, overnight and they came back and said this is what you need to do to play around with your quality controls. Problem fixed.

The good part of that is that, that expertise and state-of-the-art plan, is they are out there delivering the best quality water and the best quality plant you could possibly get. The problem is that some of the water companies are scared of that, not because “Hey, we don't want anything new” but then they get those sorts of problems they have nowhere to go. You have to send a water reading down to Geelong, and that takes a couple of weeks, then it goes back somewhere else, and there are all those sorts of issues. So it is a matter of managing and understanding those sorts of issues of where this asset is going to take you, where the service is going to take you, what are the issues going to be and how you actually deal with them and what controls you put in place. That's where I try to say this is not a financing decision, this is not just how we are getting a cold hard number which is better than another, but it is a total solution in terms of your services. What happens if you get this plant going and no-one knows how to operate it? It is those types of things that we need to think through, and that is why it takes some more money to develop these projects.

Mr THEOPHANOUS - How good are we in determining what is a good deal in terms of value for money?

Mr D'ELIA - That is a hard question. How good are we? The more and more of these projects we do, the more refined the process is becoming. Evidence from decisions made previously is always a big point that is hard to get. The benefit of a firm like us that we have got a pretty good database to tell us what is happening all around the world, and KPMG is probably the same. It is that type of experience and learning from it that is making things a lot easy. From the first couple of projects we were doing, we were looking at risk and looking at estimates of probabilities and coming up for a hard number, doing Monte Carlo simulations and having all sorts of inputs from all sorts of people and getting standards abbreviations of where the outcomes were likely to be. I think we are pretty sophisticated, and as against other countries we are pretty well advanced. But at the end of the day a lot of it is an estimate from a professional, you know, “What may happen?” But it is certainly getting a lot more scientific in the way we are approaching it.

Mr THEOPHANOUS - I am interested in the fact that we concentrate on value for money: Do you make a distinction between value for money for the government as in some of the transport stuff that has happened with the trams and various other things? Do you make a distinction between value for money from the government's point of view and value for money from the customer's point of view, that is, the commuter on the tram or on the train versus the government getting something off its balance sheet and being able to sort of say, “Well, there is a service that has been provided”. Is there is a distinction there?

Mr D'ELIA - I think there is. That was my very first point, that you look at these things in terms of what are the services that have been provided that you are asking for, and in determining those services you then look at how is it that you are going to best ensure that those services continue to be provided at that cost. So when you do your evaluation and look at whether the government can do it better or whether it is better to do it by private sector, there will be issues and evaluations surrounding the control issues and how you make sure that if you want to change things that if different standards and services are not right for the private sector, how much flexibility does the government have? In some cases it might not have some, or much, and then you may say in certain circumstances this is best done by government in-house, and run it as you did.

At the end of the day we are looking at a service and how it is going to be delivered. The way that you structure and the way that you weight your importance of the services, service standards, is then going to sort of feed back in terms of how the delivery mechanism best meets those objectives. That is always the test. You have your stakeholders, what the objectives are; you have the scope, and you play around with the delivery mechanism, balance it out and see which ones best meet your delivery objectives. Things go wrong sometimes, but in the evaluation they do look at those things.

The CHAIRMAN - Thank you, Mario and Andrew, for your time this afternoon. We have certainly covered a range of issues. We may need to come back to you while this inquiry is on.

Mr D'ELIA - Your process is what from now?

The CHAIRMAN - This is our first day on this inquiry. We have taken submissions as invited, and we are starting to receive submissions from a range of people. We will consider those submissions and continue to carry out some investigations throughout Australia and may issue an interim report along the way. Currently, our time line is toward the end of the year for the delivery of a report, but whether we meet that with a final report or an interim report, because of the nature of this particular inquiry, is something we will know further down the track, but essentially that's where we are going.

Witnesses withdrew.

Committee adjourned.