



PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

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REPORT ON PRIVATE INVESTMENT IN PUBLIC INFRASTRUCTURE

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Parliament of Victoria

Public Accounts and Estimates Committee

Report on private investment in public infrastructure

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³ During the 54th Parliament the Committee comprised ten Members of Parliament. The 54th Parliament was prorogued on 5 November 2002

DUTIES OF THE COMMITTEE

The Public Accounts and Estimates Committee is a joint parliamentary committee constituted under the *Parliamentary Committees Act 2003*.

The Committee comprises nine Members of Parliament drawn from both Houses of Parliament and all political parties.

The Committee carries out investigations and reports to Parliament on matters associated with the financial management of the state. Its functions under the Act are to inquire into, consider and report to the Parliament on:

- any proposal, matter or thing concerned with public administration or public sector finances; and
- the annual estimates or receipts and payments and other budget papers and any supplementary estimates of receipts or payments presented to the Assembly and the Council.

The Committee also has a number of statutory responsibilities in relation to the Office of the Auditor-General. The Committee is required to:

- recommend the appointment of the Auditor-General and the independent performance and financial auditors to review the Victorian Auditor-General's Office;
- consider the budget estimates for the Victorian Auditor-General's Office;
- review the Auditor-General's draft annual plan and, if necessary, provide comments on the plan to the Auditor-General prior to its finalisation and tabling in Parliament;
- have a consultative role in determining the objectives and scope of performance audits by the Auditor-General and identifying any other particular issues that need to be addressed;
- have a consultative role in determining performance audit priorities; and
- exempt, if ever deemed necessary, the Auditor-General from legislative requirements applicable to government agencies on staff employment conditions and financial reporting practices.

GLOSSARY

Added value	Added value, also ' <i>value for money</i> ' means higher quality for the same money or the same quality for less money.
Ancillary revenues	Additional income generated by the project which was not part of the original specification.
Benchmarking	A procedure for testing whether the standard and price of services is consistent with the market standard (if any), without any formal competitive tendering.
Bidder	A respondent to a request for Expressions of Interest or an invitation to submit a bid in response to a Project Brief. Typically, a bidder will be a consortium of parties, each responsible for a specific element, such as constructing the infrastructure, supplying the equipment, or operating the business. Government normally contracts with only one lead party (bidder) who is responsible for the provision of all contracted services on behalf of the consortium.
Business case	The business case sets out the overview of the rationale supporting a <i>Partnerships Victoria</i> approach and a preliminary view on how the project will be delivered. It also provides an analysis of the various impacts of the project and an indication of the likely level of market interest. The business case provides information allowing government to decide whether to support a proposed project, before significant resources are spent on its development.
Competitive neutrality	Competitive neutrality adjustments remove any net advantages (or disadvantages) that accrue to a government business simply by virtue of being owned by government.
Concession	The exclusive right granted to a commercial organization to exploit a specific project for a defined period of time.
Concession period	Duration of the contract.
Consortium	The group of parties which may act together as the Private Partner to tender for the contract. Commonly a consortium will include a builder, operating company and an equity funder.
Contract management	In the context of <i>Partnerships Victoria</i> projects, contract management incorporates all the activities required to identify, monitor and mitigate all risks over the life of the project contract to maximise value for money.
Contract risks	Contract risks are those risks which may cause actual public sector outcomes to differ from those expected when a <i>Partnerships Victoria</i> contract is entered into. They include project risks and other risks that government faces in <i>Partnerships Victoria</i> contract management.

Default	The failure of a party to perform a contractual requirement or obligation, including failures to meet deadlines, to perform to a specified standard, to meet a loan repayment or to meet its obligations in relation to a materialised risk.
Departure schedule	A departure schedule is prepared by a tenderer and lists all departures from the project brief and standard contract issued by the government. The departure schedule lists the reasons for the departure, materiality thereof and suggested amendments, all of which enable issues to be resolved prior to the incurring of legal costs in redrafting a contract.
Discount rate	The rate used to adjust for the time value of money (lost opportunity cost of tying up cash).
Discounted cash flow	A general term for analysis which discounts a stream of future cash flows in order to calculate a net present value.
Discounting	A method of comparing cash flows by adjusting them for expected inflation and time preferences (and associated risks).
Due diligence	The process by which a party to the contract seeks to verify statements, information and other material.
Equity	The capital contributed by the shareholders of a project company. The value of the equity is the value of a company or project after all liabilities have been allowed for. The equity is owned by the shareholders.
Expressions of interest (EoI)	A call by a government department or agency for expressions of interest from the private sector in a project. Responses to Expressions of Interest are used to evaluate the capability of bidders to deliver a project and may be used to gather some information from bidders on particular approaches that may be accommodated in the Project Brief. Based on the information presented in responses to an Expression of Interest, bidders are short listed to provide a final submission.
Financial models	Spreadsheets designed to predict the most likely financial outcome of a particular set of estimated costs, revenues and fixed and capital charges for delivering a service over time.
Force Majeure	Act of God. An event that is outside the control of either party to a contract.
Hidden costs	Hidden costs are costs which are incurred, but which cannot be allocated directly to the project because they are part of the fixed costs or overhead.
Infrastructure	Fixed capital assets, such as schools and hospitals, which support the provision of services. Infrastructure can also refer to a network of reticulated services such as roads, energy services, rail, airports, etc.
Input specifications	Criteria set for the technical realization of the project.

Intellectual property	Legally protected intellectual property (copyright, patents, registered designs etc.) and ideas and information which are protected as confidential information at common law or under contract.
Internal rate of return (IRR)	The IRR is the discount rate at which the present value of the investors' receipts from a project equals that of their repayments, including their initial investment. The IRR percentage return aggregates a series of annual percentages. It does not mean the investors will receive the IRR rate as a constant return each year.
Net present cost (NPC)	The equivalent cost at a given time of a stream of future net cash outlays (calculated by discounting the actual values at the appropriate discount rate).
Net Present Value (NPV)	NPV is calculated by aggregating the discounted values of a series of future cash flows with the initial investment.
Nominal dollars	Refers to financial date expressed ' <i>in the price of the day</i> ' and which is not adjusted to remove the effects of inflation. Nominal dollars do not allow for inter-year comparisons because reported changes may reflect changes to financial levels (prices and/or expenditure) and adjustments to maintain purchasing power due to inflation.
Off-balance sheet	Financing activity that is not disclosed in the balance sheet of an entity or government.
On-balance sheet	Financing activity that is disclosed in the balance sheet of an entity or government.
Optimism bias	The systematic tendency of project appraisers to underestimate capital costs and overestimate benefits.
Output specification	The output specification sets out the range of services that government is seeking to procure and the performance levels required for each of those services.
Peppercorn lease	Very low or nominal lease payments, such as \$1 per annum for long term leases of up to 99 years for Crown land.
Private party	The private sector entity with which government directly contracts. Traditionally the private party has been a special purpose vehicle created specifically for the purposes of the project. The private party is not limited to this form and can be set up under a number of structures, including a joint venture and a trust structure. Behind the contracting party, however, there may be a number of private sector interests at play, seeking to be represented through the contracting party. (See also special purpose vehicle.)
Probity	Uprightness, honesty, proper and ethical conduct and propriety in dealings. Used by government to mean ' <i>good process</i> '.

Probity auditor	An independent expert retained to audit the bidding process at critical stages, assessing and reporting whether the process has been conducted according to the required standards of probity. Before a contract is executed, the probity auditor reports to the departmental Secretary or agency chief executive and the project steering committee on the bidding process.
Public interest test	An assessment of the impact of the project on the following elements of public interest: effectiveness, accountability and transparency; affected individuals and communities; equity; consumer rights; public access; security; and privacy.
Public Sector Comparator (PSC)	The Public Sector Comparator (PSC) represents the most efficient public procurement cost (including all capital and operating costs and share of overheads) after adjustments for Competitive Neutrality, Retained Risk and Transferable Risk to achieve the required service delivery outcomes. This is used as the benchmark for assessing the potential value for money of private party bids in <i>Partnerships Victoria</i> projects.
Raw Public Sector Comparator	The base costing under a public procurement where the underlying asset or service is provided directly by the public sector on the same terms and defined performance standard required under the output specification. It does not include any allocation of value for risks and contingencies which may affect cash flows.
Real dollars	Refers to financial data measured in prices from a constant base year to adjust for the effects of inflation. Real dollars allow the inter-year comparison of financial levels (prices and/or expenditure) by holding the purchasing power constant.
Refinancing	The process by which the terms of the funding (which are put in place at the outset of a PPP contract), are later changed during the life of the contract, to take advantage of reduced risk in the project and often also improved terms and conditions from a more mature PPP funding market usually with the aim of creating refinancing benefits for the consortium.
Refinancing benefits	The benefits to shareholders of increasing and/or bringing forward their returns from the project as a result of changes to the financing structure of the consortium.
Risk	The chance of an event occurring which would cause actual circumstances to differ from those assumed when forecasting benefits and costs.
Risk allocation	The process of assigning operational and financial responsibility or specific risks to parties involved in the provision of services under a PPP.
Risk assessment	The determination of the likelihood of identified risks materialising and the magnitude of their consequences if they do materialise.

Risk category	Risk can be allocated into broad categories such as site risk, financial risk, network risk, operating risk, market/demand risk, sponsor risk and industrial relations risk.
Risk management	The identification, assessment, allocation, mitigation and monitoring of risks. The aim is to reduce their variability and impact.
Risk matrix	A method of presenting all possible significant risks likely to be encountered, the magnitude and likelihood of the risks occurring, their areas of impact, and the risk mitigation techniques to be employed.
Risk premium	The amount required to compensate an investor for assuming a particular risk attached to an investment proposal.
Scope	Extending or reducing the definition of the project, for example, whether or not to include parts of the infrastructure.
Sovereign risk	The risk that there is no remedy available at law to prevent government from legislating to affect the rights of the private party. Sovereign risk is a category of legislative and government policy risk.
Special purpose vehicle (SPV)	In establishing a project consortium, the sponsor or sponsors typically establish a private party in the form of a special purpose vehicle (SPV) which contracts with government. The SPV is simply an entity created to act as the legal manifestation of a project consortium. The SPV itself has no historical financial or operating record which government can assess.
Step-in	Government's election to assume all or some of the service delivery obligations of the private party under the contract for a period of time. The circumstances where government may have the right under the contract to exercise rights to step in may include a need to: prevent or mitigate a serious risk (to the environment; the safety of persons or property); guarantee continuity of an essential service; discharge a statutory duty; or deal with a default by the private party under the contract.
Time value of money	The principle that cash today is worth more than cash in the future.
Transaction costs	The costs associated with the development of the initial option studies, tender documents and contract models.
Transferable Risk	The value of those risks (from government's perspective) that are likely to be allocated to the private party under a <i>Partnerships Victoria</i> delivery method.
Turnkey (public sector)	A project procured through private design and construction, according to public sector specifications and objectives. When the project passes completion tests, the public sector reimburses the private party/parties for design and construction.

Unitary charge	The single periodic payment due from the government to the consortium in respect of the provision and operation of the asset.
Value for money	The achievement of the optimum combination of whole life cost and quality to meet the user's requirements.
Variable costs	Costs that change in proportion to volume levels, reflecting the direct relationship between cost and volume. May be off-balance sheet, net present value, capital asset pricing model, BAFO's, social infrastructure.

CHAIR'S INTRODUCTION

Public Private Partnerships (PPPs) are one form in the range of procurement options that are available for public infrastructure. Being one of the newest of the suite of infrastructure delivery methods available to Government, intense interest is generated whenever Governments consider their use.

PAEC considers issues of efficiency and effectiveness in expenditure of public funds and our budget estimates and budget outcomes reports often comment upon major infrastructure projects. I trust this report is an additional tool to assist in the analysis of the substantial investment by the Victorian Government in new infrastructure assets – an investment for which \$3.66 billion was allocated in the last budget, bringing the Victorian Government's total estimated investment in new infrastructure assets in 2006-07 to \$4.9 billion.

The Committee's inquiry was initiated by the former Public Accounts and Estimates Committee and deals with many complex issues.

The Committee's focus in this inquiry has been governance arrangements, risk, parliamentary accountability, the public interest, economic benefits and changes in international accounting standards relating to PPP projects.

During the latter part of our inquiry the Committee became aware that the government has taken a number of steps to improve the *Partnerships Victoria* policy and practices. We recognise the Victorian Government's leadership in introducing PPPs to Australia and that, as lessons have been learnt from past projects, changes have been made to optimise the principles and guidance materials that underpin these arrangements.

As a result of PPPs the public sector has undertaken more rigorous assessment of project briefs and detailed planning of infrastructure projects, resulting in most projects being delivered on time.

Private investment in public infrastructure is not just a partnership between government and business. It is a partnership between government, business and the community. When all three are confident of the policy and delivery framework, private investment is a viable option for providing public infrastructure and/or public services.

The committee noted the public perceptions surrounding PPPs and suggests that greater reporting and in particular a succinct project summary signed off by the Auditor-General would assist public understanding.

I thank the members of the Public Accounts and Estimates Committee for their bi-partisan endeavours on a complex topic, as well as all witnesses for their oral and written presentations to the Committee over a lengthy period. I acknowledge the initial work undertaken by the 54th Parliament's PAEC, the PAEC staff especially Executive Officer, Ms Michele Cornwell and specialist advisor, Mr Trevor Wood.

We trust that the insights, conclusions and recommendations of this report will assist future infrastructure and PPP policy development in Victoria.



Hon. Christine Campbell, MP

Chair

EXECUTIVE SUMMARY

Chapter 1 – Introduction

The Victorian Government has been active in using the public private partnership (PPP) model to involve the private sector in financing, designing, building and maintaining public infrastructure, and in some cases, delivering associated services. It has also been a driving force in encouraging other Australian jurisdictions to develop a national framework for PPPs, in recognition of the contemporary significance of this form of partnership to addressing mounting public infrastructure commitments.

To date, the government has entered into 16 PPP contracts valued at about \$4.5 billion and representing 10 per cent of aggregate public sector investment.

Common principles are in place for these projects, and most are characterised by their complexity and by the injection of significant government funding. All projects differ, however, in terms of key features such as transfer of risks, obligations of the state, ownership arrangements on completion of the PPP arrangements, and services to be provided by the private consortium.

There has been considerable debate in Victoria (and in many other jurisdictions) about the financial and economic benefits of PPPs. Submissions and evidence presented to the Public Accounts and Estimates Committee illustrate the diversity of opinion on PPPs within the community; many of the issues brought to the attention of the Committee concerned the importance of governance, the limited accountability and transparency of PPP projects and reservations as to the value of the public sector comparator.

Discussions with government officials, auditors-general, academics, peak industry bodies, industry participants, unions, community groups and parliamentary officials have been invaluable to the Committee in gaining an appreciation of the many complex issues to be addressed in assessing PPP projects.

Chapter 2 – the context of private investment in infrastructure

A fundamental characteristic of a PPP is the involvement of the private sector in the delivery of a public infrastructure project and/or public services. There is, however, no widely agreed single definition or model of a PPP.

The Committee's research indicates that jurisdictions may use a variety of forms of private investment in public infrastructure. The participation of the private sector in some projects, for example, may encompass responsibility to build, own and operate an asset, while others may extend the arrangement to the transfer of the asset back to the government after a specified period, and often at no cost. A further variation could involve the public sector assuming ownership of the asset on completion and leasing it back to the private provider.

The government's policy document, *Partnerships Victoria*, recognises that PPPs will vary according to circumstances. It states the model of partnership adopted in Victoria will be influenced by three criteria:

1. whether government should deliver part of the proposed services;
2. whether private sector involvement will constitute value for money, and if so, how it can be optimised; and
3. if the public interest test can be satisfied.

This is discussed in chapter 4 of the Executive Summary

These features of Victoria's policy framework illustrate the evolving nature of the state's approach to PPPs. As the Department of Treasury and Finance pointed out, earlier policy guidance centred around off-balance sheet financing and avoiding Loan Council borrowing restrictions, while the current policy thrust is about achieving value for money and managing risks and protecting the public interest.

Chapter 3 – Private investment in public infrastructure in Victoria

Victoria is the dominant participant in PPPs among Australian jurisdictions, with 16 projects in place at July 2006.

The government commissioned Peter Fitzgerald to undertake an external review of eight PPP projects. This review, which drew heavily on evaluations of selected projects undertaken by the Auditor-General, concluded that the eight projects provided tangible evidence of the benefits available from harnessing private sector skills and innovation of design in infrastructure.

The Committee has also undertaken an examination of certain PPP projects. Because the Committee did not have access to departmental files, the Committee's detailed reviews were limited to some major projects that have previously been the subject of comment by the Auditor-General and Peter Fitzgerald.

The Committee has made a number of significant observations from its consideration of selected PPP projects, including:

- the importance of discount rates reflecting the low market risk associated with some public sector accommodation projects;
- before proceeding with any build, own and operate arrangements entered into for certain projects public benefits need to be maximised;
- the need for more attention to be directed to the long term financial implications of PPP arrangements designated as finance leases, in terms of government debt and future budget flexibility;
- risks being returned to the government where it had previously paid significant premiums for them to be borne by the private sector; and

- a need for the government's PPP policy framework to be extended to encompass the identification and valuing of commercial rights available to private sector developers.

The Committee welcomes the government's implementation of its Gateway initiative, which is intended to bring greater rigour to its management of major infrastructure projects. The Committee considers that this initiative should lead to better decision making within government about whether major projects can be managed by the public sector on a comparable basis with projects being managed by the private sector under PPP arrangements.

Chapter 4 – Legislative and police frameworks and practices

There is no specific legislation providing a common framework for selecting, developing, managing, financing and reporting PPP projects in Victoria. Instead, these areas are addressed at government policy level. For some projects, however, new or amending legislation reflecting their specific characteristics has been necessary.

The Victorian Government released its PPP policy, *Partnerships Victoria*, and supporting guidance material in 2000. It has subsequently updated the overview guidance material and expanded the policy framework by issuing several additional documents covering key facets of the PPP process including contract management, development of the public sector comparator, discount rates, interest rate risk, and conflicts of interest. The Victorian policy charges the government with responsibility for the delivery of core social services such as teaching in schools and providing clinical services in hospitals, while ancillary services such as maintenance, computer systems, security and cleaning are commonly undertaken by the private sector consortium.

Other Australian jurisdictions have also developed PPP policies in the past five years. While these policies have drawn on and are broadly similar to the Victorian model, there are some important differences in approach between jurisdictions. A National Council for PPPs has been established to ensure greater consistency across governments in this emerging field of public policy and to provide a pipeline of PPP projects. The aggregate value of PPP projects across Australia which had been contracted was estimated at \$10 billion at November 2005. A further \$10 billion in projects were either in the market or were under consideration.

The Committee's overseas study tour and research identified numerous variations in PPP policies and practices between countries. The United Kingdom, with its extensive experience in private finance initiative contracts, is most advanced in developing partnerships with the private sector for major infrastructure projects.

The Committee identified from the experience of overseas stakeholders that many of the early PPP and PFI projects had less than ideal results, mainly attributed to inadequate preparation, poor public sector management skills and inappropriate risk allocation. All jurisdictions had learned from their early experiences and had

improved their processes. Most governments had subsequently improved governance processes and monitoring arrangements.

The collective government experience in PPP projects in Australia and overseas provides a useful opportunity for the Victorian Government to further progress its policy framework towards a model for best practice.

Chapter 5 – Governance, evaluation and accountability arrangements

The government's *Partnerships Victoria* policy includes specific coverage of governance, probity and compliance. Aspects of the policy's governance provisions highlighted to the Committee included key decision points requiring Cabinet approval, assignment of ultimate responsibility for projects to the relevant portfolio Minister, and clarity of roles allocated to project staff.

From evidence presented and from its own research, the Committee is aware of concerns about governance arrangements for major infrastructure projects in Victoria. These concerns relate to the size and complexity of available guidance material, the lock-in effect of long term contracts on the decision making capacity of future governments, the inadequate balancing of commercial and social interests, and the difficulties in comprehending voluminous contractual documentation relating to PPP projects in the absence of concise summaries of contractual arrangements.

There is also concern that government and other participating parties are becoming increasingly reliant on a limited pool of external high-fee advisors and professional experts, giving rise to potential conflicts of interest that may impede the integrity of decision making. These features of the PPP environment reinforce the importance of the government building and retaining sufficient levels of expertise in strategic and operational project management.

Apart from the United Kingdom experience, there is an absence of publicly available information on PPP evaluations. Victoria needs a program of regular evaluations and the results must be made available for public consideration.

The use of commercial in confidence reasons by government to limit public and parliamentary access to key information on major PPP contracts has diminished the accountability of government to the Parliament for substantial state expenditure.

Public confidence in PPPs depends on a strong transparency and accountability framework. The Committee considers that the Auditor-General has a major and ongoing role in informing Parliament and the community on the effectiveness of PPPs in Victoria.

Chapter 6 – Protecting the public interest

The government has included a specific public interest test within its PPP policy as a key mechanism for protecting the public interest in PPP projects. The test is applied at several stages including prior to assessment of funding options, before release of a project to the market, and before the signing of a contract.

Carrying out these steps does not automatically guarantee that the public interest has been fully served in all instances. Because the results of public interest assessments are not made public, the level of rigour and the depth of challenge applied to the assessments by government officials and/or external advisers cannot be judged by Parliament or the community. The level of reliance that can be placed on internal analyses of public interest is therefore limited.

Public assurance on the adequacy of public interest considerations during later stages of the development of projects, and through their operational phases, can best be achieved through regular independent evaluations. The Committee considers that the Auditor-General should be encouraged by Parliament to provide a strong and continual audit focus on the management and effectiveness of PPP projects in Victoria.

Chapter 7 – Value for money

A diversity of views is held on the advantages of PPPs relative to traditional procurement strategies. These views extend to some of the key elements of the PPP framework, including the soundness of decisions reached on projections of value for money offered by PPP projects.

Because value for money projections deal with future uncertain outcomes such as predictions of risk allocations and assumed discount rates, empirical experience is the only way to assess actual results. Experience has proved that economic projections and financial business cases were often unreliable when compared with actual outcomes achieved. The government does not publish a comparison between actual and estimated value for money results from PPP projects.

Differences of opinion also exist about the value and robustness of the public sector comparator (PSC), a central component of the government's PPP policy for value for money determinations. Some proponents of the PSC advocate its wider dissemination to prospective tenderers to assist in optimising outcomes, while critics view the current application of the PSC as biased towards the private sector. The Committee was advised that the PSC should, in most cases, be available to bidders as occurs in Queensland.

The government's policy documents include considerable guidance on the construction of a PSC and identify its hypothetical nature, which involves assumptions of risk and the principle of competitive neutrality. As part of its ongoing review of

PPP policy, the government should reconsider the views conveyed by Mr Peter Fitzgerald in his 2004 review, and those expressed to the Committee by the Auditor-General on ways to improve the use of the PSC, if use of a PSC is to be retained. The 2004 Fitzgerald report urged a change in discount rates and project evaluation methodology, but was not seen by the Treasurer as appropriate for Victoria at the time.

There have been some important developments in the United Kingdom based on past experience with private finance initiatives, including decisions to apply a discount rate of 3.5 per cent for public infrastructure projects together with a risk adjustment to cash flows, and to no longer use a risk-adjusted PSC.

Chapter 8 – Risk

The philosophy underpinning risk allocation in the Victorian PPP policy is one of *'optimal risk allocation'*. It seeks to minimise both project costs and risks by allocating risks to the party in the best position to control them.

The extent to which there can be complete allocation of risks between the government and private sector parties to PPPs is questionable, given government's ultimate responsibility for public services and its inability to transfer what might be described as its political risks and obligations to the electorate. Evidence presented to the Committee drew attention to the gap between formal risk allocations in PPP arrangements and the real world responsibilities that will ultimately be linked back to government if problems with projects or services are encountered. Experience from completed projects suggests that both the government and the private sector, in practice, are often poor risk managers, with some large risks going unrecognised and other risks inappropriately managed.

In terms of Victoria's record to date in managing risk allocations for PPPs, the Committee heard from the Auditor-General that:

- early projects involved the provision of guarantees and indemnities by government to the private sector, which had the substantive effect of reverting major financing risks back to the state;
- the allocation of risk between the public and private sectors has substantially evolved over time, and private investors are now more willing to accept certain levels of risk including those of an operational nature;
- with projects such as the Latrobe Regional Hospital and the Metropolitan Women's Correctional Centre, both of which were entered into in a highly competitive environment, the government opted to regain control principally because of its underlying obligation to provide the related services;
- while responsibility for service delivery may be allocated to the private sector, consumer risks, environmental risks, public consultation risks, transparency

risks and public confidence risks cannot ultimately be separated from government; and

- the increasing sophistication of PPPs highlights the importance of government ensuring it retains sufficient levels of knowledge and expertise within its ranks to effectively oversee PPP negotiations and to meet its ongoing duty of care associated with the delivery of public services.

The Committee concurs with the points raised by the Auditor-General and considers it critical that the government have effective strategies in place for continuing strong oversight of PPP projects (including risk allocations) in light of their growing sophistication and widening boundaries. The Committee also considers that the government should rectify the current vacuum in publicly available information on the state's performance in the management of risks in PPP projects.

Chapter 9 – Accounting for public private partnerships

A common characteristic of PPPs is their complexity, and this complexity influences the accounting treatment of PPP assets and obligations adopted by governments and private sector operators.

While there is currently no international or Australian accounting standard for PPPs, significant work is underway within the International Accounting Standards Board (IASB) to develop a specific international standard for PPPs. The absence of an accounting standard has led to diverse accounting treatments for PPPs across jurisdictions and corresponding gaps in accountability obligations.

In the absence of a definitive standard, Australian jurisdictions have relied on the accounting profession's standard on leases (when applicable to particular PPPs), and guidance material issued by the Heads of Treasury Accounting and Reporting Advisory Committee. This is based on a standard in place in the United Kingdom.

The direction signalled in draft pronouncements of the IASB's financial reporting interpretations committee has attracted considerable criticism from Australian jurisdictions. At the date of this report, feedback received on the draft pronouncements was under consideration by the IASB.

The debate within the accounting profession has centred on three accounting approaches:

1. a '*control*' approach favoured to date in the IASB's draft pronouncements
2. a '*risks and rewards*' approach embodied in the United Kingdom's accounting standard and relied on in guidance issued by Australian Treasuries
3. a '*rights and obligations*' approach based on proposed major revisions to the existing international lease standard.

This chapter outlines the principal features of each approach and of the views put forward by the main parties.

The Committee considers that the *'rights and obligations'* method for accounting for PPPs offers the best option. It is hopeful that an accounting standard with universal support can be issued soon to provide uniformity of practice for this complex area of public sector financial reporting.

Chapter 10 – Local government and public private partnerships

Local government in Victoria has identified a significant shortfall in the amount of funding required to meet its infrastructure requirements. With limited capacity to raise the revenue needed to replace and maintain ageing infrastructure, some local governments are looking at alternative options, including PPPs, to fund capital programs.

Local governments in Victoria and other state jurisdictions in Australia have undertaken few PPP projects to date. A major investment bank has expressed interest in using the partnership model to develop local government assets.

Councils have the power to borrow money to enable them to perform their functions. However, before entering into a partnership they are required to receive approval from the Minister for Local Government and the Treasurer..

Because there is no guidance material that specifically covers local government and PPP projects, local government needs a framework that ensures a high degree of transparency, probity and integrity. In particular, the costs for the council over the life of the project and the risks to be transferred need to be transparent.

Both the local and state governments need to carefully weigh the cost and benefits of using these complex alternative funding arrangements.

Chapter 11 – Conclusion

In the absence of public documentation, the Committee cannot conclusively state whether the PPP policy is delivering value for money over the life of the projects, compared with traditional procurement methods used by government.

The Committee's review identified a range of concerns that need to be addressed by the Victorian Government. Foremost among these concerns is that although Victoria is promoted as being at the forefront of using the PPP model in Australia, the Committee found that certain overseas jurisdictions – notably the United Kingdom and British Columbia – had taken steps to address many of the criticisms about the public sector comparator, high discount rates, and the premiums paid for the transfers of risk to the private sector that are used in PPP arrangements.

The Committee observed from its review of certain PPP projects that despite paying large premiums for the assumption of risks by private sector consortia, it was been common practice for certain risks to revert back to government without any adjustment to the discount rate.

The Committee considers policies such as the build own operate model used in earlier projects (Mildura Hospital and County Court) that treat multi-million dollar purpose built government funded assets as disposable early in their life span need to be revisited by the government.

There is no question about Victoria's need for new infrastructure. The Committee acknowledges that it is a difficult and challenging task for any government in providing infrastructure to determine the appropriate level of investment to fund hospitals, schools, roads and other essential infrastructure.

The early PPP arrangements were devised in such a way that in return for the private sector providing the infrastructure, the repayment of construction and maintenance costs was achieved through the government entering into operating leases. With the advent of the Australian equivalent of International Financial Reporting Standards, most of these earlier financial arrangements will be reclassified as finance leases, representing long term debt to be met by future governments.

There is substantial evidence to indicate that most PPPs result in infrastructure being delivered on time and within budget, with some exceptions. The Southern Cross Station, for example, ran more than 12 months behind the scheduled completion date and the third party builder incurred a substantial loss.

The Committee has reservations about the reliability of the public sector comparator because of its theoretical approach to estimating and comparing costs, particularly in relation to the valuation of risk.

The Treasurer has acknowledged that scope changes and budget and time overruns have occurred in projects procured under traditional means. The government has acknowledged this problem and implemented the Gateway Review Process. This has had some success in resolving issues that delay projects and in ensuring that infrastructure is delivered in a cost efficient manner.

The biggest barrier to determining the benefits or otherwise of PPPs has been the lack of public information about these projects, although marginal improvements have occurred. The International Accounting Standards Board is still to finalise a new accounting standard for PPPs, as previous efforts have proven unsuitable to governments worldwide because the draft accounting standard focused on disclosure in private sector financial reports and largely ignored public sector accountability requirements.

The Committee considers that accountability needs to be improved within Victoria in a range of areas such as the prompt disclosure of contracts on the government's website and providing Parliament with a schedule of repayments to consortia. The

Committee is also concerned about the excessive use of ‘commercial in confidence’ to prevent full disclosure of details such as the public service comparator, the risks to be transferred, the total amount of payments (often what is included in the lengthy complex contract is a formula rather than actual amounts), and contracts that are only released publicly months after the financial close has been agreed.

The Committee is also concerned that the high cost of preparing bids results in only a small number of consortia bidding for major PPP projects. This raises issues about whether there is sufficient competition to ensure the government gets a good deal.

The Committee has made 20 recommendations to improve the *Partnerships Victoria* policy and significantly strengthen the governance arrangements for these projects. These recommendations are also seen as contributing towards the government ensuring that PPPs provide value for money over the life of the projects.

RECOMMENDATIONS

The Committee recommends that:

Chapter 3: Private investment in public infrastructure in Victoria

- Recommendation 1:** All major infrastructure projects including PPPs be subject to independent post project reviews at the completion of the construction phase and during the operational phase to measure the degree to which agreed outcomes are met. All results be periodically reported to Parliament.
Page 66
- Recommendation 2:** Before proceeding with any further build, own and operate projects, the government ensure that public benefits are maximised.
Page 66
- Recommendation 3:** Long term peppercorn leases extending beyond the concession period should not be given to a private consortium, unless it can be clearly demonstrated that there is a public benefit.
Page 66
- Recommendation 4:** All existing public private partnership projects involving operating leases be reviewed to determine whether they should be reclassified to finance leases under current accounting standards.
Page 67
- Recommendation 5:** Public private partnership contracts should include the total amount of payments outlining the total government commitment and the impact on state debt. This information should be published on the *Partnerships Victoria* website, with summary information included in the state budget papers.
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Recommendation 6: Further guidance material be developed to cover the situation where, during the course of the public private partnership contract, transferred risk reverts to the Victorian Government.

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Recommendation 7: The Victorian Government develop a policy on maximising the benefits to the state from commercial opportunities arising from public private partnership arrangements.

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Recommendation 8: Timeframes should be reduced, where possible, for the period of concession agreements so as to limit the impact of debt repayments for future governments.

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Chapter 4: Legislative and policy frameworks and practices

Recommendation 9: The Victorian Government continue to work with the Commonwealth Government on the need to reform section 51AD of the *Income Tax Assessment Act 1936* to protect the taxpayers' interest in a way which facilitates projects while protecting the public interest.

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Recommendation 10: The *Partnerships Victoria* policy and guidelines be updated to reflect recent experiences with public private partnership/private finance initiative projects in Australia, particularly in relation to the public sector comparator, valuing risk, and the discount rate.

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Chapter 5: Governance, evaluation and accountability arrangements**Recommendation 11:****The Victorian Government:**

- (a) improve opportunities for parliamentary oversight of public private partnership financial arrangements and commitments;**
- (b) after the contractual arrangements relating to a public private partnership project have been finalised, the responsible Minister and the Department of Treasury and Finance brief the Public Accounts and Estimates Committee on the details; and**
- (c) advise Parliament when significant variations are made to a PPP contract, beyond the initial contractual arrangements.**

*Page 105***Recommendation 12:****That:**

- (a) prior to tenders being submitted for public private partnership projects, agencies should ensure applicants are aware of the limits of what will and will not be considered as commercial in confidence in relation to PPP contracts; and**
- (b) in determining whether a claim for commercial confidentiality is justified, the onus of proof should be with the tenderer, who should be required to substantiate that disclosure would be harmful to their commercial interests.**

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Chapter 6: Protecting the public interest

Recommendation 13:

That:

- (a) after public private partnership contracts are signed, the contracts be published on the Partnerships Victoria website within three months;**
- (b) a succinct (approximately three page) summary of the contract and a value for money report be prepared, modelled on the British Columbia value for money report, and include the following information:**
 - (i) the assets that are to be transferred from the Victorian Government to the private sector;**
 - (ii) the price to be paid by the government and the basis for future changes in the price;**
 - (iii) the provisions for renegotiation;**
 - (iv) the risk sharing in the construction and operational phases;**
 - (v) significant guarantees or undertakings;**
 - (vi) details of the public sector comparator.**
- (c) the Victorian Auditor-General review the details included in the contract summary and certify that it is an adequate reflection of the terms and conditions of the contract and arrange for the publication of the statement on the *Partnerships Victoria* website.**
- (d) the Department of Treasury and Finance develop a template outlining information to be included in the summary of the public private partnership contract and the value for money report, and advise departments.**

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Recommendation 14: The Victorian Government make representations to the National PPP Council to jointly fund a study on the potential financing options available to governments to fund public infrastructure projects, including the economic and social impacts of each option and publicly release the report for comment. In the event that the National PPP Council does not agree to this proposal, the Victorian Government fund such a study.

Page 118

Recommendation 15: The Victorian Government:

- (a) develop a secondment model within the public sector so that public officials with experience in complex procurement processes can be retained and deployed on projects across the public sector;
- (b) take steps to ensure Major Projects Victoria and individual departments are appropriately resourced to manage public private partnership projects;
- (c) develop individual and team procurement skills through formal qualification training; and
- (d) ensure the performance criteria and targets for senior public officials involved in public private partnership projects and traditional procurement are linked to completing projects on time and within budgets.

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Chapter 7: Value for money

Recommendation 16: The Victorian Auditor-General periodically undertake performance audits of all major public private partnership projects to determine whether value for money is being maintained over the life of a project.

Page 143

- Recommendation 17:** The value for money tools used for *Partnerships Victoria* assessment be revised to include:
- (a) benchmarked comparisons where these are possible;
 - (b) a full range of alternative funding options (including public sector funding through the budget);
 - (c) an indication of the accuracy of the public sector comparator;
 - (d) a precise definition of the traditional public sector alternative option under consideration; and
 - (e) a publicly available explanation of how the public sector comparator is used to compare tender bids.

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- Recommendation 18:** An independent assessment be made of the relative cost performance, efficiency and timeliness of all privately funded projects, similar to the Mott MacDonald (United Kingdom) report.

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- Recommendation 19:** The Victorian Government make representations to the National PPP Council to arrange for an independent study into the size, structure and competitiveness of the Australian public private partnership market to determine the degree to which its diversity is sufficient to be fully competitive.

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Chapter 8: Risk

- Recommendation 20:** The Victorian Government make representations to the National PPP Council to arrange for independent research to be undertaken on the degree to which discount rates should include a component for risk, and the size of this component.

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CHAPTER 1: INTRODUCTION

Key findings of the Committee:

- 1.1 The Victorian Government is committed to the use of public private partnerships (PPP) projects and currently has 16 projects worth \$4.5 billion under contract. These PPP projects represent a small but significant element (approximately 10 per cent) of the provision of public infrastructure.**
- 1.2 The criteria for Victorian Government usage of PPPs is that the project is large, complex in nature and there are opportunities for risk transfer and private sector innovation. The Victorian Government judges a successful public private partnership project as one that delivers value for money.**
- 1.3 The financial and economic benefits of PPPs have been subject to much debate both in Victoria and in other jurisdictions, and there are opposing views about the benefits these projects bring for the community.**
- 1.4 Submissions and evidence presented to the Public Accounts and Estimates Committee identified the potential for PPP projects to promote whole-of-life costing for assets and improved assessment and allocation of risks. A range of issues principally concerned with governance and the limited accountability and transparency of PPP projects were also raised. Other key issues concerned evaluation methods, for example that the public sector comparator should be used with caution; the fact that governments can be ‘locked in’ to contracts for long periods; the inadequacy of current infrastructure; the need to maintain infrastructure assets; and intergenerational equity.**
- 1.5 The need for improved reporting and disclosure of information in government contracts, continues to be raised as concerns in this inquiry.**

1.1 Background to the inquiry

One of the major challenges facing nearly every government is how to provide the billions of dollars of infrastructure development and maintenance required to meet the changing needs of the community. This situation is not unique to Victoria.

Over the past 15 years, many governments (including the Victorian Government) have increasingly used the public private partnership (PPP) model to involve the private sector in financing, designing, building, and maintaining public infrastructure,

including in some circumstances, providing related services. Forty-four countries have implemented or are in the process of implementing various models of PPP projects.

To encourage a more competitive market, the Victorian Government has sought to encourage other Australian jurisdictions to join together in developing a national PPP market. Some convergence has been achieved, and actual and potential PPP projects totalling \$20 billion have been identified by governments.

The Victorian Government has entered into 16 PPP contracts worth about \$4.5 billion to provide new or modernised infrastructure for public services. While the vast majority of public infrastructure remains traditionally procured, PPPs now comprise approximately 10 per cent of all public sector investment.

There have been some common sets of principles attached to most of these PPP projects but all have differed in their approach to issues such as the allocation or transfer of risk, obligations of the state, the period of the contract, ownership arrangements when the contract is completed, and the range of associated services to be provided by the private consortia, for example security management and IT services. In addition, the deal structure can be unique, very complex and can involve significant financial assistance from the government.

The extent to which PPP arrangements deliver their claimed potential depends on the specification of performance criteria, financial modelling, unanticipated events, and the nature of the relationship between the government and the private partners in the consortia. There is currently little disclosure of reviews of PPPs, either by government or by private sector partners, and limited evidence as to whether these arrangements have genuinely delivered on the promise of value for money.

Experience with PPP projects, in Victoria and in other jurisdictions, has shown that there have been both successes and failures. The policy has, not surprisingly, attracted considerable comment from the media and some academics, and has proven to be controversial.

Given that many PPP projects have encompassed infrastructure and facilities that provide essential services for the community, and the policy has important financial and social implications for the state, the Public Accounts and Estimates Committee of the 54th Parliament resolved to commence this inquiry.

That Committee considered that the inquiry would provide a valuable opportunity to explore the strengths and weaknesses of PPP projects and to examine the policy and legal frameworks and practices that may influence future projects.

The inquiry was also considered desirable because PPP processes raise complex issues about protecting the public interest, accountability and governance.

1.2 Scope of the inquiry

The terms of reference adopted by the Committee for the inquiry require it to:

1. provide an overview of the various major infrastructure projects in Victoria that have involved private sector funding since 1990, with particular emphasis on issues relating to risk allocation and protection of the public interest;
2. review and evaluate the expectations and outcomes of these projects in relation to the benefits and disadvantages to the community;
3. review Victorian, Australian and international legislative and policy frameworks and practices regarding private sector investment in public infrastructure;
4. examine the various government models for evaluating and monitoring private investment in public infrastructure projects and the governance and accountability arrangements;
5. review and evaluate mechanisms used by the Victorian Government to protect the public interest;
6. review the mechanisms used by the Victorian Government to evaluate the effectiveness of private sector investment in public infrastructure projects to determine whether they represent value for money for the government and benefit the community;
7. assess the framework for risk allocation between the public and private sectors and its application, with particular emphasis on how well risk is assessed, allocated and managed; and
8. consider and report on any other relevant matters.

These issues and other associated matters are discussed in this report.

1.3 The inquiry process

The terms of reference for the inquiry were advertised in the national press. The former PAEC appointed a Sub-Committee to conduct the inquiry.

Letters seeking submissions were sent to government departments involved in public private partnership (PPP) projects, academics, financial institutions, peak business and community organisations, and other interested parties. The Sub-Committee received 36 submissions. A list of submissions is contained in appendix 2.

The Sub-Committee also took evidence at a number of briefings and public hearings in Melbourne. A list of the hearings and the witnesses who gave evidence appears at appendix 3.

The 54th Parliament was prorogued on 5 November 2002, causing the inquiry to lapse. On 22 April 2003 the newly appointed Public Accounts and Estimates Committee of the 55th Parliament resolved to complete the inquiry, but postponed work because of other priorities.

This Committee received a further eight submissions and took evidence from witnesses in Melbourne, Sydney and Canberra, and from selected countries overseas. Details are at appendices 2 and 3.

The evidence gained from discussions with government officials, auditors-general, academics, peak industry, union and community groups, and parliamentary officials provided the Committee with valuable insight and information that enhanced its understanding of the many technical and complex issues addressed during this inquiry.

The government appointed Peter Fitzgerald to review infrastructure projects undertaken by *Partnerships Victoria* in August 2003. This report was tabled in January 2004 and the government indicated that it supported the majority of the recommendations. The Committee has taken into account the matters raised by the Fitzgerald report.

1.4 Acknowledgments

The Committee thanks all those who made submissions and gave evidence at the hearings. The Committee particularly appreciates the considerable time and effort involved in the preparation of detailed submissions and in giving evidence at the hearings. In preparing this report, the Committee has drawn heavily on the material and views presented through submissions and at private and public hearings. The Committee is grateful for this valuable input.

The Committee also sought advice from a number of experts in relevant fields in preparing this report.

1.5 Key issues raised in submissions and evidence

The following key issues, some of which have now been addressed by the Victorian Government, were raised in submissions and in evidence to the Committee:

- there is a need for consistent and appropriate evaluation methods to be applied to PPPs;⁴
- the methods used for the public sector comparator (PSC) need to be robust and accountable;⁵

⁴ For example Mr T O'Brien, Company Secretary, Cavan Group Pty Ltd, submission no.1, p.1; Victorian Trades Hall Council, submission no.5, p.1; Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.5; Moreland City Council, submission no.22, p.1; Professor G Hodge, submission no.31, p.2

- details of the PSC should be made available to bidders;⁶
- local government experience with PPPs has been limited although there is considerable potential for these types of contracts;⁷
- matters relating to risk management and allocation need to have greater scrutiny and the details need to be made public;⁸
- PPP projects are increasingly involving greater allocation of risk to the private sector, which comes at a greater cost to government;⁹
- certain risks associated with public infrastructure projects are difficult to identify and sometimes it is inappropriate to transfer them to the private sector;¹⁰
- there is a need to ensure that Victoria and Australia have continuity with PPP projects so that a competitive market is maintained;¹¹
- PPPs are one option of a range of infrastructure provisions;¹²
- lessons learnt, such as detailed planning and assessment practices for PPPs, could be utilised in other infrastructure projects;¹³
- PPP projects should continue to be driven by value for money considerations and not by whether the arrangement will be recognised as '*off-balance sheet*';¹⁴
- the benefits and disadvantages of public private partnerships need to be made clear;¹⁵

⁵ For example Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.7; Professor J Quiggin, submission no.25, p.3; Thiess Pty Ltd, submission no.32, p.11; Professor G Hodge, submission no.31, p.2

⁶ For example Australian Council for Infrastructure Development (AusCID), submission no.18, p.21; Deutsche Bank AG submission no.19, p.4; Thiess Pty Ltd, submission no.32, p.11

⁷ For example Shire of Campaspe, submission no.6, pp.1–2; Manningham City Council, submission no.10, p.2; Whitehorse City Council, submission no.20, p.4; Mr G Campbell, Partner, Maddocks, transcript of evidence, p.12

⁸ For example Hyder Consulting (Australia) Pty Ltd, submission no.12, p.2; Thiess Pty Ltd, submission no.32, p.8

⁹ Professor G Hodge, private briefing; Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.7

¹⁰ For example Deacons law firm, submission no.14, p.4; Deutsche Bank AG, submission no.19, p.5; Professor J Quiggin, submission no.25, p.31; Thiess Pty Ltd, submission no.32, p.12

¹¹ For example Hyder Consulting (Australia) Pty Ltd, submission no.12, p.3; Deutsche Bank AG, submission no.19, p.6; Mr M Lilley, Division Director, Macquarie Bank, transcript of evidence, p.17

¹² Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.4; Professor G Hodge, private briefing

¹³ Professor G Hodge, private briefing; Professor J Quiggin, submission no.25, p.3

¹⁴ Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.7

¹⁵ For example Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.7; Deacons law firm, submission no.14, p.2; Thiess Pty Ltd, submission no.32, pp.2–9

- there are concerns that the duration of PPPs can lock governments in to contracts for a long period (that is, more than 30 years) which can restrict future policy options and have implications for budget flexibility;¹⁶
- there is a need to ensure that the public interest is protected;¹⁷
- the public sector needs to assemble the appropriate levels of expertise to match the private sector at every stage of the PPP process;¹⁸
- there should continue to be open dialogue under the probity rules during the bid phase for PPPs;¹⁹
- the transaction costs for both the private and public sectors are too high;²⁰
- the discount rate is too high and does not reflect the true cost of government borrowing money;²¹
- the Victorian Government should lobby the Commonwealth Government to provide greater tax concessions for PPP projects;²²
- there is a need to review the current threshold amount (\$100 million) for PPP projects in Victoria;²³
- there is a need to ensure that the basis for price increases are clearly outlined in the contracts, particularly for toll roads, public transport and water;²⁴
- the basis for calculating public debt needs to be reviewed;²⁵
- annual financial reporting in the public sector needs to ensure that the financial details of PPP projects are fully disclosed;²⁶

¹⁶ For example Deacons law firm, submission no.14, p.2; Professor G Hodge, submission no.31, p.4; Mr R Walker, Assistant Auditor-General, Victorian Auditor-General's Office, transcript of evidence, p.16; Dr A Smith, Director, Melbourne City Link, transcript of evidence, Mr L Scanlan, (then) Queensland Auditor-General, transcript of evidence, p.16; Mr T Harris, journalist and former New South Wales Auditor-General, transcript of evidence, p.2

¹⁷ For example Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.7, Deacons law firm, submission no.14, p.10; Australian Council for Infrastructure Development (AusCID), submission no.18, p.19; Victorian Council of Social Service (VCOSS), submission no.24, p.4; Mr L Scanlan, Auditor-General, Office of the Auditor-General of Queensland, transcript of evidence, p.16

¹⁸ For example Dr S Wilson, submission no.17, p.2; Australian Council for Infrastructure Development (AusCID), submission no.18, p.5; Thiess Pty Ltd, submission no.32, p.9

¹⁹ For example Australian Council for Infrastructure Development (AusCID), submission no.18, p.5; Property Council of Australia, submission no.33, p.2

²⁰ For example Australian Council for Infrastructure Development (AusCID), submission no.18, p.22; Deutsche Bank AG, submission no.19, p.6; Thiess Pty Ltd, submission no.32, p.4; Property Council of Australia, submission no.33, p.3

²¹ Professor J Quiggin, submission no.25, p.36

²² For example Australian Council for Infrastructure Development (AusCID), submission no.18, p.23; Deutsche Bank AG, submission no.19, p.7; Thiess Pty Ltd, submission no.32, p.12

²³ For example Deutsche Bank AG, submission no.19, p.6; Mr D Johnson, General Manager, Thiess Pty Ltd, transcript of evidence, p.60

²⁴ Dr A Smith, Director, Melbourne City Link, transcript of evidence, p.17

²⁵ Professor J Quiggin, submission no.25, p.25

²⁶ For example Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.5; Professor J Quiggin, submission no.25, pp.19–20; Professor G Hodge, private briefing

- the government needs to do more to maintain infrastructure assets and intergenerational equity;²⁷
- stronger accountability and transparency mechanisms are needed for PPP projects;²⁸
- a summary of the details contained in PPP contracts should be made public;²⁹
- the appropriateness of PPPs for some social infrastructure projects is subject to debate.³⁰

The cost of this inquiry is estimated at \$196,500.

²⁷ Thiess Pty Ltd, submission no.32, p.1, Australian Education Union – Victoria, submission no.34, p.3

²⁸ Dr S Wilson, submission no.17, p.2; VCOSS, submission no.24, p.7; Professor G Hodge, submission no.31, p.4

²⁹ Professor G Hodge, submission no.31, p.4

³⁰ Mr R Walker, Assistant Auditor-General, Victorian Auditor-General's Office, transcript of evidence, p.15; Professor G Hodge, private briefing

CHAPTER 2: THE CONTEXT OF PRIVATE INVESTMENT IN INFRASTRUCTURE

Key findings of the Committee:

- 2.1** There are many different meanings and definitions given to public private partnerships (PPPs) and the projects can have many different organisational and financial characteristics. Even though the precise boundary surrounding PPPs is still evolving, there are sufficient projects and developments taking place around the world that provide useful information.
- 2.3** The reasoning behind PPP projects has changed over time. They began with broader macroeconomic concerns in terms of public sector debt levels and have since moved to more direct value for money concerns.
- 2.4** PPPs typically cover a continuum of operations that can include financing, design and development, management, operation and ownership over a long period, as well as the traditional role of construction.

2.1 Defining public private partnerships

The Committee's research identified that while the term '*public private partnership*' (PPP) has been in general use since the 1990s, there is no widely agreed, single definition or model of a PPP.

The term covers a range of different structures where a private sector consortium delivers a public infrastructure project and/or service. Concession based transport and utilities projects have existed in some countries for many years, particularly in France, Italy and Spain, with revenues derived from payments by end users, for example road tolls. The United Kingdom's private finance initiative (PFI) expanded this concept to a broader range of public infrastructure, and combined it with the introduction of services being paid for by the public sector rather than by the end users.

The use of PPPs has now spread to many countries and depending on the country and the politics of the time, the term can cover a spectrum of models. These models range from relatively short term management contracts with little or no capital expenditure; concession contracts that may encompass the design and build of substantial capital assets along with the provision of a range of services and the financing of the entire construction and operation; joint ventures where the private and public sectors jointly finance, own and operate a facility; and partial privatisation where there is a sharing of ownership between the public and private sectors.

The private funding of public infrastructure usually relates to a business relationship between the public and private sectors. Such relationships are usually long term and underpinned by a detailed commercial contract regime, under which the partnership delivers public services (the outputs) that the contract specifies in detail. The public sector obligations are detailed in documents or contracts that cover the risks to be shared and the desired policy outcomes.

The Victorian Department of Treasury and Finance defined a PPP project in much narrower terms, as ‘*a contract for a private party to deliver public infrastructure-based services*’.³¹ This definition explicitly excludes outsourcing or other service delivery arrangements where no capital investment is required. A PPP project in Victoria may, therefore, involve the design, construction, financing, maintenance, and, in some cases, operation of public infrastructure or public facilities by the private sector under a long term contract.

The Committee’s inquiry revealed that private financing of public infrastructure through PPPs covers a range of different options and techniques. *Partnerships Victoria* defines PPP projects more specifically in terms of contracts.³²

- with a value of \$50 million or more;
- that integrate design, construction, operation and maintenance over the life of the asset, in a single project package;
- that focus on services rather than on assets;
- with scope for significant allocation of risk to the private sector;
- that provide opportunity for innovation and transfer of risk to a third party; and
- that provide business opportunity and sufficient capable private sector parties to create an effective and competitive bidding process.

2.1.1 Defining infrastructure

The New South Wales Public Accounts Committee’s report *Infrastructure and Management and Financing in New South Wales* defined ‘infrastructure’ as follows:³³

Infrastructure comprises the physical assets required to satisfy the public’s need for access to major economic and social facilities and services. It may be divided into two broad types:

³¹ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Practitioners Guide*, June 2001, p.4

³² Department of Treasury and Finance *Partnerships Victoria Guidance material, Overview*, July 2006, p.8

³³ Public Accounts Committee, New South Wales, *Infrastructure Management and Financing in New South Wales, Vol.1: From Concept to Contract – Management of Infrastructure Projects*, July 1993, p.4

Economic infrastructure comprising roads; railways; ports; airports; dams and reservoirs; water headworks, water treatment and reticulation facilities; telecommunications and post facilities; and power generation facilities.

Social infrastructure comprising schools and other education facilities; hospitals, clinics and other health facilities; housing; recreational facilities and law and order facilities.

The principle characteristics of infrastructure facilities are:

- *they have high initial capital costs;*
- *they are time-consuming to build;*
- *they have long lives; and*
- *they exist to support other economic and social activities, not merely as an end in themselves.*

This definition is comprehensive because it includes economic as well as social aspects, and it outlines common characteristics.

The Victorian Government's *Partnerships Victoria* policy applies to the provision of public infrastructure and related ancillary services that involve private investment or financing:³⁴

The term 'infrastructure' can extend beyond physical assets to encompass major information technology procurements. In this context, 'related ancillary services' may encompass accommodation services arising out of the infrastructure, building-related services such as maintenance and some support services.

The *Partnerships Victoria Guidance Material, Practitioners' Guide* defines infrastructure as fixed capital assets such as schools and hospitals, that support the provision of services. Infrastructure can also refer to a network of reticulated services such as roads, energy services, rail and airports.³⁵

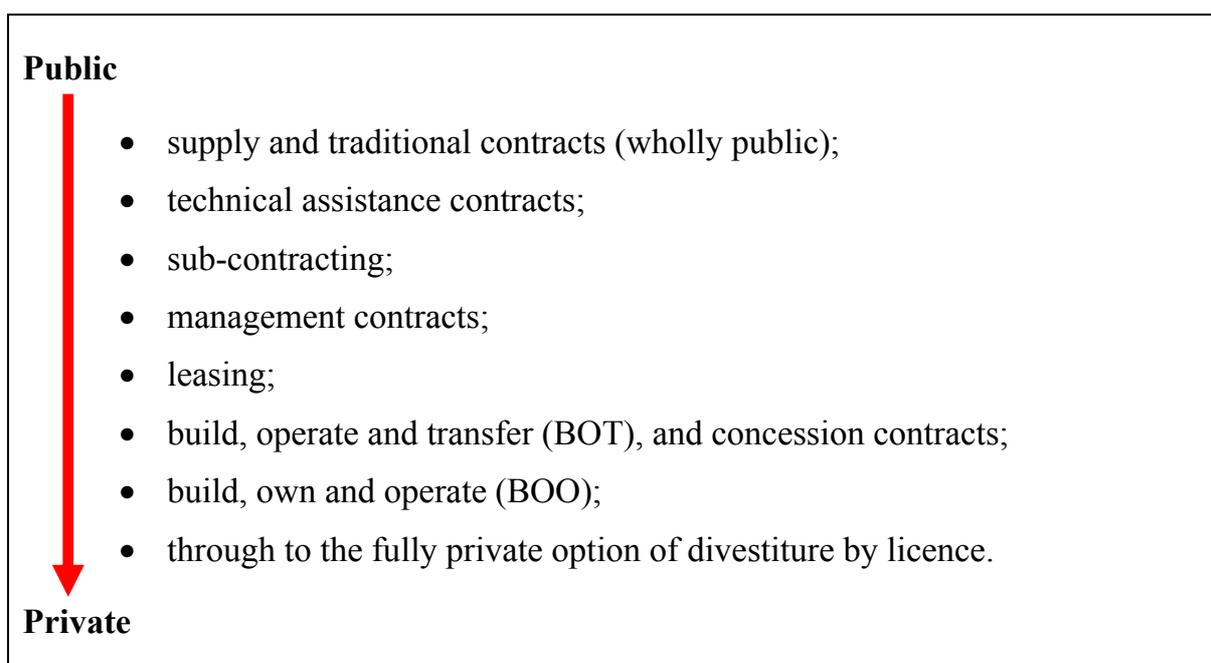
³⁴ Department of Treasury and Finance, *Partnerships Victoria*, June 2000, p.4

³⁵ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Practitioners' Guide*, June 2001, p.151

2.1.2 *Forms of private investment in public infrastructure*

A range of private sector options is available for the provision of public sector infrastructure. The World Bank suggested these options lay along a continuum from wholly public at one end to wholly private at the other:³⁶

Exhibit 2.1: Forms of private investment in public infrastructure



The first few public orientated options may include the private sector providing public infrastructure through sub-contracts or management contracts, but they do not address the issue of funding constraints on government. Funding difficulties may be bridged through the latter options, not least BTO concessions and divestiture.

Traditional public ownership (contracting out) arrangements may include design and construct, where the government specifies the asset required in terms of its functions and desired outcomes. The private sector is responsible for designing and building the asset and assumes related risks before the asset is passed onto government to operate.³⁷ This arrangement is quite different from the BOOT (build, own, operate, transfer) arrangement, whereby the service provider is responsible for the design, construction, finance, operations, maintenance and commercial risks associated with the project. The service provider owns the asset during the concession period, before the asset is transferred back to the government, often at no cost.³⁸

³⁶ Guislain P and Kerf M, Public Policy for the Private sector, note no.59, *Concessions – The Way to Privatize Infrastructure Sector Monopolies*, October 1995

³⁷ Australian Council for Infrastructure Development (AusCID), submission no.18, p.7

³⁸ *ibid.*

Previous Victorian Governments have not developed an official classification system of private involvement in infrastructure. However, the Commonwealth Economic Planning Advisory Commission produced an early classification system, illustrating the spectrum of private involvement in the provision of infrastructure, ranging from full private ownership to traditional public ownership (and no private involvement).³⁹

Exhibit 2.2: Private involvement in economic infrastructure – taxonomy

Areas of involvement	Full private ownership	BOOT type arrangements			Traditional public ownership (contracting out)	Traditional public ownership (in-house)
		BOO	BOOT	BTO		
Plan	P	G	G	G	G	G
Design	P	P	P	P	P/G	G
Construct	P	P	P	P	P/G	G
Operate/maintain	P	P	P	P	P/G	G
Ownership	P	P	P → G	G	G	G
Payment for services	C/G	C/G	C/G	C/G	C/G	C/G
Regulate	G	G	G	G	G	G

Key: P=Private, G=Government, C=Consumer, BOO=Build-Own-Operate, BOOT=Build-Own-Operate-Transfer, BTO=Build-Transfer-Operate

The Commission explained the various forms of involvement as follows:⁴⁰

- *Under full private provision, the private sector provides infrastructure in much the same way as other goods and facilities. Thus the provision of the infrastructure service reflects normal commercial criteria, subject only to a broad regulatory framework. In practice there is often a fine line between BOO projects (where government is responsible for project planning) and full private provision. Privatisation of public infrastructure can be achieved through the sale of existing facilities or the removal of barriers to entry in areas which are not natural monopolies. Under full private provision, governments may still provide subsidies to secure the provision of non-commercial facilities, or to reduce costs for particular groups of consumers.*

³⁹ Economic Planning Advisory Commission, *Private Infrastructure Task Force Report*, September 1995, pp.5–7

⁴⁰ *ibid.*

- *Under traditional public ownership (and in-house labour), government was responsible for virtually all aspects of provision. This has largely been phased out over the past two decades in Victoria;*
- *Traditional public ownership (with contracting out) involves government financing a project, but contracting out to the private sector some or all of the project design, construction, operation and maintenance through competitive agreements;*
- *BOOT-type arrangements are individual project concessions in which private operators finance and build a public facility in return for the right to operate the facility and charge a user fee. In most cases, such facilities operate within a publicly owned network. The key difference between these arrangements and contracting-out is that under a BOOT structure, the private entity provides at least some of the finance for the venture and thereby assumes some of the project risk.*

BOO, BOOT and BTO arrangements are three of the numerous possibilities here. BOO schemes remain privately owned facilities in perpetuity but under a BOOT scheme, ownership of the facility transfers to the government at the end of the concession period, usually without payment. Under a BTO scheme, the public sector takes ownership of the project on completion, and leases it back to the private provider. The government, therefore, assumes earlier ownership of the asset, although this is largely ‘cosmetic’.

Governments often supplement project revenue in recognition of wider social benefits. The government contribution may take the form of a grant, land or some other physical asset, a concession loan, or equity (that is, joint ventures).

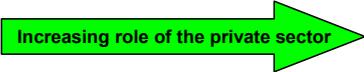
The Victorian Government’s *Partnerships Victoria Guidance Material, Overview* states that there is no preferred or standard model for projects under this policy, but that for a given project, the model of partnership is determined by three criteria:⁴¹

- whether the government should deliver any part of the proposed service;
- whether the involvement of the private sector will deliver value for money and, if so, how to optimise that value; and
- whether the project will satisfy the public interest criteria that form part of the *Partnerships Victoria* policy.

The overview document states that as a result of these criteria, there is likely to be a greater variety of models than in the past. Exhibit 2.3 illustrates the different models of government and private party involvement in projects under *Partnerships Victoria*.

⁴¹ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Overview*, July 2006, pp.8–9

Exhibit 2.3: Different roles of government and private sector in projects under Partnerships Victoria ⁴²

			
Private party role	Infrastructure and ancillary services	Infrastructure and partial private to public service delivery	Infrastructure and full service delivery direct to users
Government role	Delivery of core public services	Delivery of core public services	No service delivery
Example of services mix	Hospital facility where government provides healthcare services and private sector provides ancillary services, e.g. cleaning and security	Waste water facility where government interfaces with waste water producers providing waste water to private sector plant operators (who also provide direct services to users of recycled water)	Toll road where private sector provides all services direct to users
	Design – build – finance – maintain (DBFM)	Design – build – finance – operate (partial DBFO)	Design – build – finance – operate (full DBFO or BOOT)

Source: Department of Treasury and Finance, *Partnerships Victoria, Guidance Material, Overview, July 2006, p.9*

The earlier mentioned inconsistencies in terminology are also evident throughout the various types of project schemes. Two prominent academics, Broadbent and Laughlin,⁴³ noted that PFI in its purest form is a design, build, finance, operate (DBFO) system, involving a private sector consortium providing public based services to a public sector purchaser for a lengthy period. In contrast, the Department of Treasury and Finance advised the Committee that the Melbourne CityLink project was '*financed by the private sector as a build, own, operate, transfer (BOOT) scheme*'.⁴⁴

2.2 Arguments for and against private investment

A range of arguments has supported the private financing of public infrastructure. Such arguments have varied from macro (in terms of debt reduction and a commitment to balanced budgets) to micro concerns (in terms of project 'value for money').

The arguments for private investment in public infrastructure include:

- the government has access to a broader range of funding options;
- project delivery is earlier than might otherwise be possible through traditional procurement methods;

⁴² *ibid.*, p.9

⁴³ J Broadbent and R Loughlin, 'PPPs: Nature, Development and Unanswered Questions', *Australian Accounting Review*, 14(2) 4–10, 2004, p.335

⁴⁴ Department of Treasury and Finance, submission no.35, attachment B

- risks are transferred to the private sector which is better able to manage risks than the government;
- whole-of life costing factors in maintenance of assets;
- whole-of-life costing (where public private partnership arrangements encompass not only the design and construction costs, but allow for ongoing service delivery, operational, maintenance and refurbishing costs over the life of the asset, or for a determined period of years) allows the private company to recoup capital costs and allows for an adequate return on capital;
- the partnership approach encourages competition and provides incentives for bidders to develop innovative designs and solutions to meet the specifications for the public infrastructure; and
- infrastructure developed by the private sector can also incorporate commercial activities, which can be used in part to defray the cost of services provided to the government.

The arguments **against** the use of private finance for public infrastructure include:

- accountability to the public and Parliament for public expenditure may be weakened under PPP models;
- the long term nature of the contract reduces flexibility with policy and budget funding;
- questions arise around the value for money from PPPs because of the higher borrowing costs of the private sector;
- the public sector has adequate capacity to finance infrastructure without any private sector financing;
- financiers have, in some cases, made enormous profits through re-financing;
- it is very difficult for governments to adequately structure contracts for future unforeseen events and risks, especially over the long term;
- PPP infrastructure contract costs are more expensive than the traditional provision of infrastructure due to additional transaction and management costs, paid to legal and accounting firms ;
- because some aspects of risk are not transferable, the justification for private sector investment is diminished.

The Committee is aware that many of the arguments both for and against the use of private funds for public infrastructure parallel those arguments for and against the privatisation of public sector services and the contracting out of public services used over the past few decades.

2.3 Interest groups

The Committee received evidence highlighting the various interest groups who play a key role in the private financing of public infrastructure. Exhibit 2.4 summarises these key interest groups and indicates some of their primary interests.

Exhibit 2.4: Examples of interest groups involved in the private provision of public infrastructure

Infrastructure sector (interest group)	Interest
Engineering construction companies	Industry development – successful delivery of infrastructure
Finance sector / banking	Industry development / financial transactions
Project management consultants	Industry development / successful infrastructure delivery
Consulting advice (for example, accountants, lawyers, consulting engineers)	Industry development / successful infrastructure development for private sector
Government groups	Interest
Policy advocates	PPP activities initiated and policy success
Public servants	Sound administration of government policy
Treasury/finance officials	Veracity and clarity in financial stewardship
Project managers	Successful project delivery/business transactions (if outsourced)
Advisory accountants, lawyers, contract engineers	Successful project delivery for public sector/business transactions (if outsourced)
The public/users/community	Interest
The public	Sound planning, processes and priorities for future infrastructure
The public and users	Infrastructure provision at earliest opportunity and lowest competitive cost, user pays
Taxpayers	Accurate monitoring of financial capacity to pay and liability exposure
Community, both current and future	Confidence in infrastructure provision arrangements for the short and long term public interest

2.4 The condition of Victoria's infrastructure

Both economic and social infrastructure is fundamental to a country's standard of living.⁴⁵ For each dollar spent on infrastructure, economic growth and financial returns are stimulated.

⁴⁵ Dr C Duffield, *An Evaluation Framework for Privately Funded Infrastructure in Australia*, PhD thesis, The University of Melbourne, 2001

Infrastructure investment stimulates economic growth through job creation, purchasing of goods and services from the private sector and cost savings to industry and the public through projects such as those involving roads, transport and water facilities. Infrastructure projects also enable private companies to achieve reasonable returns on capital for shareholders and investors.

The Committee is aware that a number of academics and studies have suggested that the benefit of infrastructure investment to private industry is undoubtedly positive.⁴⁶

The Institution of Engineers Australia indicated they were concerned that much of Victoria's infrastructure is barely adequate for current needs let alone future needs; funding commitments are largely inadequate to support the substantial costs of renewal and replacement; and current planning and political processes create a short term focus in an area where a very long term focus is required.⁴⁷

The 2006-07 Budget Papers indicate that since 2000-01, the government has invested about \$13 billion in infrastructure, averaging more than \$2 billion a year, about double the annual average investment in the previous five years.⁴⁸

Dr Duffield from the University of Melbourne highlighted that *'the present level of infrastructure funding, from both public and private sector sources, must be raised if standards of living are to be maintained'*.⁴⁹ The Municipal Association of Victoria (MAV) has stated that the local government sector is responsible for over \$37 billion of community assets with roads being the single largest infrastructure item.⁵⁰ The MAV's submission indicated that a limited local government revenue stream and steadily aging infrastructure means there is now a large capital spending deficit on infrastructure items across Victorian local government.⁵¹ Private financing of local government infrastructure is still perceived as unchartered territory for the sector, although the Committee is aware that some local governments are interested in pursuing this option.⁵²

There is solid evidence that investment in public infrastructure provides net positive benefits to the community, but this does not necessarily imply that any particular type of infrastructure financing mechanism is better than another, only that investment in public infrastructure yields positive outcomes. Logically, such investments need to be undertaken with minimum financing and transaction costs.

⁴⁶ For example, Dr C Duffield, *An Evaluation Framework for Privately Funded Infrastructure in Australia*, PhD thesis, The University of Melbourne, 2001, p.23; and Allen Consulting

⁴⁷ The Institution of Engineers Australia, 2005 Victorian Infrastructure Report Card, p.vii

⁴⁸ Budget Paper No. 2, *2006-07 Strategy and Outlook*, p.6

⁴⁹ Dr C Duffield, *An Evaluation Framework for Privately Funded Infrastructure in Australia*, PhD thesis, The University of Melbourne, 2001, p.39

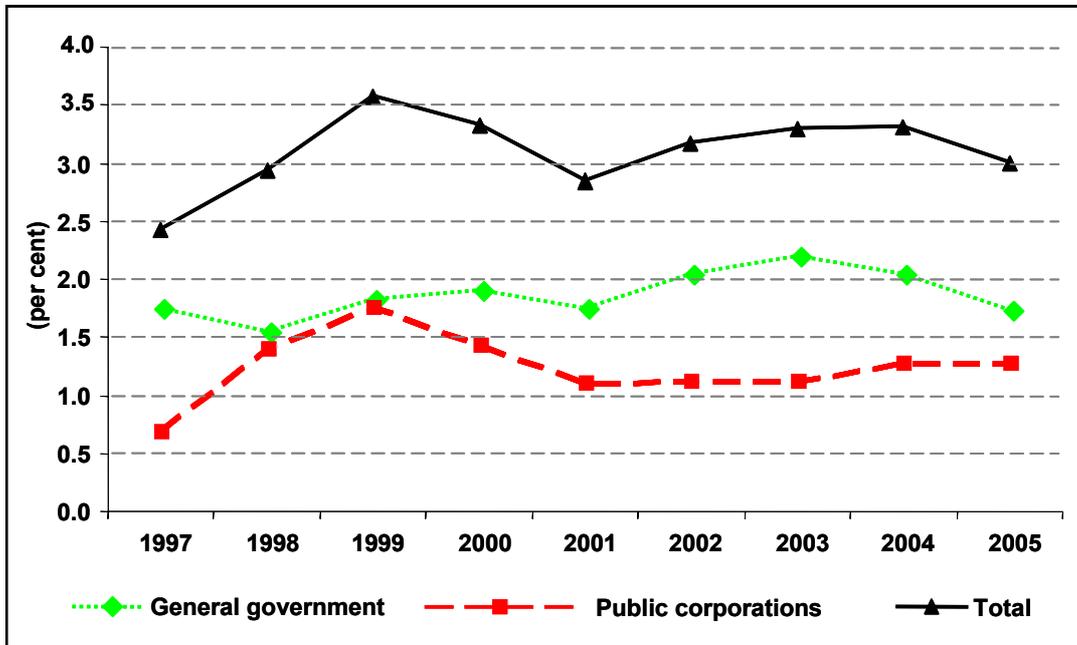
⁵⁰ Municipal Association of Victoria, Fact Sheet Council responsibilities, see www.mav.qsn.au, accessed 10 August 2006

⁵¹ Municipal Association of Victoria, submission 30, p.4

⁵² For example, Manningham City Council, submission no.10; City of Whitehorse, submission no.20; Mornington Peninsula Shire Council, submission no.27

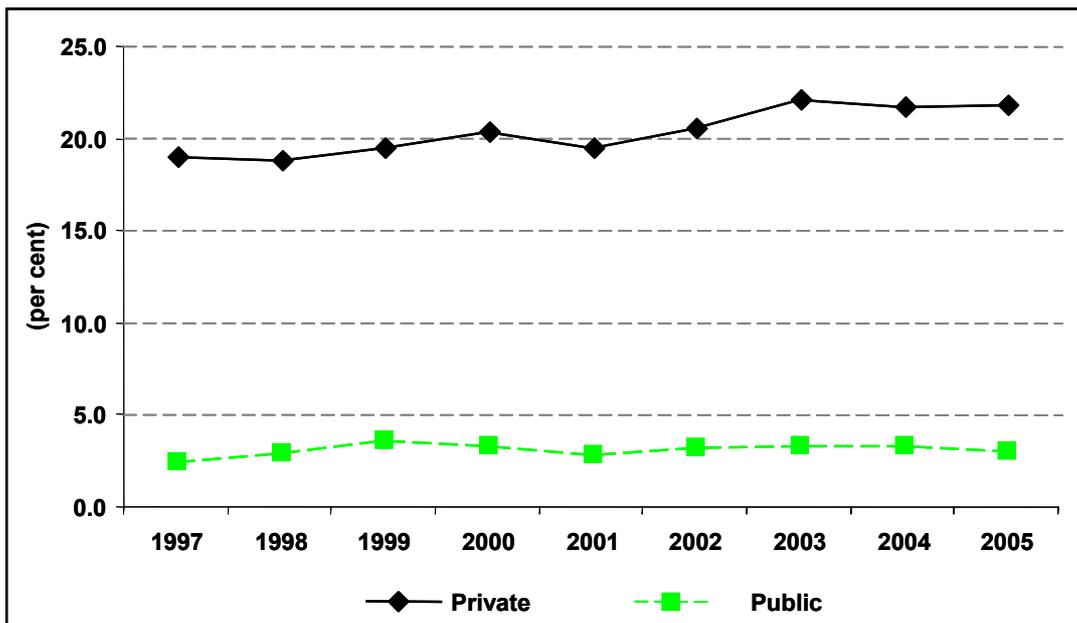
The Committee is aware that the amount of money invested by governments in developing public infrastructure, as a percentage of gross state product, has been declining (exhibits 2.5 and 2.6).

Exhibit 2.5: Victorian Government capital formation as a proportion of gross domestic product (GDP) 1997 – 2005



Source: ABS Catalogue No. 5220.0 – Australian National Accounts: State Accounts 2004-05, Table 8, p.19

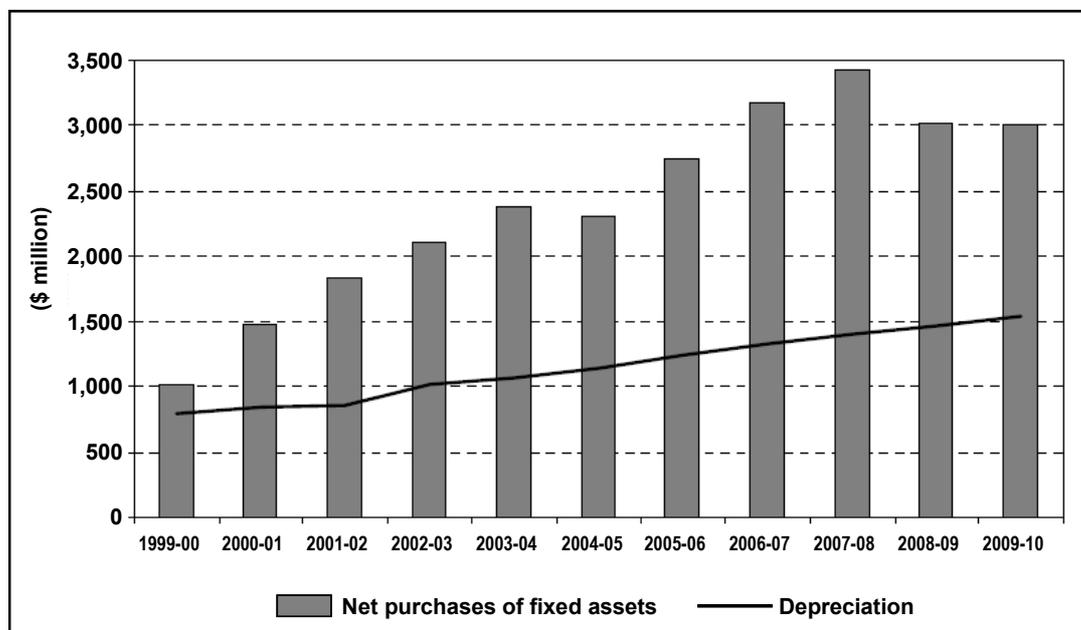
Exhibit 2.6: Victorian Government/private capital formation as a proportion of gross domestic product (GDP) 1997 – 2005



Source: ABS Catalogue No. 5220.0 – Australian National Accounts: State Accounts 2004-05, Table 8, p.19

The 2006-07 Budget Papers indicate that since 2000-01, the government has invested about \$13 billion in infrastructure, averaging more than \$2 billion a year, about double the annual average investment in the previous five years.⁵³

Exhibit 2.7: Victorian general government sector net infrastructure investment (a)



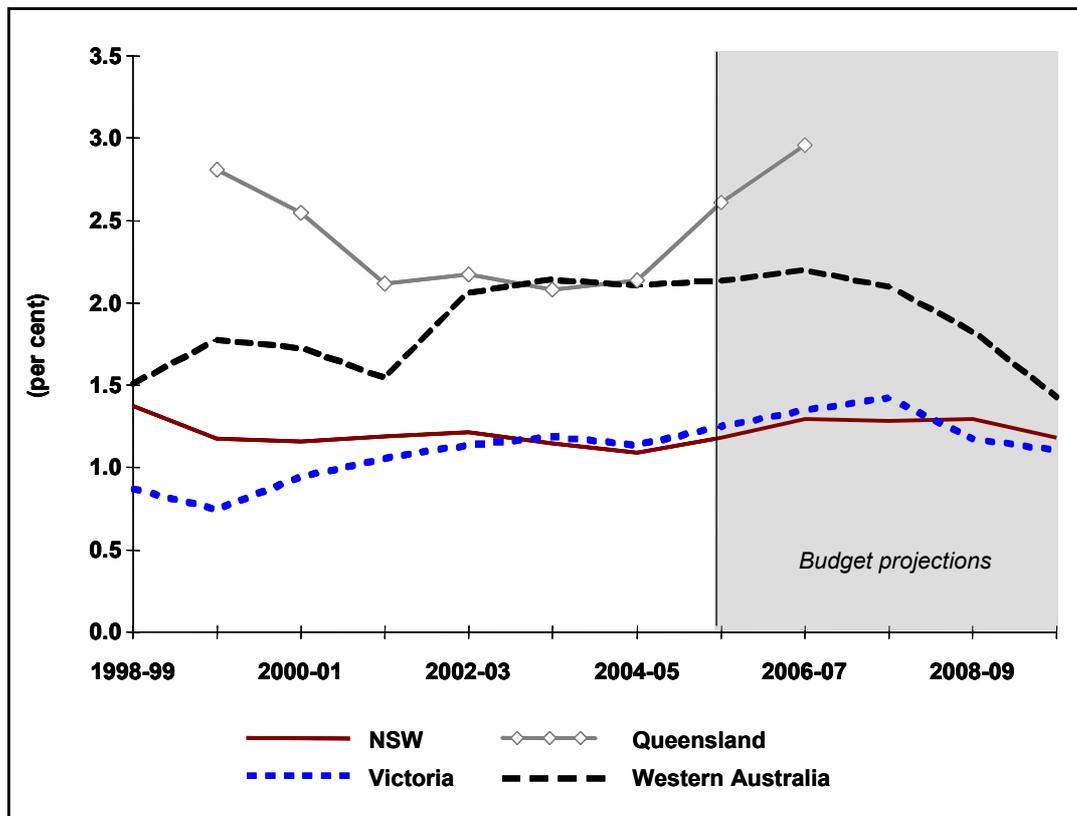
Source: Department of Treasury and Finance, Budget Paper No.2, 2006-07 Strategy and Outlook, p.6

Note: (a) includes purchases of property, plant and equipment and net contributions to other sectors of government less proceeds from sale of property, plant and equipment

The Committee noted the Victorian Government’s decision to increase funding for infrastructure. It is important that infrastructure projects are delivered in a cost effective manner, whether through traditional procurement or through a PPP arrangement.

⁵³ Budget Paper No.2, 2006-07 Strategy and Outlook, p.6

Exhibit 2.8: Government capital expenditure as a share of state output 1998-99 to 2008-09



Source: Compiled by Access Economics using state budget papers

2.5 Introduction to Partnerships Victoria policy framework

Private investment in public infrastructure has evolved significantly over the past decade. In its submission to the Committee, the Department of Treasury and Finance noted the relevant policies over this time and provided comprehensive documentation about its current *Partnerships Victoria* policy.⁵⁴ Principal guideline documents on government PPP policy have included:⁵⁵

- *Infrastructure Investment Guidelines for Victoria – Public/Private sector partnership* (issued by Treasurer Tom Roper in May 1991);
- *Infrastructure Investment Policy for Victoria* (issued by Treasurer Alan Stockdale in June 1994); and
- *Partnerships Victoria* (issued by Treasurer John Brumby in June 2000). On 3 August, 2006, the government issued an updated edition of the Overview

⁵⁴ Department of Treasury and Finance, submission no.35, p.4

⁵⁵ *ibid.*

document which provides a high-level summary of the key principles of *Partnerships Victoria* and explains the range of guidance material available.

Much common ground can be found in each of these policy documents. All investment guidelines from 1991 to the present day claim to be designed to expand Victoria's asset base. All guidelines define infrastructure in its widest sense to include economic, social and other facilities for public use. While the earlier two sets of guidelines were aimed explicitly at new and existing infrastructure, the more recent *Partnerships Victoria* guidelines are much broader and refer to the purchasing of infrastructure based services in terms of outputs.

All three sets of guidelines recognise a wide range of possibilities for private sector involvement. Earlier guidelines had no explicit limits on their application, but those of 1994 and 2000 were oriented to projects in excess of \$10 million. All sets of guidelines identified that project proposals may come from either the public or private sector, and that special legislation to govern the partnership may be enacted if required or warranted in particular circumstances.

Differences can also be found in these guidelines. The Department of Treasury and Finance advised the Committee that the 1991 guidelines reflected a strong financial need and the challenge of difficult economic times.⁵⁶ The overriding concern was '*to achieve off-balance sheet financing which would not be caught by the global limits set by the Australian Loan Council*'.⁵⁷ The objective of bringing forward the provision of infrastructure was achieved, but '*often through inefficient arrangements, some of which were later unwound at high costs to the taxpayer*'.⁵⁸ These guidelines were also very broad and more of an overview to private sector investment options, rather than being detailed guidance. They did, however, specify that all projects must undergo social and economic evaluation of benefits and costs before being approved, with an emphasis on the net present value criterion as the test for viability.

The Audit Review of Government Contracts, which reported to the current government in 2000, commented on the 1994 guidelines as follows:⁵⁹

The former government had a clear commitment to engaging the private sector in its programs. An important step in that process was the publication in 1994 of an 'Infrastructure Investment Policy for Victoria', setting out how it intended to engage the private sector in the provision of infrastructure and related services. This statement set out how the public sector would seek and develop project opportunities with the private sector. The establishment of a Privatisation and Industry Reform Division within the Treasury was also of central importance in

⁵⁶ *ibid.*

⁵⁷ *ibid.*, p.7

⁵⁸ *ibid.*, p.7

⁵⁹ Audit Review of Government Contracts, *Contracting, Privatisation Probing and Disclosure in Victoria 1992-1999*, May 2000, vol.1, p.18

overseeing the very ambitious privatisation program, centralising the skill base and ensuring greater consistency in the treatment of issues.

However, the review also concluded:⁶⁰

- *with its central focus on fiscal issues, the former government placed less emphasis than it should have on the environmental and social impacts of its policies; and*
- *unnecessary secrecy surrounded the sale of key assets and major contracts. The report makes a number of recommendations designed to ensure that in future Victoria is a model of open and transparent government.*

The Department of Treasury and Finance put to the Committee that the financial and economic outcomes have become more robust over the period of these three sets of guidelines.⁶¹

The most recent policy guidelines established for *Partnerships Victoria* seek to involve private parties through competitive bidding and appear to be more discriminating. This policy is built on the experiences of the Victorian Government and the Blair Government in the United Kingdom. In the Department of Treasury and Finance's view, *'there is now a clear quest to achieve value for money in the public interest and there are improved skills, experiences and techniques employed in the quest'*.⁶² The essence of the *Partnerships Victoria* approach is that government is not buying an asset. It is buying services at agreed quality, quantity, costs and time lines and reduces payments if these are not delivered.⁶³

The Department of Treasury and Finance put to the Committee that the objectives of *Partnerships Victoria* are:⁶⁴

- to maximise the level of infrastructure spending through a responsible use of resources in both the public and private sectors;
- to ensure that infrastructure and related ancillary services are provided in accordance with best practice, and where appropriate, to relevant international standards;
- to promote growth and employment opportunities to the whole of Victoria;
- to deliver significant and improved services to the community;
- to encourage innovation in the provision of infrastructure related ancillary services;

⁶⁰ *ibid.* vol.1, p.2

⁶¹ Department of Treasury and Finance, submission no.35, pp.4–5

⁶² *ibid.*, p.7

⁶³ *ibid.*, p.8

⁶⁴ *ibid.*, pp.8–9

- to maximise the social and economic returns from government expenditure;
- to pass on the benefits of *Partnerships Victoria* to customers, business and the Victorian community; and
- to clearly articulate accountabilities for outcomes.

The Department of Treasury and Finance also advised the Committee it will have regard for ‘*industry development, investment, recruitment and skill development transfer*’ in undertaking a *Partnerships Victoria* project.⁶⁵ The department indicated that the following principles underpin the government’s approach:⁶⁶

1. projects should focus on specifications of the end result rather than on the means of delivery;
2. *Partnerships Victoria* projects must have government approval prior to formal private sector involvement;
3. the allocation of risk and commercial arrangements should deliver best outcomes for Victoria.
4. performance measures should be established to ensure service quality meets the needs of the community and that outcomes are transparent;
5. private participation is to be subjected to competitive tendering processes;
6. an emphasis on transparency and disclosure will occur, while also acknowledging the need to protect commercial confidentiality where appropriate;
7. conduct of the public sector should always be such that confidence and probity of the partnership model is maintained;
8. standardised approaches should be used where possible to reduce transaction costs; and
9. incentives to all parties should encourage high level performance.

The following five features of the *Partnerships Victoria* model are evident:

- the private sector provides public infrastructure and related ancillary services with the government retaining responsibility for delivering core services;
- value for money must be demonstrated;
- a range of possible partnership models are accommodated within the *Partnerships Victoria* policy;
- a rigorous procurement policy involving transparent tendering has been established for all agencies; and

⁶⁵ *ibid.*, pp.8–9

⁶⁶ *ibid.*, p.9

- *Partnerships Victoria* projects will be rigorously assessed against several public interest criteria.

Guidance on how to follow these five directions has been provided in the *Partnerships Victoria Guidance Material*, which provides a framework for integrating private investment into public infrastructure. This material aims to assist policy decisions (including risk allocation and contractual issues) to assess whether infrastructure should be funded through traditional public arrangements or through private financing.⁶⁷

It outlines how the policy has evolved, from the traditional idea of governments contracting with the private sector to procuring defined service level specifications infrastructure as well as related ancillary services. It argues that the government, by purchasing defined services rather than assets, is released from responsibility for the asset, which provides greater strategic flexibility and focuses on the quality of the services being delivered.⁶⁸ Importantly, these guidelines address the questions of whether the government should deliver any parts of the process, whether the involvement of the private sector will deliver value for money, and whether the project will satisfy the public interest criteria.

⁶⁷ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Overview*, July 2006, p.4
⁶⁸ *ibid*, p.5

CHAPTER 3: PRIVATE INVESTMENT IN PUBLIC INFRASTRUCTURE IN VICTORIA

Key findings of the Committee:

- 3.1 A number of the earlier public private partnership (PPP) projects focused on transferring most of the risk to the private sector and on undertaking projects at lowest cost.**
- 3.2 Under the recent accounting standard, AASB117 (*Accounting for leases*), various operating lease arrangements need to be classified as finance leases, which form part of government debt.**
- 3.3 The Victorian Government has been paying a premium for the transfer of risk to the private sector, but as experience has shown components of risk can revert to government.**
- 3.4 More attention should be given to identifying and assessing the value of commercial opportunities available to private sector developers from certain categories of PPP arrangements.**
- 3.5 The Gateway Initiative, introduced about three years ago is expected to be of considerable benefit to the government in improving the delivery of new infrastructure. This initiative may help to make better comparisons between in-house delivery of major projects and the use of PPP arrangements.**

The inquiry's first term of reference required the Committee to provide an overview of the major infrastructure projects in Victoria that have involved private sector funding since 1990, with particular emphasis on issues relating to risk allocation and protection of the public interest. The second term of reference required the Committee to review and evaluate the expectations and outcomes of these projects in terms of the benefits and disadvantages to the community.

3.1 Overview of public private projects in Victoria 1990 to 2006

The involvement of the private sector in the funding of public infrastructure emerged as a new development in Victoria in the late 1980s and early 1990s within a context of substantial budget difficulties and Loan Council borrowing limits.⁶⁹ The Australian Loan Council was formed in 1928 and its functions included regulating borrowing by the Commonwealth and states, and placing limits on the states' borrowing powers.

⁶⁹ Mr W Cameron, (then) Victorian Auditor General, submission no.13, p.1

These limits were eventually removed in 1995 because they were being increasingly avoided by the states through sophisticated financing techniques such as entering into operating leases for public infrastructure built by the private sector.

Over the past decade, investment markets have expanded into new ventures and private sector involvement in the provision of public infrastructure has advanced worldwide. The sophistication of such arrangements has increased, as has the sophistication of the methods for allocating risk.⁷⁰

Victoria is the dominant jurisdiction in terms of the Australian public private partnership (PPP) experience.⁷¹ The Committee established that since 2000, Victoria had entered into contracts for 16 PPP projects; further projects are under consideration. By comparison, New South Wales had entered into eight projects, with the remaining states and territories collectively undertaking six projects.

In Victoria private investment in public infrastructure projects since 1990 has extended across different sectors and has included:

- the early Victorian Accelerated Infrastructure Project (1990) – comprising 10 police stations, the Werribee Hospital and the Dandenong Mental Health Community Centre;
- public transport franchise agreements, automated ticketing and the redevelopment of the Southern Cross Station;
- the Melbourne Magistrates’ Court and the County Court of Victoria;
- the St Vincent’s Hospital redevelopment, the Latrobe Hospital, the Mildura Hospital, and the Casey Community Hospital (previously Berwick Hospital);
- the Intergraph emergency services system and the more recent mobile data network;
- the new prisons project;
- Castlemaine waste water project (Coliban Water), the Wodonga wastewater treatment plant (North East Region Water Authority), the Campaspe water reclamation project (Coliban Water), and Enviro Altona wastewater treatment plant (City West Water Ltd)⁷²;
- the CityLink road project and the EastLink road project;
- the Docklands film and television studios;
- the Royal Women’s Hospital redevelopment; and
- the Melbourne Convention Centre development.

⁷⁰ Mr W Cameron, (then) Victorian Auditor General, submission no.13, p.2

⁷¹ Australian Council for Infrastructure Development (AusCID), submission no.18, p.14

⁷² This project is no longer progressing as a *Partnerships Victoria* contract due to the insolvency of the private contractor. Source: www.partnerships.vic.gov.au, accessed 30 September 2006

Further projects under consideration or being prepared for market include the Royal Children's Hospital redevelopment, the Melbourne Wholesale Market relocation and the Barwon water biosolids management project.

CityLink has been the largest infrastructure project completed to date at a cost of around \$2.1 billion, with \$1.8 billion being financed by a private consortia and \$266 million of associated works and other costs being financed by the state.⁷³ Exhibit 3.1 provides details of each project.

⁷³ Victorian Auditor-General's Office, *Report on Public Sector Agencies*, June 2002, p.117

Exhibit 3.1: Public private partnerships – Project details 1999 – 2006⁷⁴

Project	Type	Details
Public transport franchise agreements	F	Contracts let mid-1999
Castlemaine wastewater treatment	DBOT	Commissioned in 2000
Ballarat North water reclamation	DBO	Contract let 22 May 2006
Mildura Hospital	BOO	Operational in 2000
CityLink	BOOT	Completed 2000
County Court	BOO ⁷⁵	Completed 2002
Automated ticketing	DBOO	Completed 1998
Coliban water treatment (Aqua 2000)	BOOT	Completed 2002
Wodonga wastewater treatment plant	DBO	Completed 2003
Casey Community Hospital (previously Berwick Hospital)	DBFM	Completed 2004
Docklands film and television studios	DBFO	Completed 2004
Campaspe water reclamation scheme (formerly Echuca/Rochester Wastewater)	DBFO	Opened in May 2005
Mobile Data Network	DBFM	Contract executed June 2003
Southern Cross Station	DBFM	Completed July 2006
Victorian correctional facilities	DBFM	Completed 2006
Emergency alerting system	DBFM	Contract executed June 2004
Metropolitan mobile radio	DBFM	Contract executed March 2004
Royal Women's Hospital redevelopment	DBFM	Estimated completion June 2008
Royal Melbourne Showgrounds redevelopment	DBFM	Completion date September 2006
EastLink	DBFO	Completion estimated in 2008
Melbourne Convention Centre development	DBFM	Completion estimated by 2008

Notes: F Franchise
 BOO Build-Own-Operate
 BOOT Build-Own-Operate-Transfer
 DBF Design-Build-Finance
 DBO Design-Build-Operate
 DBOO Design-Build-Own-Operate
 DBFO Design-Build-Finance-Operate
 DBFM Design-Build-Finance-Maintain
 DBOT Design-Build-Operate-Transfer

Sources: Partnerships Victoria website, accessed 1 October 2006; Department of Treasury and Finance, submissions

⁷⁴ Excludes the Enviro Altona wastewater treatment plant project which is no longer a Partnerships Victoria project

⁷⁵ Victorian Auditor-General's Office, *Report on the Finances of the State of Victoria 1999-2000*, November 2000, p.129

3.2 Evaluating Victorian projects

3.2.1 Background

Department of Treasury and Finance commissioned an independent external evaluation of eight partnership projects which was undertaken in January 2004 by Peter Fitzgerald from the Growth Solutions Group. The review concluded that the eight projects examined (of which two were actually completed), provided tangible evidence of the benefits available from harnessing private sector skills and innovation of design in infrastructure. Other positive aspects were seen as timeliness of delivery, certainty of price, and a whole-of-life approach to maintenance.

The report drew attention to a need to further improve risk identification and evaluation, along with improving the pricing of the transferred market risks. There was a need for a concentrated effort to improve the skills and capabilities of public servants involved in major infrastructure developments undertaken under partnership arrangements.

The Fitzgerald report, probably the most comprehensive review of the outcomes of partnership projects within Victoria, drew heavily on the experiences of the Auditor-General in evaluating selected PPP projects.

The Department of Treasury and Finance advised the Committee that in the early years, partnership arrangements focused on transferring most of the risks to the private sector partner. Initially in the 1990s focus was placed on projects being undertaken at the lowest cost, with the focus now on value for money.

3.2.2 Projects evaluated by Public Accounts and Estimates Committee

Since the Committee was unable to undertake detailed reviews of specific PPP projects because it did not have access to departmental files, projects that were examined by the Auditor-General and/or in the report of the review of *Partnerships Victoria* provided infrastructure were examined and used as a basis for the following comments.

3.2.3 Post project review

Apart from the Fitzgerald report, independent and publicly released post project reviews have not been conducted on the outcomes obtained from PPP projects. Although opportunities exist for the Auditor-General to undertake such a function, reviews undertaken have tended to concentrate on the contractual arrangements including the rights and obligations of the respective parties, sharing of risks, and

updates on the progress of major projects. The Auditor-General is prevented under the Audit Act from commenting on government policy as it applies to such arrangements.

The Fitzgerald report was seen by the government as '*providing tangible evidence of the benefits that flowed from harnessing private sector skills and innovation in infrastructure*'. His report was critical of the discount rate of 8.65 per cent applied to the eight projects reviewed which leads to a question on whether this amount represents value for money, particularly given that the discount rate adopted in the United Kingdom is now 3.5 per cent plus a risk adjustment to the cash flow. In July 2003, the government subsequently acknowledged that with accommodation projects, such as the County Court, Casey Hospital and the Mildura Hospital, there is a low market risk and the discount rate should have been 5 per cent as compared with the 8.65 per cent discount rate.⁷⁶

The Committee seeks to demonstrate the importance of having ongoing, independent, post project reviews publicly reported to highlight any advantages and deficiencies in contractual arrangements. Benefits can be noted and deficiencies highlighted then systematically addressed in further projects.

3.2.4 Build, own and operate arrangements

The Committee is aware of build, own and operate (BOO) arrangements which involve the private sector designing, building, financing and managing public infrastructure for a period of years over which the government will make payments which, in effect, repay the capital cost and maintenance costs and allow a return on capital to the developer. At the end of the concession period the actual ownership of the building will remain with the developer for the remaining period of the lease on the Crown land.

In March 1999 a contract for \$26.3 million was entered into with a developer to build the Mildura Hospital on Crown land leased to the developer for 99 years. The agreement involved the government repaying the developer \$211.3 million over 15 years, inclusive of construction costs, maintenance services and a return on capital.⁷⁷

The Melbourne County Court was built under a BOO arrangement.⁷⁸ The successful tenderer was granted a 99 year lease on the Melbourne site for a nominal rent. The contract was entered into in June 2000 for \$193.6 million, inclusive of maintenance over the 20 year concession period.

⁷⁶ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Use of Discount Rates in the Partnerships Victoria process, Technical Note*, July 2003, p.18

⁷⁷ Victorian Auditor-General's Office, *Report on the Finances of the State of Victoria 1999-2000*, November 2000, p.127

⁷⁸ *ibid.*, p.129

Before proceeding with any further build, own and operate projects, the Committee considers that the government should ensure that public benefits are maximised.

3.2.5 Government debt

With the exception of self funding arrangements such as tollways, most of the PPP arrangements provide for private sector financing of the facility, with the debt, in effect, repaid by the government over periods ranging from 15 to 35 years. The early contracts usually provided for operating leases which meant that the debt was not recorded as a liability in the government's financial report.

Several of these arrangements have subsequently been reclassified to finance leases, or will need to be reclassified to finance leases with the advent of the new IFRS rules on leases. Finance leases are regarded as government debt. Regardless of their classification, operating or finance, leases will continue to be met from public sector budgets many years into the future.

The Committee accepts that PPPs can be an appropriate form of funding public sector infrastructure in certain circumstances. More attention, however, needs to be given to improving public sector delivery of major projects which has the inherent advantage of obtaining cheaper finance. Whilst the cost of private sector provision of infrastructure may initially appear cheaper than public sector provision (according to the public sector comparator), over the long term period of the agreements the private sector looks to a rate of return on private equity of around 11 per cent or higher.⁷⁹

The Committee considers that the long term financial implications of PPP arrangements on the state's finances need to be carefully considered by the government.

3.2.6 Transfer of risk

One of the potential advantages of PPP arrangements is the transfer of major risks to the private sector which in turn adds to the cost of projects.

The Committee acknowledges that the *Partnerships Victoria* policy has made a considerable effort to identify the various types of risks and which party is best suited to assuming the risks. *Partnerships Victoria* released the document *Standard Commercial Principles* in June 2005 which clearly sets out the range of commercial principles to be applied when entering into PPP contracts and the preferred allocation of risks. The Committee noted that ultimately the government is responsible for the delivery of infrastructure assets and services and, in extreme circumstances, private sector contractors will walk away if the project cannot provide a return on capital or if the companies are facing bankruptcy or being placed in receivership. The government

⁷⁹ R Opiat, Director, Business Development, Boulderstone Hornibrook, transcript of evidence, p.180

must then reach a compromise or take back the project and complete it, for example, Latrobe Regional Hospital.

The government's key objective of this project was to deliver improved health services to public patients in the Latrobe Valley through a private sector provider. The successful tenderer (Australian Hospital Care Ltd) was awarded the contract to build, own and operate the new Latrobe Regional Hospital from January 1997. In return for the services delivered, the government paid the company a service fee, inclusive of a facilities component to service the debt incurred by the company in building the facility.⁸⁰ The company incurred large losses and the government was forced to take back the hospital into public ownership. This example illustrates that regardless of efforts being made to transfer major risks to the private sector, the ultimate risk (that is, the impact of public health services on the public) was borne by the government.

Based on the practical experience gained from the 16 partnership contracts executed to date,⁸¹ the Committee considers that more definitive guidance is required in circumstances where transferred risk reverts to the government. Where this risk is of a material nature Parliament should be advised. The Committee also suggests that where risk is deemed to be transferred to the private sector, the government needs to be actively involved in monitoring the progress of the project.

3.2.7 Period of concession arrangements

With major projects such as the Southern Cross Station, the consortia will recoup the cost of construction, inclusive of the risk premium, opportunity cost of capital, and profit margins over many years. Payments are structured so that the total cash flow over the concession period will be sufficiently large enough to compensate for these factors. The longer the concession period, the higher the total payments by the state. With repayments being met from future budgets, the extent of these repayments will impact on budget flexibility for alternative expenditure.

3.2.8 Commercial arrangements

A limited number of PPP arrangements can create opportunities for commercial development by the private sector. The extent to which the public sector can benefit from such arrangements is a complex issue, but warrants detailed examination and policy development. Obviously, revenue received by the government from such arrangements should be maximised where possible, depending on a range of factors.

The Committee observed from a financial analysis undertaken in 2001 of the Southern Cross Station project that the preferred developer was willing to pay the state \$68.6 million for the commercial rights to the interchange facility and adjoining properties. Under the public sector comparator, these rights were estimated under a

⁸⁰ Victorian Auditor-General's Office, *Report on Public Sector Agencies*, June 2002, pp.75–79

⁸¹ *Partnerships Victoria*, website, www.partnerships.vic.gov.au, accessed 1 October 2006

traditional process to be worth \$39.9 million, a variance of \$28.7 million or 72 per cent less than the Civic Nexus offer. Civic Nexus eventually paid \$66 million for the rights, a factor that substantially influenced its winning bid, as the tender for the interchange facility and rail modifications was \$313.9 million, substantially more than the PSC of \$296.7 million.

The Committee makes the further observation that more attention and expertise should be directed towards identifying and valuing commercial rights in any future projects.

The Committee acknowledges the complexity of this issue, but considers a policy should be developed on the exploitation of commercial rights. Such a policy should form part of the *Standard Commercial Principles*, issued by *Partnerships Victoria* in June 2005.

A further example of the complexity of commercial arrangements can be found in Citylink.

At the time the contract was entered into (in 1995), it was one of the largest infrastructure projects ever undertaken in Australia. The contract was awarded to Transurban, a consortium comprising Transfield Holdings Pty Ltd and Obayashi Corporation. The CityLink project involved the linking of three major freeways in Melbourne, leading to the construction of 22 kilometres of road, tunnel and bridge works as well as other related works.

The main contractual document for the arrangements was the '*Concession Deed*' entered into in October 1995, which detailed the risk sharing arrangements, toll levels, control of the property, rights to cash flows, concession fees, and the length of the concession period (34 years). The concession period could be reduced if the project provided a net return to CityLink shareholders of 17.5 per cent per annum.⁸²

The concession fees represented a return to the state to compensate for the cost of acquiring the tollway land and the undertaking of associated works, costing around \$365 million relative to the tollway. Under the terms of the Concession Deed, Transurban was to pay these fees on the basis of \$95.6 million per annum for the first 25 years, \$45.2 million per annum for years 26 to 34 and \$1 million per annum for the remaining three years.

The concession fees are paid in the form of concession notes issued each year which represent promises to pay the government the annual fee either at the completion of the concession period (in 2034), or when certain profitability levels were achieved. The Committee understands that the profitability level was deemed as a net 10 per cent return. A further option was that the concession notes could be redeemed by the government if Transurban achieved an after tax return of 17.5 per cent and had

⁸² G Hodge, *The risky business of public private partnerships*, National Council of the Institute of Public Administration, Australia, 2004

repaid all its borrowings for the project.⁸³ The concession notes were non-interest bearing, which meant that their real value decreased each year in line with inflation.

The Committee acknowledges that the incentives and concessions provided by the government to developers are designed to encourage private sector participation in major projects. Evidence provided to the Committee by a large developer⁸⁴ stated that the average investor's return from PPP projects was between 11 and 13 per cent. The Committee accepts that in order to attract private sector developers, an adequate return on capital must be available. However, Parliament should be informed when significant changes are made to a PPP contract beyond the initial contractual arrangements.

3.3 Undertaking infrastructure projects within government

Despite the benefits available under traditional procurement, experience over many years has seen traditional methods resulting in cost increases, changes to the scope of a project, failure to deliver projects on time, and design faults. The Treasurer has acknowledged these problems, which he has attributed to the *'failure to identify and manage project risks at all stages of a project's life cycle'*.⁸⁵ In contrast, one of the major benefits of partnership arrangements has been the very sophisticated risk assessment and subsequent risk allocation to those parties best suited to managing the risk.

Within the public service, there is a need to improve expertise in project management, contract negotiation and financial evaluation and costing of projects. Acknowledging that while public service skills need to be supplemented by the use of external consultants, it is important that government has sufficient capacity to undertake extensive PPP work. The Committee acknowledges that the engagement of additional full-time staff in these areas is difficult for a number of reasons, including the government's inability to offer competitive packages to attract and retain staff with a high-level of expertise in project management.

The government has recognised these problems and sought to enhance project assessment within government by implementing the Gateway Initiative. This initiative is intended to bring greater rigour to project assessment and management across government, mainly for projects procured by traditional processes. The initiative is based on a similar program used in the United Kingdom. The Committee requested feedback from the Treasurer on the status of the Gateway Review Process as part of

⁸³ Finance and Treasury Professional Journal, August 2003, p.19

⁸⁴ R Opiat, Director, Business Development, Boulderstone Hornibrook, transcript of evidence, p.180

⁸⁵ Hon. J Brumby, MP, Treasurer, address to the Australian Council for Infrastructure Development (AusCID), 3 July 2003

its review of the 2006-07 Budget Estimates. The Treasurer advised the Committee that:⁸⁶

The Gateway initiative has been in place for only three years and yet the initiative is widely perceived to be promoting efficient asset planning and investment in Victoria. Overall, Gateway initiative users report that each of the four components is evolving as a useful tool for investment performance assessment and planning and delivery. Since the Initiative's introduction both the average project delay and the number of projects exceeding budget has decreased. Whether this is a result of the Gateway initiative is difficult to determine at this stage, due to variables relating to length of implementation time and external developments.

Generally, the users feel that:

- the initiative's first component, the Gateway Review Process, has helped to identify project issues at key decision points by independent review teams. More than 80 per cent of the government's High Risk Asset Investment projects have now undergone one or more Gateway Reviews. However, due to the long delivery time of high risk projects, no project has progressed through all six gates in the review process;*
- the initiative's second component, the Multi-Year Strategy, has improved the alignment of asset projects with government strategic objectives and departmental plans;*
- the initiative's third component is project lifecycle guidance material. Business case guidance was the first material to be developed. The Gateway Initiative Business Case Development Guidelines are now widely used by all departments and are seen as a useful decision-making tool for both departmental Secretaries and ERC [Expenditure Review Committee] in determining how asset procurement should best occur. Other guidance material is in preparation; and*
- the initiative's fourth component, Asset Investment Reporting provides for quarterly reporting on all projects over \$10 million and identified high risk projects. Presently Asset Investment Reporting indicates the health of current asset procurement projects. It is now being modified so that it also indicates the capacity of departments to implement planned projects.*

There is a strong sense from Gateway users across government that the initiative has positively influenced the way their department and agencies plan and manage their asset projects. The majority of users agree that a

⁸⁶ Hon. J Brumby, MP, Treasurer, response to the Committee's follow-up questions, Inquiry into the 2006-07 Budget Estimates, received 26 July 2006, p.6

greater proportion of government capital projects will be delivered on time, on budget and within scope as a result of the introduction of the Gateway initiative. Similarly, most users agree that the Gateway Initiative has given them a clearer understanding of project risks.

According to the Treasurer, considerable progress has occurred in ensuring that capital projects are delivered on time, on budget and within scope. Project risks are also becoming more readily identified.

The Committee welcomes the use of the Gateway initiative because it has the potential to enable better decision making about whether major projects can be managed by the public sector on a comparable basis with projects managed by the private sector under PPP arrangements. This should lead to better value for money in infrastructure development.

The challenge for the government now is that while project delivery is apparently improving, attention must be given to improving programmed maintenance over the lifetime of new infrastructure. The importance of maintaining assets over their lifetime has been recognised under the *Partnerships Victoria* policy. When ownership of assets reverts to the government at the end of the concession periods, invariably such arrangements also provide for maintenance over this period. The government must apply the same requirements to major assets delivered under traditional procurement methods as it demands from the private sector when undertaking partnerships projects.

The Committee recommends that:

Recommendation 1: **All major infrastructure projects including PPPs be subject to independent post project reviews at the completion of the construction phase and during the operational phase to measure the degree to which agreed outcomes are met. All results be periodically reported to Parliament.**

Recommendation 2: **Before proceeding with any further build, own and operate projects, the government ensure that public benefits are maximised.**

Recommendation 3: **Long term peppercorn leases extending beyond the concession period should not be given to a private consortium, unless it can be clearly demonstrated that there is a public benefit.**

- Recommendation 4:** All existing public private partnership projects involving operating leases be reviewed to determine whether they should be reclassified to finance leases under current accounting standards.
- Recommendation 5:** Public private partnership contracts should include the total amount of payments outlining the total government commitment and the impact on state debt. This information should be published on the *Partnerships Victoria* website, with summary information included in the state budget papers.
- Recommendation 6:** Further guidance material be developed to cover the situation where, during the course of the public private partnership contract, transferred risk reverts to the Victorian Government.
- Recommendation 7:** The Victorian Government develop a policy on maximising the benefits to the state from commercial opportunities arising from public private partnership arrangements.
- Recommendation 8:** Timeframes should be reduced, where possible, for the period of concession agreements so as to limit the impact of debt repayments for future governments.

CHAPTER 4: LEGISLATIVE AND POLICY FRAMEWORKS AND PRACTICES

Key findings of the Committee:

- 4.1** There is no overarching enabling legislation for public private partnership (PPP) projects in Victoria, but on occasions it has been necessary to enact legislation for specific projects to enable the infrastructure to proceed.
- 4.2** The Victorian Government released its *Partnerships Victoria* policy documents in 2000 and later produced detailed guidance material. This documentation has provided the model that has largely been adopted by other Australian jurisdictions. Some states have different policies and guidelines in terms of the value of the PPP project, the processes of development, governance arrangements, and various technical and terminological issues, but there has recently been a convergence towards greater consistency in documentation across jurisdictions.
- 4.3** At November 2005, Australia-wide there had been \$10 billion in PPP projects contracted; over \$4 billion in projects were in the market; and over \$6 billion of projects were being considered as PPPs.
- 4.4** Research revealed that there are many different types of PPPs internationally and that the models applied differ between countries.
- 4.5** Internationally few restrictions seem to apply to the policy arenas to which PPPs may be applied. PPP projects have covered broad economic projects such as roads, buildings, tunnels, port development, sports stadiums, wastewater management schemes, hospitals and schools.
- 4.6** Most jurisdictions have experienced mixed results through PPPs, although the projects have improved over time as lessons have been learned.
- 4.7** In all countries reviewed, public finance initiative (PFI)/PPP projects accounted for approximately 10 to 15 per cent of total government investment in infrastructure.
- 4.8** The major PPP models in the United Kingdom are the PFI and the Local Improvement Finance Trust (LIFT) models. With more than 700 PFI projects now operational, the United Kingdom Government is the most experienced; some projects have also reached maturity.

- 4.9** The United Kingdom PFI model, which has been largely adopted by most overseas countries, is different to the PPP model adopted in Victoria and in other Australian jurisdictions.
- 4.10** The Committee's discussions with a range of stakeholders in the United Kingdom have indicated the largely positive impact of PFIs. PFI projects were seen to be less suitable for information technology and small capital value projects and in cases requiring specific people services, such as in health care or in frontline services such as defence.
- 4.11** Discussions held with stakeholders in Ireland, France, Belgium and The Netherlands and in British Columbia highlighted the mixed results from PPP/PFI projects. All identified that some of their early projects had less than ideal results, partly due to a lack of adequate preparation and process, inadequate management skills within the public sector and problems with risk allocation. All jurisdictions indicated that they had learned from their previous experiences and changes had been made, particularly in improving the process for assessing value for money, the public sector comparator, and ensuring that there was a competitive market of potential tenders. To address community concerns about the lack of transparency and accountability of PPP projects, most governments have strengthened governance processes and systems for evaluation and review.

The third inquiry term of reference required the Committee to review Victorian, Australian and international legislative and policy frameworks and practices regarding private sector investment in public infrastructure.

4.1 Victorian legislative and policy frameworks

The Victorian Government released its *Partnerships Victoria* policy in mid 2000. This policy outlines the scope, objectives and principles and addresses at a high level issues such as core services, public interest, risk allocation and value for money. More detailed guidance material relating to the policy was released later, including:

4.1.1 Policies

- *Contract Management Policy* – the 2003 policy statement outlines the components of the Contract Management Framework and sets out the accountabilities and responsibilities for contract management in *Partnerships Victoria* projects.
- *NMU Water Authority Approval Process for Partnerships Victoria Projects* – the 2001 policy statement outlines the streamlined process for a non-

metropolitan urban water authority when pursuing water and wastewater projects under the *Partnerships Victoria* policy.

4.1.2 Guidelines

The documents listed below range from comprehensive guidelines to advisory notes on smaller scale specific issues.

- the *Guidance Material, Overview* was updated in July 2006⁸⁷ and summarises key *Partnerships Victoria* principles and outlines the key detailed guidance material documents.
- the *Practitioners Guide* was created in June 2001 and addresses the what, why and how questions in relation to *Partnerships Victoria* projects, and sets out the approach to key commercial issues (for example payment structures and bid evaluation) and public process issues (for example public interest test, probity and disclosure).
- *Risk Allocation and Contractual Issues* was also developed in June 2001 and outlines the background methodology for risk allocation, describes major types of project risks and contractual issues, and sets out the government preferred approach for each. The Standard Commercial Principles document is also referred to (see below).
- *Contract Management Guide* was prepared in June 2003 and provides guidance on contract management issues throughout the lifecycle of a *Partnerships Victoria* project.
- *Standard Commercial Principles*, developed in June 2005 details the current considered position of the state in relation to *Partnerships Victoria* risk allocation.

4.1.3 Technical notes

- the original June 2001 technical note, the *Public Sector Comparator*, provides detailed guidance on the construction and application of the Public Sector Comparator (PSC), which is essentially the government's financial benchmark for the project.
- the *Public Sector Comparator, Supplementary Technical Note* was developed in July 2003 and builds on the initial Public Sector Comparator (PSC) Technical Note described above. It provides additional practical guidance in the form of 'lessons learned' and a detailed hypothetical example on constructing a PSC.

⁸⁷ Original overview was released in June 2001 with the first set of *Partnerships Victoria* guidance material

- the *Use of Discount Rates in the Partnerships Victoria Process* document was prepared in July 2003 and provides specific guidance on calculating and using discount rates in undertaking discount cash flow analysis for the purposes of constructing a PSC and evaluating bids.

4.1.4 Advisory notes

- *Determining the Inflation Rate* was prepared in August 2005 and recommends that the inflation rate used in *Partnerships Victoria* project financial modelling will continue to be sourced from the state budget papers.
- *Managing Interest Rate Risk* was also prepared in August 2005 and outlines the principles of managing interest rate risk up to financial close for a project.
- *Disclosure and Management of conflict of interest* was developed in October 2005 and provides guiding principles and tools to manage diverse conflicts of interest that may emerge when engaging advisers for *Partnerships Victoria* projects.
- the *Interactive Tender Process* was prepared in October 2005 and provides an overview of recent experience with the interactive tender process used in some *Partnerships Victoria* projects.

4.1.5 Legislation underpinning Partnerships Victoria policy framework

The Committee's research confirmed that there is no specific enabling legislation for PPP projects in Victoria. The Committee was advised by the Department of Treasury and Finance that '*in Victoria, Ministers of the Crown have broad powers to contract for matters falling within the normal matters of government and no legislation enabling private sector investment in public infrastructure is generally required*'.⁸⁸

Deacons law firm advised the Committee that '*provisions of the Financial Management Act 1994 and Project Development and Construction Management Act 1994*' superseded previous centralised infrastructure procurement arrangements. Further, '*the Project Development and Construction Management Act 1994 can be used to give powers to statutory bodies within government to control and expedite projects and in terms of construction management, the process is decentralised with departments and agencies now complying with Ministerial Guidelines and Directions as to the procurement of the necessary services for government construction work*'.⁸⁹

It has been necessary from time to time, however, to enact legislation for major projects or amend existing Acts to enable infrastructure to proceed. Deacons law firm informed the Committee that common provisions have been used in the *Health Act* 1958, the *Corrections Act* 1986, and the *Casino Control Act* 1991 to facilitate projects.

⁸⁸ Department of Treasury and Finance, submission no.35, p.8

⁸⁹ Deacons law firm, submission no.14, p.3

More extensive provisions appear in the *Melbourne City Link Act 1995* and the *EastLink Project Act 2004*.⁹⁰ These legislative changes enabled the establishment of the Mildura and Latrobe hospitals, privately owned and operated prisons, Crown Casino and the Melbourne CityLink and EastLink projects.

4.1.6 Partnerships Victoria policy framework

The eight objectives and nine principles underpinning *Partnerships Victoria* were outlined in chapter 2. These objectives and principles covered an array of policy objectives, project management practices and process requirements and appear somewhat confusing.

Focusing on the government's high level policy objectives, *Partnerships Victoria* intends to:

- maximise the level of infrastructure;
- promote growth and employment opportunities in Victoria;
- deliver significantly improved services; and
- maximise the social and economic returns of government expenditure.

Each of these policy objectives is underpinned by:

- ensuring best practice in infrastructure provision;
- encouraging innovation;
- articulating accountabilities for outcomes;
- passing benefits on to customers, business and communities.

Several of the principles underpinning *Partnerships Victoria* aim to clarify what is being pursued by government. They focus on specifying the end result, the best outcomes in allocating risks, the establishment of transparent performance measures, and the provision of incentives to encourage high level performance.

Several principles also specify that the *Partnerships Victoria* process should ensure government approval of projects; adopt competitive tendering processes; emphasise transparency and disclosure; seek to ensure confidence in the probity of the partnership model; and minimise transactions costs through the use of standardised approaches where possible.

The Department of Treasury and Finance advised the Committee that further principles of the policy aimed to ensure government retained responsibility for the delivery of 'core social services' while the provision of public infrastructure and

⁹⁰ *ibid.*

related ancillary services were not retained.⁹¹ Thus, the private sector may provide and operate infrastructure while core services (such as teaching in government schools or providing clinical services in hospital) will be provided directly by the government. Treasury and Finance stressed that value for money must be demonstrated under the *Partnerships Victoria* policy.⁹²

The Department of Treasury and Finance indicated that '*generally, full government funding will be allocated for non self funding projects before market interest in a PPP is formally sought*'.⁹³ Projects having a net present value of at least \$10 million, but more likely \$25 to \$30 million for most types of projects, are likely to have the most potential for *Partnerships Victoria* treatment.⁹⁴ The policy was seen by Treasury and Finance to be applicable to a range of partnership models and over a variety of commercial scenarios. The department also indicated that a rigorous process had been designed involving '*a transparent tendering process and focus[ed] attention on upfront planning work such as the output specification, commercial issues and resources allocated to the project*'.⁹⁵

Exhibit 4.1 outlines the nine steps in a *Partnerships Victoria* project, from conception to implementation.

⁹¹ Department of Treasury and Finance, submission no.35, p.9

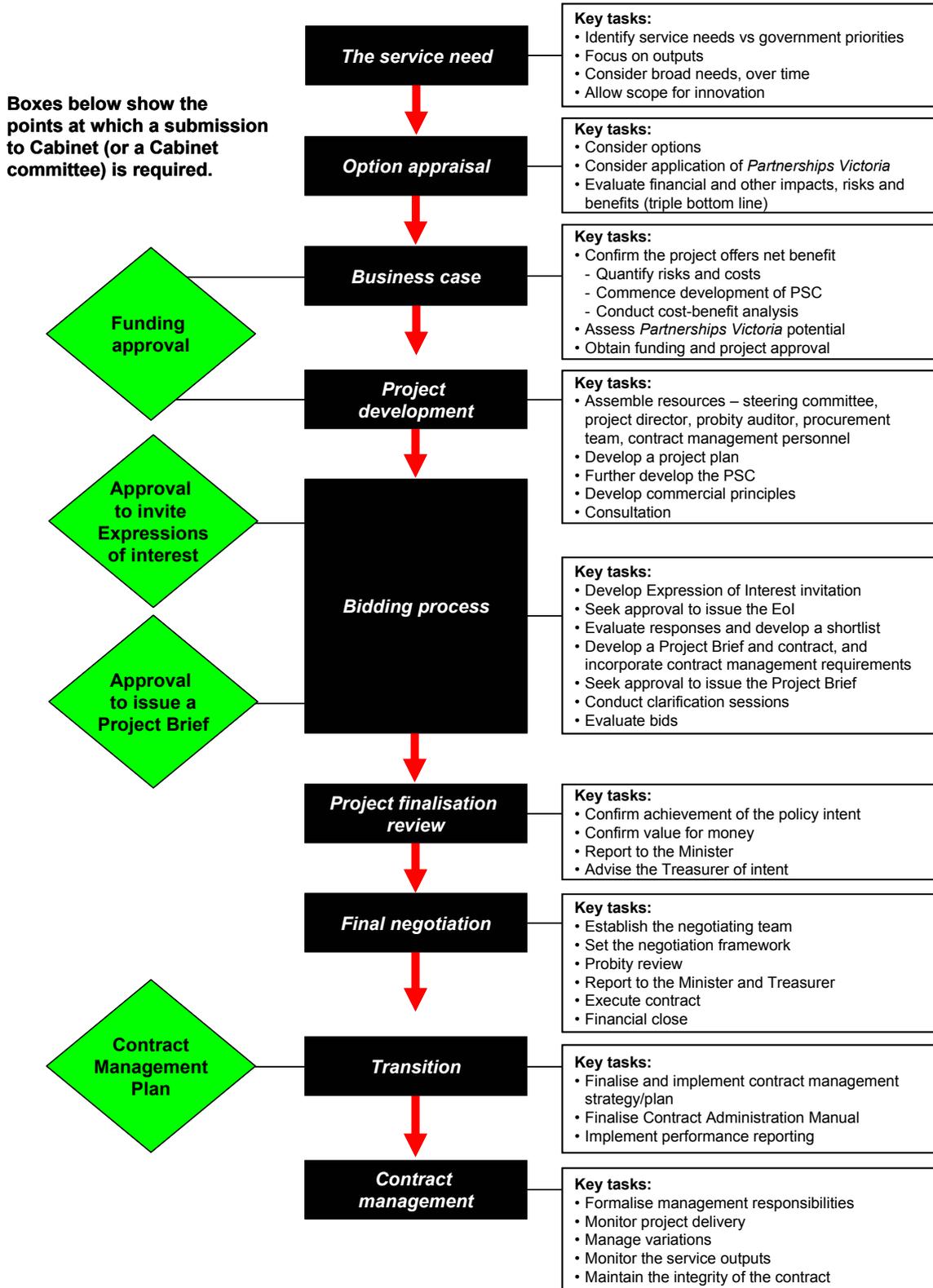
⁹² *ibid.*, p.10

⁹³ *ibid.*

⁹⁴ *ibid.*

⁹⁵ *ibid.*, p.11

Exhibit 4.1: Major stages in developing a Partnerships Victoria project



Source: Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Overview*, July 2006, p.15

Target figures specifying the proportion of infrastructure spending likely to be pursued in future through the *Partnerships Victoria* policy do not appear to have been formally set, although the Treasurer announced that *the current proportion is around 10 per cent of the government's annual capital asset investment, although this may range anywhere from 5 per cent to 20 per cent depending on the particular year.*⁹⁶

In response to a recommendation in the Fitzgerald report that the bidding process be streamlined with a view to reducing the cost of tenders and encouraging more bidders to participate, the Department of Treasury and Finance released in February 2006 three proposals to reduce bid costs:⁹⁷

1. developing a departure schedule instead of marked-up contracts;
2. ranking evaluation criteria in the project brief;
3. presenting the public service comparator early in the bid phase.

Following comment from industry groups, the Department of Treasury and Finance advised that the status of these proposals is:⁹⁸

- *the Partnerships Victoria interactive tender process advisory note is being updated to include a PSC presentation and other changes to improve the depth and scope of interaction between government and bidders. The aim of this presentation is not to disclose the detailed costings of the PSC, rather to further clarify the government's expectations. The revised advisory note will be finalised shortly;*
- *the introduction of standard contract clauses will be completed during 2006-07. The use of departure schedules will also be considered as part of this exercise as industry groups have emphasised that these initiatives should be considered jointly;*
- *other initiatives, such as the mapping of evaluation criteria to submission requirements and streamlining bid submission requirements are being considered and will be rolled out on a project to project basis.*

⁹⁶ Hon. J Brumby, MP, Treasurer, *A national approach to PPPs – The importance of creating a 'single market' appearance to gain global attention: Australia's experience* speech given at the 13th annual conference on Public Private Partnerships 2005 conference, 28 November 2005, Toronto, Canada, p.4

⁹⁷ *Partnerships Victoria*, website, www.partnerships.vic.gov.au, accessed 8 August 2006

⁹⁸ S Schinck, Director, Strategic Management, Department of Treasury and Finance, email, 27 September 2006

4.2 Legislative and policy frameworks in other Australian jurisdictions

In the past five years, all Australian jurisdictions have issued policy documents governing the identification, establishment and operation of PPP arrangements. Victoria was the first to issue its guidelines under its *Partnerships Victoria* initiative. Soon after, in November 2001, New South Wales issued its *Working with Government: Guidelines for Privately Financed Projects*. Other states and the Commonwealth followed. All the guidance material had its origins in principles developed by the Heads of Treasuries working party.

The Committee's review of these documents highlighted that the governing principles or framework adopted by the different jurisdictions are broadly based on Victoria's PPP policy and guidelines. There are material variations on matters such as fair value compensation on termination, change in law and change of control provisions, they contain various technical and terminology differences, and they also follow slightly different processes for the development of a PPP project.

The Committee was advised that because of criticisms from industry that the PPP policy needs to be implemented more consistently to reduce bid costs, some limited progress has been made in achieving consistent principles and practices across jurisdictions. The National Council for PPPs, a forum for coordination between federal and state Ministers and officials, was set up in 2004 as part of the move towards having a more consistent approach to PPPs across all Australian jurisdictions.

The major differences in policies and practices are:

- **core and non-core services** – New South Wales, Victoria, Queensland, Western Australia, the Australian Capital Territory and the Northern Territory draw a distinction between core and non-core services, and expressly preclude private involvement in the provision of core services;
- **value for money test** – the framework in Queensland does not apply without special Cabinet committee exemption if the capital value of a project is \$30 million or less or its net present value does not exceed \$50 million. In Victoria, New South Wales, Northern Territory, and the Australian Capital Territory there is an explicit presumption that the project will generally not satisfy the value for money test unless it has a total contract value (in net present value terms) of more than \$10 million (Victoria) or \$20 million (New South Wales, Australian Capital Territory, Northern Territory) or can be bundled together with other similar projects to overcome that threshold. At the Commonwealth level, the \$20 million and \$50 million thresholds are only relevant for determining the level of approval required;
- **long term** –the duration of the project must not be less than 5 years for the Commonwealth; 25 years or more for New South Wales, the Australian Capital Territory and South Australia; and up to 30 years for Victoria.

- **public sector comparator (PSC)** – the New South Wales policy requires it be used for all projects, while the South Australian guidelines state that it is not necessary where the project is financially free-standing (consumer funding rather than government funding). The other jurisdictions follow Victoria’s lead, which requires the construction and use of a PSC except in the rare situations where the Department of Treasury and Finance agrees that a PSC is not required. In that case, an appropriate benchmark still needs to be constructed to demonstrate value for money.
- **release of the PSC** – one way the policies diverge is in the matter of the PSC’s release to the public and, more significantly, to bidders. The Commonwealth and SA policies have no general rule on release, and in those jurisdictions that do, approaches range from complete confidentiality to a general policy of release. The PSC is to remain confidential in Western Australia until the contract is executed, while Victoria, Tasmania and the Australian Capital Territory have a general rule against disclosure of the total PSC value.

The Committee observed that full adoption of the PPP model varies considerably across jurisdictions. Victoria and New South Wales are at the forefront; Queensland, South Australia, Western Australia and the Northern Territory have each completed one PPP. The Federal Government and the other Australian jurisdictions all have PPP policies in place but as yet have not completed a project. Exhibits 4.2 and 4.3 show the number and type of PPP projects either undertaken or in the pipeline.

Exhibit 4.2: Completed or signed public private partnership projects in Australia at July 2006

Project		Cost
		(\$ million)
Commonwealth of Australia	Defence Headquarters Joint Operation Command Facility	300 ⁹⁹
Northern Territory	Darwin City Waterfront Redevelopment/ Darwin Convention and Exhibition Centre	1,100 ¹⁰⁰
New South Wales	New schools project #1	137 ¹⁰¹
	Cross City Tunnel	680 ¹⁰²
	Western Sydney Orbital	2,230 ¹⁰³
	Alternative waste technology facility	75 ¹⁰⁴
	Lane Cove Tunnel	1,100 ¹⁰⁵
	Parramatta Transport Interchange	100 ¹⁰⁶
	Sunshine Electricity Company Co-generation Plants	215 ¹⁰⁷
	Chatswood Transport Interchange	360 ¹⁰⁸
Western Australia	CBD courts complex	195 ¹⁰⁹
Queensland	Southbank Education and Training Institute	550 ¹¹⁰
South Australia	Regional police stations & courts administration	45 ¹¹¹
Tasmania	Risdon Prison redevelopment	90 ¹¹²
Victoria ¹¹³	County Court	195
	Docklands film and television studios	40
	Campaspe Water reclamation scheme (formerly Echuca Rochester Wastewater treatment plant)	40
	Victorian correctional facilities	275
	Emergency Alerting System	100
	Royal Women's Hospital redevelopment	364.4 ¹¹⁴
	Wodonga Wastewater Treatment upgrade	32
	Casey Community Hospital	120
	Southern Cross Station (formerly Spencer Street Station)	309 ¹¹⁵
	Mobile Data Network	140
	Metropolitan Mobile Radio	120
	EastLink	2,500
	Royal Melbourne Showgrounds redevelopment	108
	Melbourne Convention Centre development	367 ¹¹⁶
	Ballarat North water reclamation (Central Highlands)	less than 50

⁹⁹ The current total cost estimate for the HQJOC Project is approximately \$300 million. The cost includes the buildings and infrastructure; the command, control, communications and information systems; land acquisition; workplace relocation costs, and design, professional fees and construction contingency; but excludes goods and services tax. Source: www.defence.gov.au/kid/hqjoc/pages/faq.htm, accessed 24 July 2006

¹⁰⁰ www.waterfront.nt.gov.au/waterfront/about/index.html, accessed 24 July 2006

¹⁰¹ NSW Auditor-General's 2006 The New Schools Privately Funded Project, p 10

¹⁰² NSW Joint Select Committee on the Cross City Tunnel, p.22 – First Report February 2006

¹⁰³ Source: www.mallesons.com/expertise/project_finance/5501627W-03.htm, accessed 24 July 2006

¹⁰⁴ www.globalrenewables.com.au/en/operations/eastern-creek-ur3r-facility/, accessed 24 July 2006

¹⁰⁵ Mr Carl Scully, MP, NSW Minister for Roads, media release, 9 December, 2003

¹⁰⁶ www.parracity.nsw.gov.au/news/20020531_367.html, accessed 24 July 2006

¹⁰⁷ NSW Budget Statement 2005-06, p.9

¹⁰⁸ Has an estimated value on completion in excess of \$360 million. <http://cti.cri.com.au/>, accessed 24 July 2006

¹⁰⁹ www.wlg.com.au/about-the-project.html, accessed 24 July 2006

¹¹⁰ 19 April 2005 Queensland Premier's Office, Included in this amount are construction costs of approximately \$230 million

¹¹¹ www.plenarygroup.com.au/content/newscentre/32, accessed 24 July 2006

¹¹² www.smh.com.au/news/National/Risdon-Prisons-infamous-past/2005/05/09/1115584891860.html, accessed 24 July 2006

¹¹³ *Partnerships Victoria*, website, www.partnerships.vic.gov.au

¹¹⁴ *Partnerships Victoria*, website, www.partnerships.vic.gov.au, \$364.4 million tenders vic website \$250 million

¹¹⁵ *Partnerships Victoria*, website, www.partnerships.vic.gov.au, \$309 million; tenders vic website \$341 million

¹¹⁶ *Partnerships Victoria*, website, www.partnerships.vic.gov.au, \$367 million; tenders vic website \$370 million

Exhibit 4.3: PPP projects in the market in Australia at July 2006¹¹⁷

Project	Estimated timing
Commonwealth Government of Australia	
Single Living and Environment Accommodation Precinct	EOI close – November 2005 Issued RFP (Part 1) – December 2005
Mulwala Munitions Factory Redevelopment	RFT close – March 2005 Outcome expected in 2006
New South Wales state government	
Bonnyrigg Living Communities Project (Social Housing)	EOI close – 30 March 2005 RDP issue – September 2005 RDP close – February 2006
Forensic Hospital	RDP close – December 2004 Contractual close – second half 2005
Mater Hospital, Newcastle	RDP close – December 2004 Contractual close – second half 2005
Newcastle Port Multi-Purpose container terminal	EOI close – February 2003 RDP close – August 2005 Contractual close – early 2006
Newcastle Community Health Centre	RDP close – 19 November 2004 Financial close – second half 2005
RailCorp Rolling Stock	EOI close – 13 October 2004 RDP close – October 2005 Contractual close – mid 2006
New Schools (second batch)	EOI close – May 2005 RDP close – September 2005 Financial close – early 2006
Queensland state government	
Townsville Industrial Recycling	NM Rothschilds & Sons (Australia) announced as preferred partner for PPP in June 2005. Subject to market confirmation, Rothschilds will build, own and operate the recycling project.
North South Bypass Tunnel	Two short listed consortia have been invited to submit detailed tenders by December 2005. EIS approved by Queensland's Coordinator General.
Townsville Ocean Terminal	Preferred developer announced – September 2005 Contract Finalisation – December 2005
Gold Coast Marine Development Project	EOI release – October 2005 EIS commenced – October 2005
Victorian state government	
Barwon Water – Biosolids Management	EOI Close – 5 June 2005 Release RFT: Oct 2005 Contractual Close – May 2006 Facility completed – November 2007
Royal Children's Hospital	Three short listed consortia have been invited to submit a full costed proposal for the hospital

¹¹⁷ National Public Private Partnerships Forum: Projects in the Market, at July 2006 www.pppforum.gov.au

Exhibit 4.4: Potential PPP projects at 10 July 2006¹¹⁸

Projects	Possible release (to the market)	
	<12 months (+)	>24 months (%)
New South Wales state government		
Health related projects		
Water supply projects		
Queensland state government		
New Queensland Drivers License		+
Airport Link (North South Bypass Tunnel Stage 2)		+
Very High Speed Broadband (Project Visa)		+
Lockyer Water Reliability		
Gold Coast Public Transport		
Victorian state government		
Melbourne Wholesale Market Relocation		+
Housing Sector		%
Supreme Court Redevelopment		
Hospital Sector		
Research Facilities		
Water Sector		
Aged Care		
Western Australian state government		
Office Accommodation		+
Health Infrastructure		
Public Housing		

The Committee's research confirmed that there are no general laws in any Australian jurisdictions governing PPP procurement.

4.3 International legislative and policy frameworks

The Committee's overseas study tour and research revealed that there are many different types of PPPs and that the models applied differ from country to country. In fact, the PPP concept is evolving in different ways in each country. And as the following exhibits indicate, the legislative and institutional positions also vary.

¹¹⁸ National Public Private Partnerships Forum, www.pppforum.gov.au, national pipeline/potential projects, accessed 27 September 2006

Exhibit 4.5: Summary of PPP in selected overseas countries

Country	Experience with PPPs
United Kingdom	The British government launched its PPP development policy in 1992 under the Private Finance Initiative. Since then the technique has been applied systematically to virtually every area of significant government capital spending in the UK. Partnerships UK was established in 2000 to promote PPP/PFI concepts. It also works on local authority projects.
France	France has a long established tradition of public private cooperation (especially in sectors such as water) using the concession structure. PPPs are not permitted in the social infrastructure area. The tunnel Prado-Carriage in Marseille was toll-financed. Three major road projects have been launched as public private partnerships since 2000 (Millan Viaduct, A19 and A28) and cross border projects such as the Perpignon-Fiqueras high speed link and the Lyon-Turin high speed link have involved PPPs.
Ireland	In 1999, a pilot PPP road programme including three roads and a light rail system was initiated. The M4 PPP Toll Motorway Project is part of a group of 11 projects to be finalised over the 2004-07 period. Toll bridges, government offices, prisons and schools have been designed, built, financed and operated by the private sector. There is a strong commitment to a formal PPP program and central committees facilitate PPPs.
The Netherlands	Kennis-centrum PPPs was set up in 1999 and a major pilot project (the high speed rail) was started. Projects underway since then include road, railway, harbours and water projects (for example, enlargement harbour Rotterdam) and the Delfland wastewater treatment project.
Canada	
• British Columbia	There have been eight transactions since 2004, including the Richmond Airport Vancouver Rapid Transit and the Sea to Sky Highway.
• Ontario	CAD \$2.3 billion of a CAD \$30 billion 5 year infrastructure spending program will be undertaken under Ontario's Alternative Financing and Procurement approach.

Exhibit 4.6: Summary of PPP institutional development

Country	PPP unit	PPP law
United Kingdom	✓	-
Belgium		++
France	✓✓	++
Ireland	✓	+++
The Netherlands	✓	-
British Columbia, Canada	✓	-

- Notes:
- +++ comprehensive legislation in place
 - ✓ actively involved in PPP promotion
 - ✓✓ PP unit in progress (or existing but in a purely consultative capacity)
 - ++ comprehensive legislation being drafted/some sector specific legislation in place

4.3.1 United Kingdom

At April 2006, 700 PFI transactions had reached financial close, with a total capital value of £35.5 billion.¹¹⁹ Partnership arrangements are being used to procure a vast range of infrastructure including hospitals, prisons, roads, schools, computer systems and government accommodation. The British Government's experience and approach has served as a model for partnership arrangements in other jurisdictions. And because it is one of the few jurisdictions where some projects have reached maturity, analysis of project outcomes is possible.

HM Treasury noted that the use of the terms 'PPP' and 'PFI' which refer to government relationships with the private sector, can cause confusion and are often used interchangeably. It defines the difference between the two, however, in terms of PFI being a procurement tool and PPP as being an ownership structure, noting that:¹²⁰

The vast majority of PFI contracts represent a liability for a stream of payments that stretches over the long term, and which the government will have to meet from revenue expenditure in the year in which they are liable. In a PPP deal by contrast, the government owns an equity stake in a company, an asset, and this is therefore different in kind from a PFI transaction.

It is evident from this distinction that the broader policy use of the word partnership in the *Partnerships Victoria* model does not imply fundamental differences to a UK PFI transaction.

The private financing of public infrastructure in the United Kingdom over the past decade has been characterised by a large number of projects delivered in the midst of continued controversy.¹²¹

Wide reviews on this method of project delivery have been undertaken, importantly including several formal and high level reviews. Britain's experience with PPPs and PFIs has delivered some spectacular successes such as the DBFO (design, build, finance and operate) roads program¹²² and some failures such as the Railtrack and IT projects.¹²³ A number of innovative governance developments have been initiated, and Britain is now regarded as a world leader in this technique in terms of consulting advice.

¹¹⁹ HM Treasury (UK), *PFI: meeting the investment challenge*, July 2003, p.19

¹²⁰ *ibid.*, p.118

¹²¹ PFI 'More expensive than public funding', Staff and Agencies, *The Guardian*, newspaper, 11 October 2002

¹²² Office of Government Commerce, UK (2002) '*OGC PFI Material*', see: www.ogc.gov.uk/sdtoolkit/reference/ogc_library/PFI/series_other/library/dbfo/dbfo_contents.html

¹²³ HM Treasury (UK), *PFI: meeting the investment challenge*, July 2003, p.54

Several reviews undertaken by the United Kingdom Public Accounts Committee, the United Kingdom Audit Office, the United Kingdom Treasury provided useful information about their experiences with PFIs, particularly in relation to social infrastructure. Appendix 4 provides a summary of this information.¹²⁴

Evidence received by the Committee highlighted the following issues in relation to PFI/PPP projects in the United Kingdom:

- PPP transaction costs were high and appear likely to remain relatively so despite the development of templates;¹²⁵
- views on the usefulness and effectiveness of the public sector comparator (PSC) varied. Several witnesses said that it was of limited value and was capable of being manipulated to produce a desired result. These witnesses saw the comparator as being largely discredited, and more art than science.¹²⁶ Others, however, regarded the PSC as a useful decision making guide;¹²⁷
- gain sharing arrangements had improved from early days where the private sector gained from any refinancing of PFI projects. A protocol has been developed to provide for a 50/50 split between the government and the private sector for any projects refinanced on more favourable terms;¹²⁸
- PFIs have considerable time allocated to detailed planning and are more likely to be delivered on time and on budget;¹²⁹
- the overwhelming response from the business community was that it was not opposed to information about contracts being available to the public on the web;¹³⁰
- the life cycle approach to project procurement and management was seen as advantageous because it ensured the inclusion of maintenance requirements within administration processes;¹³¹

¹²⁴ These include *PFI: Meeting the Investment Challenge*, July 2003; *Study into Rates of Return Bid on PFI Projects*, October 2002; *Review of Large Public Procurement in the UK*, July 2002; *The Green Book: Appraisals and Evaluation in Central Government*, 2003; *Public Private Partnerships: The Government's Approach*, 2000; and *Building Better Partnerships Report*, IPPR 2001; *PFI: strengthening long term partnerships*, 2006 and *Report on Operational PFI Projects by Partnerships UK*, 2006

¹²⁵ Overseas hearings; also advised in Australia by Mr G Campbell, Partner, Maddocks, transcript of evidence, p.15; Mr G Joyce, Graeme Joyce Pty Ltd, transcript of evidence, p.28; Ms C Hilder, Director, Policy, Australian Council for Infrastructure Development, transcript of evidence, p.42

¹²⁶ Overseas hearings; also advised in Australia by Professor J Quiggin, Australian Research Council, Senior Fellow, School of Economics, Australian National University, transcript of evidence, p.210

¹²⁷ Overseas hearings; Mr J Stewart, Chief Executive Partnerships UK, also advised in Australia by Mr G Joyce, Graeme Joyce Pty Ltd, transcript of evidence, p.24

¹²⁸ Overseas hearings, Mr J Stewart, Chief Executive, Partnerships UK; Mr O Robbins, Head, Corporate and Private Finance Team, HM Treasury

¹²⁹ Overseas hearings, officials from HM Treasury; Mr J Stewart, Chief Executive Partnerships UK

¹³⁰ Overseas hearings, Mr S Harris, Head, International Financial Services, PPP Export Group; and Ms L Grist, the PPP Forum

¹³¹ Overseas hearings; also advised in Australia by Ms C Hilder, Director, Policy, Australian Council for Infrastructure Development, transcript of evidence, pp.41–42

- significant concerns existed about the capacity of government departments to manage PPP contracts, given the length of contracts (some for 20–30 years), and the loss of corporate memory;¹³²
- there was a clear need for a public interest test;¹³³
- several witnesses noticed the change in rationale in the United Kingdom from earlier days when off-balance sheet objectives changed towards fiscal objectives (the provision of extra resources), and value for money objectives (lower costs and improved quality). It was also noted that the fiscal objectives were essentially ‘*a bogus argument*’ that confused financing and funding;¹³⁴
- PFI projects were now seen to be less suitable for information technology, and for small capital value projects (less than £20 million, or A\$50 million), and in cases requiring specific people services such as in health care, or in frontline services such as defence;¹³⁵
- PFI projects seem to be driven by tight fiscal rules designed essentially to win the trust and maintain image with financial markets, in other words, a debt adverse government philosophy;¹³⁶
- although risk transfers are part of PFI contractual arrangements, there are limitations on how far a government may transfer risk because the ultimate responsibility rests with government itself (National Insurance data, Passports Projects in the UK).¹³⁷ ‘... *at the end of the day the buck starts and stops with the elected government*’;¹³⁸
- PFI projects were reported as comprising 12 per cent of the United Kingdom Government’s infrastructure projects, although in some sectors (hospitals) over the last decade there have been few projects that were not PFI projects. Previous contractually oriented arrangements for delivery and management of infrastructure had broadened to now include new governance arrangements, including public interest companies (for example housing associations), not for profit companies, including public enterprises (Railtrack, hospitals) and others

¹³² Overseas hearings, Mr I Wootton, Partner, Infrastructure, Government and Utilities, PricewaterhouseCoopers

¹³³ Overseas hearings, Mr P Maltby, Research Fellow, Public Private Partnerships, Institute for Public Policy Research and Professor A Pollock, Chair of Health Policy and Health Services Research Unit, University College of London

¹³⁴ Overseas hearings, for example Mr P Maltby, Research Fellow, Public Private Partnerships, Institute for Public Policy Research

¹³⁵ Overseas hearings, Mr J Stewart, Chief Executive Partnerships UK; Mr O Robbins, Head, Corporate and Private Finance Team, HM Treasury

¹³⁶ Overseas hearings, representatives from Partnerships UK

¹³⁷ Overseas hearings, representatives from the National Audit Office

¹³⁸ Overseas hearings, Mr P Maltby, Research Fellow, Public Private Partnerships, Institute for Public Policy Research; also advised in Australia by Ms G Grace, General Secretary, Queensland Council of Unions, transcript of evidence, p.98

such as credit guaranteed finance (where the public sector guarantees finance and the private sector delivers agreed risk bearing);¹³⁹

- the government was looking at expanding the PFI concept into different models;¹⁴⁰
- projects under 20m GBP are 'bundled up' so that one contractor can do 5-6 schools¹⁴¹
- the Gateway process was essential to ensure that any potential problems were quickly resolved;¹⁴²
- a sensitive issue was labour relations (workers rights) for those affected by the transfer between the public and private sectors;¹⁴³
- the largest single area of PFI projects was schools, which had a mixed result;
- the value for money mechanisms were described as 'a vast array of assumptions', rather than a science;¹⁴⁴ and
- the PFI projects are the only game in town, and driven by PFI credits. If departments did not follow this route then projects were unlikely to receive funding.¹⁴⁵

Although 'the framework [Partnerships Victoria] is similar to that adopted in the United Kingdom',¹⁴⁶ there are some notable differences. The Partnerships Victoria policy tends to be more of a one-off approach compared with that in the United Kingdom, where contracts are standardised and multiple projects are pursued so that once a blueprint is available, several projects can then be undertaken efficiently:¹⁴⁷

... 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 ...

¹³⁹ Overseas hearings, Mr J Stewart, Chief Executive Partnerships UK; Mr O Robbins, Head, Corporate and Private Finance Team, HM Treasury

¹⁴⁰ *ibid.*

¹⁴¹ Overseas hearings, officials from HM Treasury

¹⁴² Overseas hearings, Mr J Stewart, Chief Executive Partnerships UK; Mr O Robbins, Head of Corporate and Private Finance Team, HM Treasury

¹⁴³ Overseas hearings, Mr P Maltby, Research Fellow, Public Private Partnerships, Institute for Public Policy Research; Professor A Pollock, Chair of Health Policy and Health Services Research Unit, University College of London

¹⁴⁴ Mr P Davies, PricewaterhouseCoopers, London

¹⁴⁵ Overseas hearings, Mr M Lipson, Public Private Partnership Program (Local Government), Mr P Maltby, Research Fellow, Public Private Partnerships, Institute for Public Policy Research

¹⁴⁶ Mr R Walker, Assistant Auditor-General, Victorian Auditor-General's Office, transcript of evidence, p.16

¹⁴⁷ Mr M D'Elia, Director, Project Finance, PricewaterhouseCoopers, transcript of evidence, p.76

An academic has identified the following differences between the Victorian and United Kingdom processes:¹⁴⁸

- the possibility of the PFI scheme is discussed with potential bidders after discussion of the original specification.
- negotiations occur prior to evaluation of bids in the United Kingdom, whereas all Australian procedures reviewed provide for negotiations after evaluation of the detailed tenders and a preferred proponent has been selected.
- there is a test of actual risk transfer to the private sector prior to award to ensure that at least 70 per cent of PFI risk is transferred.

4.3.2 Europe, Canada and Ireland

Evidence taken by the Committee in Ireland, France, Belgium, The Netherlands and British Columbia highlighted the following issues in relation to PPP projects undertaken in their respective countries:

- there was great diversity in the way the PPP model has been used in each country;
- the PPP arrangement has been mainly used for complex economic projects such as toll roads, bridges, tunnels; railways; water facilities. Some social projects have been undertaken for example with schools in the Republic of Ireland¹⁴⁹ and housing in The Netherlands;
- some projects have failed and changes to policy and procedures have been made in light of these experiences;
- there needs to be transparent accountability procedures and regard for the public interest to overcome the considerable public scepticism about PPPs,¹⁵⁰
- PPP deals are very costly to negotiate and these costs need to be factored into the assessment;
- competition is essential if value for money for money is to be achieved. Where only one bid has been received, government needs to reconsider whether the project is suitable as a PPP arrangement;
- PPPs are complex in structure and governments need to invest in developing the core skills and capacity required to support these complex procurements in departmental areas;
- need to improve the basis for calculating the public sector comparator, if the PSC is to be retained;

¹⁴⁸ Dr C Duffield, *An Evaluation Framework for Privately Funded Infrastructure in Australia*, PhD thesis, The University of Melbourne, 2001, p.56

¹⁴⁹ Overseas hearings, for example Mr J Person, Comptroller General, Office of the Comptroller and Auditor-General, Republic of Ireland

¹⁵⁰ Overseas hearings

- PPP arrangements represent only a small part of governments' infrastructure acquisition. They are too complex and costly for small projects;
- most jurisdictions had a central or a number of Centres of Expertise to provide support to individual government departments;
- the additional costs associated with private finance must either be justified by risks transferred to the private sector or be offset through innovative proposals;
- based on experience, some jurisdictions, for example Canada, have built a number of additional safeguards into some projects, for example regulating maximum toll charges; building in prepayment rights (a right to buy out some or all of the private debt finance after a specified number of years); sharing any refinancing benefits, particularly post-construction; and gain sharing, for example from toll revenues; and
- in the Republic of Ireland, the trade union was supportive of PPPs provided they participate in the process and had an involvement in the development of the framework.¹⁵¹

Overall the experience had been mixed. It was generally agreed that PPPs offer a number of potential advantages but there are also a number of potential drawbacks. These issues are discussed in greater detail throughout this report.

4.4 Policy framework review

Witnesses including ABN Amro, Transfield, AusCID and the Institution of Engineers Australia advised the Committee that they supported the Victorian policy framework and commented that it is more comprehensive and sophisticated than the former policy.¹⁵²

AusCID also supported the high standards of probity and accountability inherent in the *Partnerships Victoria* documentation, and supported the use of a probity officer in ensuring the fair treatment of all bidders in projects. In its submission to the inquiry Thiess Pty Ltd advised the Committee that:¹⁵³

With past downsizing of departments the required level of technical expertise may not always be readily available today in-house. The assistance by suitably qualified and experienced consultants with capacity for the task is encouraged.

¹⁵¹ Overseas hearings, Mr P Keating, Assistant Secretary-General, IMPACT

¹⁵² For example, 'AusCID recognises Victoria's *Partnerships Victoria* policy as an excellent PPP framework' Australian Council for Infrastructure Development (AusCID), submission no.18, p.18

¹⁵³ Thiess Pty Ltd, submission no.32, p.9

Transfield Pty Ltd raised the concern that *'it is essential that greater transparency, and indeed consistency, is exhibited by the Victorian Government in the identification of projects to be delivered by the private sector on a build, fund and maintain/operate basis'*.¹⁵⁴

AusCID advised that transaction costs need to be minimised, and that this was particularly the case for smaller PPPs where standard contracts and more efficient project and contract administration would help bring forward development of these projects.¹⁵⁵

Several witnesses noted that it is too early to pass a final judgement on the current policy. Deutsche Bank advised, however, that no significant projects had been delivered for which the relevant components of the public sector comparator (PSC) have been disclosed to bidders under the *Partnerships Victoria* policy.¹⁵⁶ At that time, Deutsche Bank reported that it was keen to see the PSC developed in practice, and that government must demonstrate that a full and appropriate value for risk has been ascribed under the traditional procurement option.

Other private sector organisations emphasised the importance of specific parts of the policy, including:¹⁵⁷

- the *Partnerships Victoria Practitioners' Guide* which emphasised the importance of the release of a thorough and well crafted project brief and the efficiency of the associated process;
- the importance of efficient final negotiations with preferred bidders.

The Victorian Auditor-General also advised the Committee that the *Partnerships Victoria* policy provided a sound foundation, stating that *'Our assessment of the framework indicates that it provides a sound platform for the development of PPPs'*.¹⁵⁸ The Auditor-General, however, qualified this by stating that the absence of an evaluation culture with PPPs to date indicated that future PPP performance could not be guaranteed:¹⁵⁹

... given that our assessments of PPPs over the past 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.

¹⁵⁴ Transfield Pty Ltd, submission no.15, p.4

¹⁵⁵ Australian Council for Infrastructure Development (AusCID), submission no.18, p.22

¹⁵⁶ Deutsche Bank AG, submission number 19, p.4

¹⁵⁷ For example Thiess, submission no.32

¹⁵⁸ Mr W Cameron, (then) Victorian Auditor General, submission no.13, p.4

¹⁵⁹ *ibid.*

Professor Quiggin noted that the *Partnerships Victoria* documents envisaged a preferred position in which governments contract with a single party to undertake design, construction, finance and operation of infrastructure, but that the position under which risk will be allocated optimally is limited, suggesting that:¹⁶⁰

A single contractor model will be appropriate only in a minority of cases. For most infrastructure projects, standard public procurement procedures, with subsequent public ownership of the asset will be preferable.

Some academic research has noted the joint role of government as agency for the project and regulator of the process, as well as governance for the community, and has argued for the need for ongoing regulation during the concession period.¹⁶¹

Other commentators were also critical of the *Partnerships Victoria* framework. Professor Hodge, for example, was concerned that insufficient attention had been paid in the guidelines to aspects of policy, planning and public accountability:¹⁶²

The commercially narrow guidelines of Victoria do seem to treat PPPs as if they were simply a purchasing decision, and leave government exposed in my view to re-learning future lessons in that public infrastructure is part of an inherently policy based fabric, that public consultation is simply part of public policy development, and that public accountability is expected throughout the process. In other words, there appears to have been a failure to recognise firstly the need for strong governance independent of the government of the day and secondly the need to see public policy as an inherent part of the PPP decision process.

Dr Duffield pointed out that the neutrality of a regulator would assist in protecting the interests of all parties including the public interest. It would also expedite negotiations, ensuring the process remained transparent and ensuring that the use of commercial in confidence clauses were not abused, thus providing open government policies and ensuring the contract was executed as agreed.¹⁶³

A number of submissions highlighted the shortcomings of the current Commonwealth taxation arrangements for PPP projects. Dr Duffield commented that a number of schemes have existed over the years to assist with taxation relief for suitable infrastructure projects, for example, the infrastructure – borrowings tax-offset scheme

¹⁶⁰ Professor J Quiggin, submission no.25, p.2

¹⁶¹ Dr C Duffield, *An Evaluation Framework for Privately Funded Infrastructure in Australia*, PhD thesis, The University of Melbourne, 2001

¹⁶² G Hodge, *Who Steers the State When Governments Sign Public-Private Partnerships?* Paper presented to the International Research Symposium on Public Management, Edinburgh, April 2002, p.9

¹⁶³ Dr C Duffield, *An Evaluation Framework for Privately Funded Infrastructure in Australia*, PhD thesis, The University of Melbourne, 2001, p.61

(Division 396 of the *Income Tax Assessment Act 1997* (Cwth)).¹⁶⁴ The CityLink project, for example, relied to an extent on the availability of tax concessions.

The Committee was advised by Thiess that the current taxation regime is arguably the most critical issue facing private investment in infrastructure in Australia,¹⁶⁵ commenting that *'it should not be necessary to create expensive and complicated structures to overcome tax rulings related to private investment in public infrastructure. The whole taxation matter is complex, it is time consuming and adds significantly to costs that are ultimately passed on to the end user and it must be resolved'*. Similarly AusCID informed the Committee that:¹⁶⁶

The most significant hurdle which is constraining increased private investment in public infrastructure is Section 51AD of the Australian Taxation Act. This provision was introduced in 1983 to prevent tax exempt parties (for example, state and territory governments) from entering into arrangements with tax paying parties (private sector) for the ownership and delivery of services (for example, infrastructure) in such a way that the federal tax revenues reduced. Typically there are leasing arrangements under which companies may receive tax-deductions and transfer the benefit of those reductions as lower costs to the public sector client. As it stands S.51AD is a serious impediment to the implementation of many forms of PPPs ... the use of shadow tolling as a form of paying for infrastructure services is restricted, if not ruled out, by S.51AD as it currently stands.

In June 2003 the Commonwealth Government released for comment, an exposure draft legislation covering the taxation of infrastructure financing.¹⁶⁷

At the time this report was prepared, these reforms were still under discussion.¹⁶⁸

4.5 Conclusion

In light of the experiences discussed in this chapter and overseas developments, the Committee suggests it would be timely to review operational projects with a view to updating the policy and guidance documents in light of experience and providing best practice for future PPP projects.

¹⁶⁴ *ibid.*, p.44

¹⁶⁵ Thiess Pty Ltd, submission no.32, p.12

¹⁶⁶ Australian Council for Infrastructure Development (AusCID), submission no.18, p.23

¹⁶⁷ Senator The Hon. H Coonan, MP, Minister for Revenue and the Assistant Treasurer, media release C062/03, *Taxation of Infrastructure financing bill released for comment*, 26 June 2003

¹⁶⁸ Blake, Dawson Waldron, *PPP Update*, September 2006, p.15

The Committee recommends that:

Recommendation 9: **The Victorian Government continue to work with the Commonwealth Government on the need to reform section 51AD of the *Income Tax Assessment Act 1936* to protect the taxpayers' interest in a way which facilitates projects while protecting the public interest.**

Recommendation 10: **The *Partnerships Victoria* policy and guidelines be updated to reflect recent experiences with public private partnership/private finance initiative projects in Australia, particularly in relation to the public sector comparator, valuing risk, and the discount rate.**

CHAPTER 5: GOVERNANCE, EVALUATION AND ACCOUNTABILITY ARRANGEMENTS

Key findings of the Committee:

- 5.1 **Current Victorian public private partnership (PPP) accountability arrangements comprise governance, probity and compliance. Each project in Victoria is overseen and is the responsibility of the relevant portfolio Minister, with the Treasurer responsible for the whole of government policy framework. For some projects the Treasurer may work with the portfolio Minister for part of the project. In addition, the Minister for Major Projects is responsible for Major Projects Victoria.**
- 5.2 **The Committee concurs with the view of the Auditor-General that the effective management and monitoring of public private partnerships, once established, is critical to the outcomes achieved.**
- 5.3 **The two reviews of PPP projects undertaken for the government (the Russell and Fitzgerald reviews) have shaped policy and practices.**
- 5.4 **For all infrastructure projects, meaningful and timely information about contract performance needs to be published.**
- 5.5 **Many PPP contracts are complex and lengthy (for example the Southern Cross Station contract is 620 pages). A succinct summary should be made publicly available. A project summary would also enhance public understanding of PPPs.**

5.1 Introduction

*Traditional public sector accountability arrangements do not fit these diverse forms of partnerships. Consequently, there is a need for tailored, innovative approaches based on a full appreciation of the risks and benefits involved, if there is to be credible accountability to Parliament for both the results and the manner in which they are achieved. This is particularly the case where the public sector makes use of private sector financing to deliver public services.*¹⁶⁹

The fourth inquiry term of reference required the Committee to examine the various government models for evaluating and monitoring private investment in public infrastructure projects, and the governance and accountability arrangements.

¹⁶⁹ P Barrett, AM, (then) Auditor-General for Australia, *Auditing in a Changing Governance Environment*, presentation, Senate Occasional Lecture Series, Canberra, 21 June 2002, p.14

This chapter looks at how PPPs are governed, how decisions are made, and how evaluation and monitoring arrangements contribute to public accountability requirements. These include policy making, project planning, pre-decision consultation, estimation of financial viability and net community welfare, evaluation of tender bidders and choice of successful tender, monitoring of project throughout construction, performance audits by the Auditor-General after completion and the post completion evaluation of outcomes achieved. These evaluations should cover economic, social and other community interests as well as financial arrangements. This chapter will also review accountability arrangements, and because accountability requirements cover a broad arena, a range of institutions will be relevant to ensure appropriate governance.

5.2 Governance of PPPs

Good governance in a liberal democracy relies on a '*democratic political system operating in conjunction with an accountable system of government*'.¹⁷⁰ In broad terms, it is a system that is transparent, accountable, just, fair, democratic, participatory and responsive to people's needs.¹⁷¹ This is different to the narrower idea of corporate governance, or the way large organisations are directed and controlled, where the focus is more on matters such as the responsibilities of directors and internal management functions.

This report considers the governance of infrastructure financing in terms of decision making and institutional arrangements in the democratic system.¹⁷²

5.2.1 Current arrangements

Evidence presented by the Department of Treasury and Finance outlined the major stages in developing a *Partnerships Victoria* project. Updated in the June 2003 *Contract Management Guide*, the guidelines specified nine major stages, and highlighted the major points at which Cabinet approval, or approval by a Cabinet committee, is sought.

Reference was also made to the use of probity plans and the publishing of final contracts. Although the department's presentation did not discuss accountability arrangements in relation to Parliament, the Auditor-General or the community, the Committee noted the following broad principles underpinning the *Partnerships Victoria* policy:¹⁷³

¹⁷⁰ J Buckley, *The Art of Governance: Putting the Pieces Together*, Global Education Centre Inc., Adelaide, 2002

¹⁷¹ Commonwealth Innovations (1999)

¹⁷² See also Public Accounts and Estimates Committee, *Report on Corporate Governance in the Victorian Public Sector*, May 2005

¹⁷³ Department of Treasury and Finance, *Partnerships Victoria*, June 2000, p.7

- *there should be an emphasis on transparency and disclosure of the processes and outcomes, acknowledging the need to protect commercial confidentiality where appropriate;*
- *the conduct of the public sector should always be such that confidence in the probity of the partnership model and the way in which it is implemented is able to be maintained at all times.*

The guidelines, however, appear to regard the question of governance more narrowly, as simply an element of project management commerce.¹⁷⁴

Governance is concerned with processes for project decision-making. It defines the behavioural controls within the government party that ensure accountable project outcomes and processes. Governance is concerned with accountability and responsibilities. It encompasses authority, stewardship, leadership and control.

The department indicated that its governance framework comprised three discrete components: governance, probity and compliance.¹⁷⁵ The *Partnerships Victoria* guidelines note that good governance for projects requires relevant staff having clear roles, appropriate skills and resources. It defines senior managers (usually the chief executive officer or deputy secretary) and contract directors as having overall responsibility for the project and for the successful delivery of government services.¹⁷⁶ The department advised that Cabinet involvement in decision making occurred at the following points:¹⁷⁷

1. Initial business consideration of the project business case as part of normal budget allocation for funding approval and project approval.
2. The approval to invite expressions of interest for the proposed *Partnerships Victoria* project.
3. Application for approval to issue a project brief and contract, against which private bids may then be accepted.
4. Finalisation of the contract management strategy.

The Committee also understands that Cabinet gives the final sign off on the preferred bidder.

In terms of governance, the department's submission explained that *'each Partnerships Victoria project is overseen by, and is the responsibility of, the relevant portfolio Minister'*.¹⁷⁸ The department argued that this arrangement provided a clearer accountability in contrast to the previous government, where a responsible Minister

¹⁷⁴ Department of Treasury and Finance, *Contract Management Guide*, p.70

¹⁷⁵ *ibid.*, p.69

¹⁷⁶ *ibid.*, p.71

¹⁷⁷ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Overview*, July 2006, p.15

¹⁷⁸ Department of Treasury and Finance, submission no.35, p.17

and the Treasurer worked in partnership to develop the project. The submission indicated that the Treasurer was responsible for the whole of government policy framework and for preparing detailed policy and guidance to assist implementation.¹⁷⁹

Notwithstanding this situation, the department also argued that there may nevertheless *'remain projects with particular commercial characteristics (for example, the redevelopment of Southern Cross Station) where it is appropriate for the Treasurer to work with the portfolio Minister for at least part of the project'*.¹⁸⁰

This applies to traditional procurement also.

Governance arrangements in the United Kingdom have evolved into a mixture of groups forming part of the PFI industry. HM Treasury has policy responsibility for the PFI, a number of partnerships, and responsibility for state owned businesses. The Treasury Taskforce established in 1997 was designed to bring specialist skills and experience to the public sector and to be a focal point for PFI activities. It was replaced by *'Partnerships UK'* (PUK), an independent entity with 51 per cent private ownership and 49 per cent government owned. PUK acts as a PPP developer working alongside the public sector.¹⁸¹ The Office of Government Commerce (OGC) was also initiated in 2000 to replace the policy facet of the previous Treasury Taskforce. The Private Finance Unit within OGC is now responsible for developing and promoting PFI policy.

Together with these formal bodies, a 4Ps¹⁸² program exists in the United Kingdom at local government level to encourage investment through PFI as well as through the PPP forum, which was established by private organisations to promote the benefits of PPPs.

5.2.2 Assessing governance arrangements

The Department of Treasury and Finance released 477 pages of practitioner technical and risk allocation contractual information in June 2001, with included 44 tasks and three points for Cabinet approval. A further 372 pages of guidance notes including the *Contract Management Policy*, *Contract Management Guide* and various technical notes were added to the guidance material in June 2003. Since then other documentation has been released. Total guidance material for private financing of public infrastructure projects totals 849 pages.

Four governance concerns have been evident in past private funding of public infrastructure projects. These concerns covered high level program governance (covering multiple projects) and governance arrangements for individual projects.

¹⁷⁹ *ibid.*

¹⁸⁰ *ibid.*

¹⁸¹ G Allen, *The Private Finance Initiative (PFI)*, Research Paper, House of Commons Library UK, p.17

¹⁸² 4Ps works in partnership with all local authorities to secure funding and accelerate the development, procurement and implementation of PFI schemes, public private partnerships, complex projects and programmes

1. The concern first was the strong sense that partnership deals can essentially be a two way affair rather than also including the community's interests, directly and explicitly. The Russell review of government contracts identified that the CityLink enabling legislation, for example, provided scope to override any potential delays from the normal complications of due process.¹⁸³ The review stated that *'the corollary is that there appears to have been less emphasis on due process, given the desire for rapid implementation. This highlights the need for government to balance the risks of extremes on a continuum between 'paralysis by analysis' and 'action with diminished accountability'*.
2. Secondly, several submissions¹⁸⁴ raised concerns about the 'lock in' effect of long term contractual arrangements.¹⁸⁵ Despite advice from the Department of Treasury and Finance that such arrangements gave governments *'strategic flexibility'*, the concern was that not only the current government but a dozen or so future governments were locked into the agreement signed, with the consequence that future governments had reduced capacity to govern and implement policies in the public interest. The Russell review recommended that the government should avoid contractual obligations that affect its discretion to develop alternative policy settings.¹⁸⁶ The Committee recognises that while such a *'lock in'* effect has always existed in funding major infrastructure, it may be exacerbated where complex service contracts and long term financing arrangements were involved.
3. The third governance concern involved the partnerships where consumers or users were essentially to pay for the facility, for example, by tolling roads, and there has not always been provision for the protection of such consumers in balancing commercial and social interests. This is an oversight given the magnitude of the financial deals being initially endorsed and the essential nature of the services. The Committee noted that the current policy and guidance material have taken into account lessons learned from past projects and this is highlighted when comparing two recent toll road projects.

¹⁸³ E W Russell, E Waterman, and N Seddon, *Audit Review of Government Contracts: Contracting, Privatisation, Probity and Disclosure in Victoria 1992-1999, An independent report to Government*, Vol.2, May 2000, p.99

¹⁸⁴ For example, Deacons law firm, submission no.14, p.2 and Professor G Hodge, submission no.31, p.3

¹⁸⁵ E W Russell, E Waterman, and N Seddon, *Audit Review of Government Contracts: Contracting, Privatisation, Probity and Disclosure in Victoria 1992-1999, An independent report to Government*, Vol.2, May 2000, p.99

¹⁸⁶ *ibid.* p.84

Exhibit 5.1: Comparison of toll road projects in Victoria

CityLink	EastLink
Signed 1995, IIPV policy	Signed 2004, <i>Partnerships Victoria</i> policy
No discounts for weekend usage for cars	Discounts for weekend usage for cars
Road traffic volume reduction measures on associated roads	No associated road closures (apart from short term construction closures) or diversions
Penalties for public transport and competing road improvement projects	No penalties for public transport improvements or road improvements
Infringement regime includes administrative fees	Lower infringement regime
No direct share in refinancing benefits	Share in specified refinancing benefit
Limited community consultation	Extensive community consultation

Source: Department of Treasury and Finance, email, received 2 October 2006

4. The fourth concern was the lack of clarity of contractual obligations in partnership deals.¹⁸⁷

These governance issues point to the potential for conflicts of interest. The Committee considers it important to be able to separate the functions of governing in the public interest (for example infrastructure planning, policy advocacy, interest groups, long term regulatory functions of monopoly contractual arrangements) and rigorous monitoring and evaluation.

The trend for government to increasingly rely on external advisors and professional experts to support or even help make decisions on PPPs strengthens these direct concerns around conflicting interests. Together with the project transactions, there can be large fees associated with this advice – the development of the public sector comparator, for instance, can attract a fee of up to one million dollars.¹⁸⁸ Commercial firms usually wish to protect their intellectual capital and future business prospects, and inevitably argue that high level commercial transactions require high levels of financial sophistication and expertise. Nonetheless, the degree to which the public observes future governments relying on this advisory industry¹⁸⁹ instead of its own intelligence, leaves government open to the criticism that decisions are not being made in the public interest. It is possible that the industry now providing PPP advice may not be regarded as independent. At a minimum, the government needs to have expertise and capacity to underpin and strengthen decision making in the public interest and it is essential that there is sufficient expertise in Department of Treasury and Finance to manage PPP projects.

¹⁸⁷ Professor G Hodge, submission no.31, p.3

¹⁸⁸ P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, January 2004, p.31

¹⁸⁹ D Guttman, *The Shadow Pentagon*, Centre for Public Integrity, 2003
see: www.publicintegrity.org

The magnitude of expenditures devoted to large infrastructure projects, in line with the above governance concerns, suggests that there is now a need to clearly separate these functions.

An allied governance concern is the degree to which the comprehensive and rational processes presented in the governance guidelines are followed in practice. The Department of Treasury and Finance did not provide the Committee with any specific information on this question.

Significant roads projects have been successfully delivered in the past by private contract arrangements under public funding. The government must seriously consider whether overseeing major infrastructure contracts for the state needs to be centralised, rather than responsibility being spread across various portfolios.

The Committee noted with interest the following comments:¹⁹⁰

Deutsche Bank welcomes the central involvement of the Department of Treasury and Finance on all PPP projects as this is helping to develop a highly specialised and informed skill base within government.

The Committee noted that the decentralised project governance arrangements for some major projects, for example within the Department of Justice for running private prison projects; within the Department of Human Services for running private hospital projects; and within the Department of Infrastructure for Southern Cross Station, have all encountered problems.¹⁹¹ At the current time, the desire to pursue decentralised arrangements seems to be in conflict with the need for high level expertise to manage these complex infrastructure arrangements. This issue is further discussed in Chapter 6.

5.3 Evaluation and monitoring of PPPs

5.3.1 Current arrangements

Current arrangements to evaluate and monitor private investment in public infrastructure were detailed in the Department of Treasury and Finance submission. The following major evaluation tasks were outlined:¹⁹²

- option appraisal, where various available options are considered in terms of scale, output specification, risk transfer and the potential market;
- the business case, where there is a detailed construction of a business case, including output specification, indicative costs, construction of a preliminary

¹⁹⁰ Deutsche Bank AG, submission no.19, p.3

¹⁹¹ Department of Treasury and Finance, submission no.35, p.33

¹⁹² *ibid.*, pp.15–17

public sector comparator, statement as to government commitment and cost benefit analysis;

- government approval, where there are four examinations of a PPP project by Cabinet or a committee of Cabinet;
- bid evaluation, where expressions of interest are assessed against each other and also for value for money against the most efficient public sector method; and
- a fifth evaluation task is also noted by the department in post-commissioning, where it is a requirement to ensure that the contract provides the level of value for money for which it was originally designed.

The Department of Treasury and Finance indicated that the primary mechanism used by the Victorian Government to evaluate the effectiveness of private sector investment in public infrastructure projects was the aim of value for money, and the quantitative construction of a PSC.¹⁹³ The department explained that the PSC was a tool estimating the whole-of-life risk adjusted cost of a project if it was financed and operated by government, and asserted that it provided a fall back delivery option for government. One of the keys to constructing the PSC is the reference project.¹⁹⁴

The most likely and efficient form of public sector delivery that could be employed to satisfy all elements of the output specification, as outlined in the Project Brief, based on current reasonably achievable best practice. The defining attribute of the Reference Project is that government retains ownership and operational responsibility [but not necessarily direct delivery] over the infrastructure and related services. In many cases, the public sector service delivery method may involve a significant element of outsourcing or third party contractor involvement including a variety of design and construct (for example, turnkey), operation and maintenance agreements.

While the Committee accepts this information, the alternative delivery option was not particularly clear.

In terms of monitoring PPP projects, the Auditor-General emphasised that while the broad framework for evaluating prospective PPPs is set out in the policy documentation, the effective management and monitoring of these arrangements, once established, is critical to the outcomes achieved.¹⁹⁵ Retaining the detailed in-house knowledge of the arrangements once a contract is signed, for example, has been a major issue in the United Kingdom.¹⁹⁶

¹⁹³ *ibid.*, p.20

¹⁹⁴ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Public Sector Comparator, Technical Note*, June 2001, p.8

¹⁹⁵ Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.5

¹⁹⁶ Report on Operational PFI Projects by Partnerships UK, March 2006, p.10

5.3.2 Assessing arrangements

The Committee has previously noted that at present, apart from in the United Kingdom, little international evaluation of private funding of public infrastructure arrangements is available. This is remarkable considering the size of the investment. While there have been at least two reviews in Victoria to improve the policy framework, the Committee understands that there have been few rigorous evaluations of the relative effectiveness of actual projects particularly to compare with the predictions of cost savings and the business cases submitted.

A critical issue in relation to evaluations is the precise comparison being undertaken. To undertake this it is necessary to compare realistic past performance with realistic present performance, rather than a mythical past with the worst of the present performance. What is needed is a transparent assessment of actual contract outcomes from current privately funded projects.

The 2004 review of *Partnerships Victoria* provided infrastructure figures detailing the payments to be made by the state for privately funded projects already committed.¹⁹⁷ However, due to the unique nature of the projects, it was not practical to attempt any comparison with similar projects that had been publicly funded.

The Committee is aware that much of the PPP debate is about the cost of private involvement in infrastructure funding, and not whether the private sector should be involved in infrastructure provision.¹⁹⁸

What the Committee has observed is *'uncritical enthusiasm'* by proponents, and this issue has been commented on in academic research.¹⁹⁹ This enthusiasm presents a potential conflict of interest because those policy advocates are unlikely to undertake rigorous evaluations, including external peer review, with any degree of independence.

¹⁹⁷ P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, January 2004, pp.7–15

¹⁹⁸ J E de Bettignies and T W Ross, *The Economics of Public-Private Partnerships*, draft report, Vancouver: Sauder School of Business, University of British Columbia, 2003
also note that 'of course, if what the public sector is buying is a more or less standard product, buying construction services is not really different from buying office supplies in a regular market, with the implication that the term 'partnership' is probably not appropriate'.

¹⁹⁹ M J Treblicock and R Daniels, (1996). *Private provision of public infrastructure: An organisational analysis on the next privatization frontier*. University of Toronto, Law Journal, 46, 1996, pp.375–426

5.4 Accountability arrangements

5.4.1 Current arrangements

Partnerships Victoria documentation states that the ultimate accountability for projects ‘may rest with government, even though the contractual responsibility for certain deliverables is transferred to the private party’.²⁰⁰ The Committee noted the Department of Treasury and Finance guidelines which stated that these demanding reporting and procedural standards should make service provision transparent under a *Partnerships Victoria* project.²⁰¹

The Auditor-General indicated in his submission that he was concerned about the ongoing oversight and monitoring arrangements for PPPs, and the potential to lose corporate memory over the life of the contract:²⁰²

Typically ... the specific purposes of project teams are established ... However, once the arrangements are established and operating, these teams generally are dispersed, with a resultant loss of detailed knowledge of the arrangements. This represents a major issue impacting on the effective ongoing oversight of the arrangements ... A further issue that emerges from these long term ‘outsourcing’ arrangements is that, over time, there is a loss of expertise in the effective oversight of these arrangements given that the state may no longer be involved in areas similar to those subject to PPPs, and therefore individuals responsible for oversight functions may not fully appreciate the associated management issues. 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.

Ministerial accountability for these projects seemed to be implicit and across multiple portfolios and including the Minister for Finance, the relevant portfolio Minister and the Minister for Major Projects.

²⁰⁰ Department of Treasury and Finance, *Contract Management Guide*, June 2003, p.68

²⁰¹ Appendix H of the *Contract Management Guide* also provides guidance as to public sector accountability, access to information in government contracts, with particular reference to the Freedom of Information Act, and commercial in confidence materials, disclosure of contractual information, Whistleblower Protection Act, the Public Records Act, and the confidentiality of Cabinet documents and Privacy legislation

²⁰² Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.5

5.4.2 Assessing arrangements

Submissions made to past inquiries by the PAEC of the 54th Parliament revealed a considerable range of views on the issue of accountability and contracted services.²⁰³ There was fundamental disagreement in two earlier inquiries as to whether such contracting lessens or enhances the accountability of government for the provision of public services.²⁰⁴ These inquiries noted that the introduction of contracted works and services both extended and blurred the accountability chain, and recommended that principles of transparency and openness guide contracting arrangements in the public interest. These reports noted that accountability was fundamental to good government, and that *'the expectation that government should be accountable is a product of the electorate's grant of power to government'*.²⁰⁵ Such accountability was not only seen in terms of delivery of services for works but in the following terms:²⁰⁶

Access to information permits the electorate to assess the government and participate more effectively in the policy and decision making processes of government. Without information, people cannot adequately exercise their rights and responsibilities as citizens and make informed choices.

As well, the former Committee's report on Commercial in Confidence noted that in the 90's accountability could be undermined by a convergence of the vested interest of public officials and contractors, and provided evidence from several witnesses that this interest was a real and significant problem at the time. It also found that the impetus for secrecy had come mainly from government rather than from the public sector. It commented that:²⁰⁷

Members of the public are entitled to know, as an aspect of assessing the economic and social management of the government of the day, what contracts are entered into on their behalf, and on what terms and conditions. They are entitled to know what public moneys are expended, both directly and indirectly, and precisely what is to be delivered under the terms of the contract. They are equally entitled to know how legal and financial risks are allocated between the contracting parties. They are entitled to know what monitoring and enforcement procedures exist in the event of contractual default.

²⁰³ Public Accounts and Estimates Committee, *Outsourcing of Government Services in the Victorian Public Sector*, March 2000; Public Accounts and Estimates Committee, *Commercial in Confidence Material and the Public Interest*, March 2000

²⁰⁴ *ibid.*

²⁰⁵ Public Accounts and Estimates Committee, *Commercial in Confidence Material and the Public Interest*, March 2000, p.22

²⁰⁶ *ibid.*

²⁰⁷ *ibid.*, p.xxxiii, p.102

In considering this issue, the Committee agreed with the view put by the (then) Victorian Auditor-General, that:²⁰⁸ *‘the various checks and balances in the public accountability process may be costly to administer ... but they are designed to protect a government’s reputation and the interest of the public at large’.*

The current policy for providing access to contractual information is an improvement on past practices. Departments must report summaries for contracts more than \$100,000 but less than \$10 million on the Victorian Government Purchasing Board’s Contracts Publishing System web site.²⁰⁹ Contracts more than \$10 million in value are required also to be disclosed in full on this system, subject to criteria contained in the *Freedom of Information Act 1982*, allowing material to be withheld in some circumstances.²¹⁰

The Committee also heard that there was a need to make the contractual information not only available on the internet in a timely manner but in a format that is accessible and understandable to the public. This was particularly important because the contracts were complex, they often ran to hundreds of pages (for example the contract for the Southern Cross redevelopment is 620 pages) and the financial schedules are difficult to understand. It was suggested to the Committee that a two or three page summary of the contract verified by the Auditor-General should be available including summary financial payment information. While understanding the difficulties in achieving this, the Committee considers that such an accessible, understandable summary is in keeping with the need for this type of documentation to be considered by Cabinet, is in line with the *Partnerships Victoria* framework, and is a practice that has been adopted in other jurisdictions, such as New South Wales.

A project summary would assist in understanding PPP projects in terms of risk transfer, the level of services to be provided, the responsibilities of each party to the contract, and the particular net price paid by government.

Few submissions from the private sector discussed accountability, governance or monitoring arrangements, and the Committee noted the views of the Institution of Engineers Australia which argued that:²¹¹

Public support for private investment will depend on transparency and accountability. If governments keep private investment contracts secret, or use commercial in confidence reasons to black out large chunks of the contracts, then community support for them will quickly turn into rejection. It is therefore in the best long term interest of the private sector to push for government openness. This means making all contracts and

²⁰⁸ *ibid.* p.xxxiii, p 86

²⁰⁹ Government of Victoria, *Victorian Government Purchasing Board Procurement Policies*, 2002, p.42

²¹⁰ For example, section 34 of the FOI Act provides exemption in respect of third parties’ business information acquired from a business, commercial or financial undertaking. Agencies must demonstrate that the disclosure of information would be likely to unreasonably expose the undertaking to disadvantage.

²¹¹ The Institution of Engineers Australia – Victorian Division, submission no.29, p.4

variations and negotiated outmodes publicly available except for intellectual property issues. Costs should be disclosed.

The Victorian Auditor-General's submission supported this, making reference to the policy statement *Ensuring Openness and Probity in Government Contracts* and the government's policy platform whereby the onus on public sector entities has shifted from that of non-disclosure to that of disclosure of contracts.²¹²

The Committee urges the government to ensure that use of confidentiality clauses is kept to an absolute minimum in contracts relating to PPP projects.

The Committee recommends that:

Recommendation 11:

The Victorian Government:

- (a) improve opportunities for parliamentary oversight of public private partnership financial arrangements and commitments;**
- (b) after the contractual arrangements relating to a public private partnership project have been finalised, the responsible Minister and the Department of Treasury and Finance brief the Public Accounts and Estimates Committee on the details; and**
- (c) advise Parliament when significant variations are made to a PPP contract, beyond the initial contractual arrangements.**

Recommendation 12:

That:

- (a) prior to tenders being submitted for public private partnership projects, agencies should ensure applicants are aware of the limits of what will and will not be considered as commercial in confidence in relation to PPP contracts; and**
- (b) in determining whether a claim for commercial confidentiality is justified, the onus of proof should be with the tenderer, who should be required to substantiate that disclosure would be harmful to their commercial interests.**

²¹² Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.5

CHAPTER 6: PROTECTING THE PUBLIC INTEREST

Key findings of the Committee:

- 6.1 The Victorian Government should improve disclosure for PPP projects.
- 6.2 Judgements regarding what is in the public interest are inherently complex and contestable, and policy choices in the public interest cannot be reduced to objective technical calculations.
- 6.3 The Department of Treasury and Finance advised that at the early option appraisal stage of a PPP it undertakes a preliminary assessment of the public interest test and then completes a fuller analysis during the period when the business case is being developed.
- 6.4 The outcomes of the public interest test applied to PPPs in the *Partnerships Victoria* policy framework and the business case for the project are not publicly released.
- 6.5 The role of evaluation in protecting the public interest is crucial and there is a need to evaluate projects from the community's perspective.
- 6.6 The increasingly complex arrangements relating to PPPs present challenges in relation to public accountability.
- 6.7 The public sector capability to plan projects, formulate major project contracts and to monitor and manage compliance, should be strengthened to enable increased reliance on the public service for ensuring the public interest is met.

6.1 Introduction

The fifth inquiry term of reference required the Committee to review and evaluate mechanisms used by the Victorian Government to protect the public interest.

A range of ideas exist as to what constitutes '*the public interest*'. Everyone working in government, as well as those associated with government, likes to believe that they work towards '*the public interest*'. As a consequence, the term is usually cited in support of all policy proposals.

The idea of the public interest is simple enough: it represents the common good, the collective good, the public benefit or the national benefit.²¹³ The task of defining the benefit held in common in a community is given to government. Indeed, government is given special powers and resources and is elected to use those powers and resources to further the public interest. But it is also more than this, because accountability and transparency in the operations of the public sector, is fundamental to good government.

As previous Public Accounts and Estimates Committee inquiries have found, determining the veracity of claims for the public interest as a whole inevitably involves some balancing of competing claims and criteria.²¹⁴ The optimal balance between the individual on the one hand and sectional interests and common community interests on the other is wholly contestable and best made explicit through the political process. As one academic has pointed out:²¹⁵

judgements [regarding the public interest] are inherently complex and contestable ... policy choices in the public interest cannot be reduced to objective, technical calculations ... and ... assessments of the public interest always involve political assessments, whether taken by politicians, public servants, courts, advisory councils or any other citizens.

While efforts have been made to define the public interest to more manageable statements, they have inevitably risked criticism of severe oversimplification, for example, viewing the public interest in terms of 'community service obligations' or the 'effective and efficient provision of works and services' leaves aside a raft of much wider issues for the public, ranging from the place of economic markets in serving social objectives, citizen involvement in defining the role of government itself, and the contestability of claims to the public interest. Quite simply, while there is universal agreement that the public interest must be considered, there is a divergence of views on what constitutes the overall 'public interest' when determining benefits arising from PPP projects.

Trends towards outsourcing and contracting of government activities over the past decade, including the private finance of public infrastructure through PPP arrangements, has led to an accountability paradox whereby some parts of accountability appear to have improved while others have weakened. Professor Hodge argues that while managerial accountability for outputs, financial performance and competitive market results often appear to have been strengthened, political

²¹³ R Mulgan, 'Perspective on the Public Interest', *Canberra Bulletin of Public Administration*, (9), 2000, pp.6–12

²¹⁴ Public Accounts and Estimates Committee, *Commercial in Confidence Material and the Public Interest*, March 2000, p.24

²¹⁵ R Mulgan, 'Perspective on the Public Interest', *Canberra Bulletin of Public Administration*, (9), 2000, p.7

accountability and accountability in public interest matters relating to PPP projects seem to have weakened.²¹⁶

While the current government makes judgements on today's public interest, it is also critical to ask the question as to how the public interest is protected in the medium and longer term, given that contractual arrangements for infrastructure deals can span several decades. Further, the public interest is by its nature dynamic and changes over time. In Australia, for instance, what constitutes the public interest has changed remarkably over the last three years in light of terrorism threats and globalisation.

So how may the medium and long term public interest be protected? Victoria's network of accountability mechanisms including parliamentary committees, the Auditor-General, the Ombudsman, freedom of information provisions, and other mechanisms, such as transparency requirements, all protect the long term public interest. It is through this accountability network and through high levels of transparency that risks to the pursuit of public interest can be minimised. Such risks might include undue influence of interest groups or suppliers, undeclared conflicts of interest, or too few independent evaluations of policy directions with PPP projects.

6.2 Key existing mechanisms protecting the public interest

The Committee received evidence that the public interest in relation to PPP projects is protected under existing arrangements in several ways:

- planning processes must include consultation with the community, particularly local communities, when determining the benefits or otherwise of major PPP projects on those communities most affected by such undertakings in making decisions about project commitments;
- there is usually a separation of governing mechanisms from the state's commercial interests throughout decision making processes in major infrastructure projects, and once decisions have been made to proceed with a major infrastructure project, the public interest is also protected through competitive tender arrangements that encourage value for money for the state;
- there are high levels of transparency in contractual arrangements and commitments;
- there is a network of accountability elements including freedom of information, administrative law, the Auditor-General; parliamentary committees and the Ombudsman;
- there is ultimate electoral accountability through voting.

²¹⁶ Professor G Hodge, 'Who steers the state when governments sing Public Private Partnerships', Presentation, International Research Symposium on Public Management, April 2002, p.9

6.3 Protecting the public interest through Partnerships Victoria

The Committee was advised by the Department of Treasury and Finance that *'in projects undertaken prior to the introduction of the Partnerships Victoria policy there was no formal mechanism for assessing the impact of a project on the public interest'*.²¹⁷

The *Partnerships Victoria* policy requires all projects to undergo a specific public interest *'test'*, which has eight elements:²¹⁸

1. effectiveness – is the project effective in meeting the government's objectives?
2. accountability and transparency – do the partnership arrangements ensure that the community can be well informed about the obligations of the government and the private sector partner, and that these can be oversights by the Auditor-General?
3. affected individuals and communities – have those affected been able to contribute effectively at the planning stages, and are their rights protected through fair appeals processes and other conflict resolution mechanisms?
4. equity – are there adequate arrangements to ensure that disadvantaged groups can effectively use the infrastructure?
5. public access – are there safeguards that ensure ongoing public access to essential infrastructure?
6. consumer rights – does the project provide sufficient safeguards for consumers, particularly those for whom the government has a high level of duty of care, and/or are most vulnerable?
7. security – does the project provide assurance that community health and safety will be secured?
8. privacy – does the project provide adequate protection of users' rights to privacy?

The Department of Treasury and Finance further advised the Committee that the public interest test is comprehensive and is applied at a number of different stages in the project development process:²¹⁹

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

²¹⁷ Department of Treasury and Finance, submission no.35, p.18

²¹⁸ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Practitioners' Guide*, June 2001, pp.76–79

²¹⁹ Mr G Maguire, Assistant Director, Commercial Division, Department of Treasury and Finance, transcript of evidence, p.10

the contract is signed that the contract fully caters for all public interest elements.

Partnerships Victoria Guidance Material, Public Sector Comparator, Technical Note continues explaining that ‘*the Treasurer is responsible for developing and overseeing the Partnerships Victoria policy*’. In terms of accountabilities, however, the Committee noted that:²²⁰

Although ultimate responsibility for a particular project lies with the relevant portfolio department or agency, the Department of Treasury and Finance generally retains an integral role in the procurement process. This may take the form of a general facilitatory, advisory and oversight role, with the contribution of personnel, resources and cost information, including the process of construction of the public sector comparator. The Department of Treasury and Finance will also advise the Treasurer on financial and commercial exposures of the state.

Further, that:²²¹

The extent of the Department of Treasury and Finance’s role is determined on a project by project basis, but is influenced by the resources of the relevant portfolio department or agency, as well as the size, nature, complexity and importance of the project, and the resources of the Department of Treasury and Finance.

The guidelines also promote the appointment of external advisors to assist with the development of the public sector comparator.

6.4 Assessing public interest protection

6.4.1 Public interest test

The initiation of a specific public interest test in *Partnerships Victoria* was a sensible step forward.²²² The public interest test should be an explicit consideration in project design.

²²⁰ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Public Sector Comparator, Technical Note*, June 2001, p.74

²²¹ *ibid.*

²²² B Moylan, Senior Management Policy, Partnerships Victoria, Department of Treasury and Finance, Seminar Series, Melbourne University Private

The Department of Treasury and Finance explained to the Committee that *‘public interest issues are considered from the early option appraisal stage of the investment evaluation process, when the department or agency decides whether it should explore the delivery of the project by way of Partnerships Victoria’*. Furthermore:²²³

At the later stages of the development of a business case, all projects are required to undergo a full public interest test. This involves an assessment of the impact of the project on the eight elements of public interest ... and ... As part of the public interest test, a decision must be made on whether suitable measures can be established that adequately protect the public interest. Suitable measures that protect the public interest may involve insertion of certain conditions into the contract and/or changes to legislation and regulations. After all relevant issues and potential public interest protection mechanisms have been examined an on-balance assessment is provided to allow government to decide whether the public interest would be properly protected by the proposed delivery arrangements.

The Committee considered that while the public interest test may be technically superior to previous arrangements, it was nonetheless no guarantee of the public interest being served. The Committee understands that the results of the public interest test are not public, and in the absence of transparency as to whether the test has been undertaken by public administrators, there is a risk that rather than being an objective independent test of the public interest, it might become a framework for the defence of projects advanced by policy proponents.

The Victorian Auditor-General stated that the PFI experience with the public interest test in the United Kingdom had been mixed and that recent rail disasters raised serious questions about the risks and benefits of PFIs.²²⁴ While the *Partnerships Victoria* public interest test includes security, it is doubtful whether such a checkbox ethos would be sufficient to guarantee safety. This would need to be the subject of separate professional analysis and investigation. The public interest test should also include an assessment of whether those affected by projects have been able to contribute effectively at the planning stages and have their rights protected through fair appeals processes and other conflict resolution mechanisms.

(a) Public consultation

The Institution of Engineers Australia advised the Committee of its strong support for private investment in public sector infrastructure, but noted that while sound in theory, *‘the devil is in the detail’* and that outcomes depended *‘on the asset being provided*

²²³ Department of Treasury and Finance, submission no.35, p.18

²²⁴ IPAA Seminar, Government Contracts – The next generation, Lessons from the review of government contracts, presentation by the (then) Victorian Auditor-General, 3 October 2000, p.6

and the structure of the deal'. The Institution judged that private sector financing was not suitable for all projects:²²⁵

Such long term planning would need to be done on the basis of infrastructure lifecycles and not just on the initial infrastructure delivery. Given that major projects can take several years until they are at a point where a construction project is initialised, planning should be robust and broad enough to gain realistic commitments. The Institution suggested that the long term infrastructure needs of Victoria be established, including the examination of a full range of infrastructure funding options in addition to the current partnership arrangements. It also suggested that:²²⁶

An effective way to produce this material is to broaden the terms of reference of the Infrastructure Planning Council and to include representation from Ministers, infrastructure owners, constructors, users and community representatives. Most of the specific resource projects could be outsourced but to maintain relevant competencies for government planning professionals, a substantial part of the research should be undertaken in-house. All reports should be made public.

In other words, the public interest would best be served through a strong forward planning capability that is seen to be representative of community needs, rather than being perceived to be driven by financial interests.

After a project is constructed, there is a further question of processes required to guarantee the public interest in terms of ensuring that contractual arrangements are adhered to and that the public interest is upheld throughout the period of the contract. The Committee was advised that expertise in government needed to be strengthened for it to be an informed buyer and regulator. In the Institution's view, commensurate skills are needed to the private sector to ensure value for money and include engineering, legal and financial expertise as well as subject matter expertise.²²⁷

(b) Role of evaluation in protecting the public interest

The role of evaluation in protecting the public interest (both pre-project and post-implementation) is critical. The report by an academic with experience in PPP matters noted that current processes did not necessarily include evaluation of projects from the community's perspective or directly consider equity issues.²²⁸ Given that the objectives of PPP projects were clearly to have positive community outcomes, the degree to which these stated objectives were being met on actual projects warrants following-up.

²²⁵ The Institution of Engineers Australia – Victorian Division, submission no.29, p.2

²²⁶ *ibid.*, p.4

²²⁷ *ibid.*, p.6

²²⁸ Dr C Duffield, *An Evaluation Framework for Privately Funded Infrastructure in Australia*, PhD thesis, The University of Melbourne, 2001, p.64

The Committee noted that *Partnerships Victoria* policy is orientated towards providing guidance material encouraging private investment in public infrastructure and has not addressed the need for increased independent evaluations of built projects. The Committee considers, therefore, that a program of independent evaluations of large infrastructure projects constructed in Victoria under private funding should be undertaken. An evaluation of the cost-effectiveness of publicly funded projects over the same period should also occur, where practical, given that PPP projects tend to be of a unique nature and direct comparisons with projects undertaken by the public sector is not always possible.

6.4.2 Public interest matters

The Committee received little evidence from the private sector on the public interest tests, although Dr Arndt²²⁹ discussed the concept of public interest in narrow terms of government controlling services.

The then Executive General Manager of Project Development, Transfield Pty. Ltd., also advised the Committee that in his experience, the private sector adapts well to requirements relating to the concept of public interest and the broader social, rather than just economic, goals.²³⁰

The objectives of the *Partnerships Victoria* policy appear to the Committee to be generally consistent with protecting the public interest. Risk allocation philosophies and value for money tests also appear to aim at this protection, although the real test is not so much the aim as the performance of projects implemented under these policy guidelines. The absence of independent evaluations of privately financed infrastructure in Victorian means that it is not currently known whether the public interest has been protected in many of these PPP projects.

Specified objectives underpinning the policy, such as *'maximising the level of infrastructure spending ...'* or *'establishing long term mutually beneficial partnerships with the private sector'* as noted in Chapter 2 would find few critics. The Committee does, however, have reservations about the *Partnerships Victoria* strategy being the only way, or indeed the best way, of achieving these policy objectives because it may take several years before difficulties and problems become apparent.

One central matter of public interest that appears to underpin the private financing of public infrastructure is the government's broader policy platform of low public debt. The Committee was advised that *'the idea that problems with public debt can be resolved by encouraging the private sector to undertake infrastructure investment is superficially appealing'*. However, given that often *'private infrastructure initiatives have been associated with a series of guaranteed government payments'*, this has had

²²⁹ Dr R Arndt, transcript of evidence, p.31

²³⁰ Mr H Fischer, (then) Executive General Manager, Project Development, Transfield, transcript of evidence, p.69

'exactly the same economic and fiscal effects as the repayment of interest on a debt'.²³¹ Furthermore, Professor Quiggin advised the Committee that *'the crucial issue in assessing a government balance sheet is not the level of debt per se but the government's net worth'*.²³² Thus, although the use of long term leases has become particularly popular in reducing reported levels of public debt, the government's obligation to make payments under such leases is effectively equivalent to the requirement to make interest and principal repayments on public debt.²³³

To assess the best manner of funding public infrastructure, the Committee considers that other funding alternatives are now worth examining, in addition to both the private financing and *'traditional'* public financing contractual arrangements. The Committee considers that the government should approach the National PPP Council to undertake a review of other options available to governments to fund infrastructure assets and services.

New potential arrangements worthy of investigation could include bonds, venture funds, pooled development funds and encouraging superannuation funds to invest in specialised infrastructure or property trust. The Committee is aware that Industry Funds Management Pty Ltd, a significant superannuation fund incorporating a range of smaller union based and workplace superannuation funds, has invested in the Spencer Street redevelopment through acquiring a controlling interest in ABN Amro's security in the project. This investment will give the fund access to the cash flow from the government over the next 30 years as well as commercial rights within the Southern Cross Station.

Superannuation assets in Australia now stand at \$844.6 billion²³⁴ and these funds are looking for secure longer term investments. Funding of government infrastructure by the superannuation funds is one alternative that should be explored by the National PPP Council.

The Committee considers that in assessing any public interest matter, the Victorian public sector must have the necessary expertise to effectively manage PPP projects. To this end, the government should ensure it has sufficient in-house expertise to provide high level advice about these complex arrangements and to provide the strategic management skills to monitor and evaluate the outcomes of these projects. It is essential that the public sector does not become dependent on external advisers to undertake these tasks because there is a potential for conflicts of interest when a small group of advisory firms are providing advice to both government and tenderers. In all major projects, central to the question of protecting the public interest is the reliance the community places on Ministers and public officials, rather than on external advisers who may have vested interest, to act in the interests of the community.

²³¹ Professor J Quiggin, submission no.25, p.17

²³² *ibid.*

²³³ *ibid.*, p.19

²³⁴ Australian Prudential Regulation Authority, *Superannuation assets near \$850 billion*, media release, 12 April, 2006

The Committee noted with interest the following comments made by two senior consultants working on PPP projects:

A partner with Deloitte was quoted in a recent media article:²³⁵

There's a need for complete transparency in these projects, where you invite an independent third party in on behalf of the taxpayer – the auditor-general or another group – to scrutinise the process and ensure there are no conflicts of interest between the parties involved.

And a partner from Freehills told the Committee:²³⁶

... Australia ... is a pretty concentrated market and you will have heard from others about how concentrated the construction market is, with a very small number of substantial players. That is simply a fact of life we have to deal with. It means that Chinese walls are inevitable because there are relatively few players in each relevant piece of business ...

... Mitcham-Frankston was the first situation in which a government said there can be no common advisers in that situation. In other words, what the government did was effectively interfere in the market for advisers and so they said to financial advisers, law firms, including mine, 'You cannot act for both these bidders' because, as it has turned out, there are two related consortia bidding in Mitcham-Frankston. That's a prohibition that is only on the advisers. It is not a prohibition that the request applied to the bidders themselves. Why make the distinction? ...

... I think my point is that this sort of issue is better left to the probity contracts, the Chinese walls and the way in which the market behaves, including a strong monitoring regime, again. There would need to be, if there ever were, common advisers. If an investment bank had two competing teams advising relating bidders, it would have to deal with those Chinese walls itself. The government would have to impose probity requirements and they would have to be monitored. But to prevent two separate divisions of Macquarie Bank doing competing tenders is selectively focusing on some suppliers and not others and potentially depriving the government of even better competition ...

The Committee is aware that the Department of Treasury and Finance has issued a guidance note about managing conflicts of interest with advisers engaged in providing assistance with PPP projects.

²³⁵ J Lewell, Partner, Deloitte, quoted in 'Partners in time', *The Age* newspaper, 7 August 2006

²³⁶ Mr W Napier, Partner, Freehills, transcript of evidence, pp.23–24

6.5 Conclusion

The Committee's review of developments overseas and in other Australian jurisdictions revealed that a number of steps have been taken to improve the transparency and accountability of PPP/PFI arrangements and to demonstrate that community interests are being protected. The Committee is particularly impressed with the arrangements that apply in British Columbia where, after the financial close on all PPP projects:²³⁷

- (a) a value for money disclosure report is published. This report describes the rationale, objectives and processes that led to the decision to use the PPP option. It explains how value for money was measured and how it is expected to be achieved in the context of current market conditions. It also includes a risk allocation summary and key terms on the contract;
- (b) fairness and probity opinions for large projects are published; and
- (c) the Auditor General reviews the value for money disclosure report prepared by Partnerships British Columbia and assesses whether the report fairly describes the context, decisions, procurement processes and results to date of the project and publishes his report.

After the agreement is finalised, the contract is published with a summary that includes the financial details and obligations of both parties.

The Committee recommends the following actions be taken to better protect the public interest:

Recommendation 13:

That:

- (a) after public private partnership contracts are signed, the contracts be published on the Partnerships Victoria website within three months;**
- (b) a succinct (approximately three page) summary of the contract and a value for money report be prepared, modelled on the British Columbia value for money report, and include the following information:**
 - (i) the assets that are to be transferred from the Victorian Government to the private sector;**

²³⁷ British Columbia, Ministry of Transportation, *Project Report: Achieving Value for Money – Kicking Horse Canyon – Phase 2 Project*, June 2006, see www.partnershipsbc.ca/, accessed 19 September 2006

- (ii) the price to be paid by the government and the basis for future changes in the price;
 - (iii) the provisions for renegotiation;
 - (iv) the risk sharing in the construction and operational phases;
 - (v) significant guarantees or undertakings;
 - (vi) details of the public sector comparator.
- (c) the Victorian Auditor-General review the details included in the contract summary and certify that it is an adequate reflection of the terms and conditions of the contract and arrange for the publication of the statement on the *Partnerships Victoria* website.
- (d) the Department of Treasury and Finance develop a template outlining information to be included in the summary of the public private partnership contract and the value for money report, and advise departments.

Recommendation 14:

The Victorian Government make representations to the National PPP Council to jointly fund a study on the potential financing options available to governments to fund public infrastructure projects, including the economic and social impacts of each option and publicly release the report for comment. In the event that the National PPP Council does not agree to this proposal, the Victorian Government fund such a study.

Recommendation 15:

The Victorian Government:

- (a) develop a secondment model within the public sector so that public officials with experience in complex procurement processes can be retained and deployed on projects across the public sector;
- (b) take steps to ensure Major Projects Victoria and individual departments are appropriately resourced to manage public private partnership projects;

- (c) develop individual and team procurement skills through formal qualification training; and**
- (d) ensure the performance criteria and targets for senior public officials involved in public private partnership projects and traditional procurement are linked to completing projects on time and within budgets.**

CHAPTER 7: VALUE FOR MONEY

Key findings of the Committee:

- 7.1 Value for money includes whole-of-life cost and quality, cost effectiveness, risk transfer, innovation, and asset use to meet the customer's needs.**
- 7.2 To ensure a competitive process, it is essential that there is a sufficient number of private sector companies, including construction and service companies and financial institutions.**
- 7.3 The Victorian Government undertakes five tasks to evaluate potential public private partnerships (PPPs). The primary mechanism for evaluating PPPs is the philosophy of value for money and the quantitative construction of the public sector comparator (PSC).**
- 7.4 Predictions of value for money are inherently dependent on economic projections, risk allocations and cash flows and the assumed discount rate used for long term contracts.**
- 7.5 There is much debate on the veracity of the compilation of the PSC. Critics claim it is fundamentally flawed while proponents claim it is essential for judging value for money.**
- 7.6 In light of the recommendations in the 2004 Fitzgerald review and a variety of international discount methodologies, the government needs to revise its current practices of risk adjustment and evaluation.**
- 7.7 There are different methodologies for risk allocation and discounting cash flows, for example the United Kingdom Treasury uses a 3.5 per cent discount rate and makes a separate risk adjustment to the cash flows.**
- 7.8 The government is examining ways of reducing high bid costs for both government and the private sector, which should assist the number of tenderers participating in PPP projects.**
- 7.9 This report shows how the Victorian Government assesses value for money in PPPs. It is important the community is satisfied that PPP projects genuinely offer value for money over the alternative methods of delivering and financing public infrastructure.**
- 7.10 In light of the variety of discounting methodologies used on PPPs and the ongoing debate in this area, the Victorian Government should ensure it adopts best practice.**

7.11 One advantage of public private partnerships over traditional approaches is the more systematic and upfront analysis to risk and which party is best able to manage it and bear that responsibility. Lessons learnt from this could be applied to traditional procurement.

7.1 Introduction

The sixth inquiry term of reference requires the Committee to review the mechanisms which the Victorian Government uses to determine whether proposals and bids represent value for money for the government and benefit the community.

The question of value for money in public investments is central to the role of government. The philosophy of ensuring government achieves best value for its limited taxation resources has a long history and valuations have encompassed both qualitative and quantitative methods. Formal technical methods of evaluating the economics of investments have been available since the mid 1950s for major infrastructure projects.²³⁸ But despite the literally thousands of infrastructure projects invested in, the application of cost-benefit analysis has been less than systematic for many governments around the world.

7.2 The value for money concept in infrastructure

The ‘*value for money*’ concept is central to the *Partnerships Victoria* policy, yet a precise definition of the concept is not outlined in the policy documentation. The United Kingdom National Audit Office defines value for money as the achievement of the optimum combination of whole-of-life cost and quality to meet the customers requirements.²³⁹ At its broadest level, value for money could be assessed on the basis of cost effectiveness analysis, with the degree of progress made towards socially oriented goals investigated. Such analysis would not attempt to place a value perhaps on the lives saved through safety improvements. If economic concepts were adopted, economic welfare improvements could be assessed against economic costs through a cost-benefit analysis. The tools for such analyses and a range of criteria indicating the degree of economic success achieved, are readily available. These include net present value methods and internal rate of return.

From a narrower perspective, financial analysis could compare the cost of undertaking an infrastructure project through private funding of infrastructure with the cost of undertaking the same project through alternative government funded infrastructure with, for example, the private sector designing and constructing the infrastructure.

²³⁸ HM Treasury (UK), *The Green Book: Appraisal and Evaluation in Central Government*, HM Treasury (UK), London, January 2003

²³⁹ National Audit Office, (UK), *Examining value for money of deals under the Private Finance Initiative*, 1999, p.66

Cost effectiveness and economic analyses would therefore indicate in the broadest context whether value for money has been achieved. Alternatively, financial analyses could compare privately funded infrastructure with publicly funded infrastructure. Of course such comparisons would assume the use of traditional competitive bidding techniques in order to get the cheapest bid for set criteria.

Value for money can be interpreted as absolute performance in terms of high value for the community, or relative performance compared with alternative infrastructure provision options.

The *Partnerships Victoria* policy outlines several forces that are considered to 'drive' Victoria's pursuit of value for money. These include risk transfer and innovation.²⁴⁰ Added to these drivers are incentives for high performance and competition in bidding.

By necessity, most of the value for money methods noted are predictive and based on estimates of what might be achieved in the future, rather than on actual costs or benefits experienced in practice. Only experience would give an accurate indication of the degree to which value for money is actually obtained. As experience has shown, with the Cross City Tunnel in New South Wales, for example, both economic projections and financial business cases can be notoriously unreliable when judged before the event.²⁴¹

Value for money requires contracts to be effectively formulated, managed and enforced.

A wide range of issues is likely to influence the achievement of value for money in projects together with several considerations central to the measurement of value for money. As the Fitzgerald report identified, assessments of value for money are inherently dependent, for example, on the effectiveness of risk transfer between parties and other factors including the assumed discount rate used for long term contracts.²⁴²

²⁴⁰ Department of Treasury and Finance, *Partnerships Victoria, Guidance Material, Overview*, July 2006, p.8

²⁴¹ Joint Select Committee on the Cross City tunnel, *Report on the Cross City Tunnel and Public Private Partnerships*, Second Report, pp.25–26

²⁴² P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, January 2004, p.22

7.3 Value for money in private investment in public infrastructure: international findings on PFI projects

The *Partnerships Victoria Practitioners' Guide* states that the policy can potentially deliver significant benefits in the quality of services and the cost of provision. Furthermore.²⁴³

Partnerships Victoria shares many of the characteristics of the public private partnerships models adopted by a number of countries around the world including the United Kingdom (where a large number of projects have been completed), South Africa, Ireland, Germany, The Netherlands, Japan, Finland and Denmark. The United Kingdom experience has been the subject of extensive review and projects there have been found to deliver average savings of 17 per cent compared to traditional public sector delivery.

This '17 per cent savings' finding is widely cited in the literature by proponents of PPP projects and is sourced from a report by Arthur Andersen and Enterprise LSE looking at business cases for 29 projects rather than at outcomes.²⁴⁴ As the United Kingdom Institute for Public Policy Research (IPPR) identified:²⁴⁵

We will not know the actual outcomes for many years – hence the headline number quoted by Arthur Andersen of a 17 per cent average efficiency gain is in danger of gaining a reputation for 'settling the issue once and for all' which it does not deserve.

Nonetheless, the Committee noted that this 17 per cent figure has often been referred to in Victoria. The Committee noted that notwithstanding the confidence of reports that value for money had been achieved, these analyses compared PFI signed contracts against PSC calculations rather than comparing performance with realistic

²⁴³ Department of Treasury and Finance, *Partnerships Victoria guidance Material, Practitioners' Guide*, June 2001, p.6

²⁴⁴ Arthur Andersen and Enterprise LSE, *Value for Money Drivers in the Private Finance Initiative*, a report commissioned by The Treasury Taskforce January 2000,

²⁴⁵ Institute of Public Policy Research, *Building Better Partnerships, The final report of the Commission on Public Private Partnerships*, 2001, pp.90–91.

The IPPR found that a significant shortcoming of the Arthur Andersen study is that the researchers were unable to break down the projected value for money savings by sector. The National Audit Office reports suggest that the PFI appears to be achieving significant efficiency gains in some prisons and road projects. However in two critical areas – schools and hospitals – the gains appeared marginal. Furthermore, the IPPR stated that the projected efficiency savings in the prisons PFI projects of around 10 per cent appear to result from two significant features: the prison PFI projects are 'full' design, build, finance and operate (DBFO) models where all of the operation and management of the public service is part of the contract. There is no separation out of ancillary and core services. This is in contrast to PPP projects in Victoria where the government has made a commitment to directly deliver core services such as correctional services; and the Prison Service is the sole purchaser and has built up expertise in contracting. Both of these key features are absent in education and in health in the UK. In these cases a very restricted model of DBFO is being used with the operating element encompassing only a narrow range of ancillary services such as maintenance, cleaning and occasionally IT

public sector benchmark projects. The veracity of such conclusions may be questionable and would be a useful piece of additional work.

The Committee recognises that providing accurate and reliable research results assessing value for money is a difficult task. Not surprisingly, there have been numerous findings on value for money. The IPPR states for instance that:

... the economic arguments for PPP and in particular for PFI have been confused from the start. Two rationales have been offered: one serious, one spurious. The potentially serious argument is that in the right circumstances PPPs can offer significant value for money gains and generate improvements in service quality. At the moment the evidence on value for money is variable across sectors, PFI seems to be offering significant gains in roads and prisons but not in hospitals and schools. The spurious argument is that using private finance to pay for capital investment allows government to undertake more projects than would otherwise be the case. All PFI projects are publicly funded and incur future liabilities for the Exchequer.

In their review of international experience, the working group on PPPs in Northern Ireland²⁴⁶ noted that PFI schemes in Scotland had reported estimated cost savings of 20 per cent for the provision of water infrastructure²⁴⁷ and 20 to 30 per cent in Ireland; the first four DBFO (design, build, finance and operate) road projects in England were quoted as experiencing overall savings estimates of 12 per cent;²⁴⁸ for health, the UK National Audit Office suggested smaller savings against the public sector comparator of less than 5 per cent or increased costs;²⁴⁹ savings estimates for education were less than 5 per cent; and for technology projects, mixed success was found. Again, these findings have been made against the PSC, which itself has been controversial.

The Northern Ireland Working Group commented that as well as anomalies within the PSC, there has been wide debate around several matters, including:²⁵⁰

- the discount rate, with higher discount rates favouring PPPs and lower ones favouring traditional procurement;
- the valuation of risk, with early work by Arthur Andersen and the London School of Economics Treasury Taskforce suggesting that 60 per cent of the savings attributed to PPP contracts come from the valuation of risk;

²⁴⁶ Office of the First Minister and the Deputy First Minister, (UK), *Review of Opportunities for Public Private Partnerships in Northern Ireland*, Working Group Report, 2002, see: www.ppp-ni.gov.uk/publications.htm, accessed 19 September 2006

²⁴⁷ Transport and the Environment Committee, Scottish Parliament, *Report on inquiry into Water and the Water Industry*, Vol. 1, 9th Report, 2001

²⁴⁸ National Audit Office, (UK) *Private Finance Initiative: The First Four Design, Build, Finance and Operate Roads Contracts*, January 1998

²⁴⁹ National Audit Office, (UK), *The PFI Contract for the New Dartford and Gravesham Hospital*, May 1999

²⁵⁰ Office of the First Minister and the Deputy First Minister, (UK), *Review of Opportunities for Public Private Partnerships in Northern Ireland*, Working Group Report, 2002, see: www.ppp-ni.gov.uk/publications.htm, accessed 19 September 2006

- transaction costs, where value for money comparisons do not normally take into consideration the high procurement or transaction costs associated with PPPs, and where (for some projects in health and education) these costs have been similar to the projected savings;
- the quality of service, where the temptation is to use the value for the money comparison as simply a pass/fail test;
- value for money versus affordability, where despite the United Kingdom Government's assurances that PPPs should only proceed where they deliver better value for money, evidence from organisations such as the IPPR suggest that some PPP programs are still driven by affordability constraints and the need to secure off-balance infrastructure rather than value for money;
- independent review, where given constraints on public spending, PPPs are perceived to be *'the only show in town'* and public sector comparators are developed to guarantee funding rather than as an independent review of viability; and
- value for money assessment being provisional, given the long term contractual nature of the infrastructure, making judgments at this early time weak.

Significantly, the Northern Ireland Working Group acknowledged the questionable nature of much of the evidence around, stating that:

In considering the potential benefits arising from public private partnerships, the Working Group recognised that there is still a widely acknowledged lack of hard, particularly quantitative, evidence. This problem was highlighted in the IPPR report last year and did present the Group with particular difficulty in arriving at definitive or absolute conclusions in this regard.

The Victorian experience of value for money in terms of *'on time'* project delivery, is similar to that in the United Kingdom. Mention was made of the on time performance of PFI projects against government procurement in chapter 4. The Committee noted that the evidence for on time project delivery was more available than the evidence for value for money.

The size of the competitive market in the UK and throughout Europe should not be underrated and should be taken into consideration when looking at the Australian context.

There is a paradox here in that privately financed infrastructure in Victoria is unlike the United Kingdom PFI schemes. And some evaluations and assessments of the United Kingdom experience are not applicable here, for example, the role of competition and the preference for negotiating with a single winning bidder based on early expressions of interest differ between the two. The relatively smaller and more recently developed market in Victoria compared with the United Kingdom's more

competitive market and experience would seem to be another important factor in interpreting value for money estimates.²⁵¹

The Department of Treasury and Finance did not quantify for the Committee the value for money results of projects in Victoria; neither relative nor absolute evaluations were presented. The 2004 Fitzgerald review examined the policy in detail by looking at the *Partnerships Victoria* guidance materials, the literature on PPPs, the process by which the first eight projects have been selected and evaluated, and relevant contractual documents. Because the report aimed to enhance the achievement of value for money outcomes for Victorians through application of the policy, it recommended that a significant realignment of the policy was needed and that the present concept of the PSC needed reform. It found that the weighted average saving was 9 per cent against the risk adjusted PSC using the then prevailing discount rate.²⁵² The Fitzgerald report fell short, however, of presenting clear practical financial comparisons between *Partnerships Victoria* projects and projects delivered through alternative traditional infrastructure provision methods.

7.4 Value for money in private investment in public infrastructure: the public sector comparator

The general notion of a public sector comparator (PSC), or a standard against which various options for providing public infrastructure can be tested, is a good, although theoretical, one. The PSC has been the subject of intense debate. A central issue in assessing value for money through the PSC is the actual basis against which privately financed projects are compared. Unfortunately the precise nature of both this traditional '*public delivery*' mechanism and the financial methodology used to characterise this delivery mechanism are unclear.

There is considerable guidance material available on constructing a PSC. The *Partnerships Victoria Guidance Material, Public Sector Comparator, Technical Note*, p.6) explained that the PSC is the hypothetical risk-adjusted cost of public delivery of the output specification of a *Partnerships Victoria* project. The *Partnerships Victoria* policy states that:²⁵³

The PSC is intended to reflect the costs and budgeting imposts of the project as if government were to deliver it. The reference project used as a basis for the PSC should be a real alternative, capable of public sector implementation.

²⁵¹ P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, January 2004, p.33 goes even further. After noting the high level of PFI investment and large number of projects undertaken so far in the UK, Fitzgerald states that 'It should not be assumed in an immature market such as Australia, that PPP outcomes will always be competitive'.

²⁵² P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, January 2004, p.17

²⁵³ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Practitioners' Guide*, June 2001, p.61

The *Public Sector Comparator Technical Note* guidelines further explain that the PSC ‘estimates the hypothetical risk-adjusted cost if a project were to be financed, owned and implemented by government ... and is based on the most efficient form and means of government delivery’.²⁵⁴ In theory, this is the true and full cost of government meeting the output specification according to the guidelines. In reality, however, it is a hypothetical calculation based on assumptions of risk transfer and on the principal of competitive neutrality, which removes any net competitive advantage government may have by virtue of its public ownership. The guidelines explain that: ‘in many cases, the public sector delivery method may involve a significant element of outsourcing or third party contractor involvement, including a variety of design and construct (for example, turnkey), operation and maintenance agreements’.²⁵⁵

In conducting a value for money assessment, factors other than the PSC are also taken into account, such as other bid evaluation criteria and costs and risks not included in the PSC or in bids.²⁵⁶ Some of the evaluation criteria in the project brief, for example, will take into account non-financial and non-quantifiable factors.²⁵⁷

The Committee noted that as well as the development of a PSC, *Partnerships Victoria* guidelines require major infrastructure projects to be subject to a full cost-benefit analysis to establish the economic viability of a project. In constructing the PSC, it is critical to be clear about both the basis for the calculation (since this is clearly a hypothetical case rather than actual payments made) and the physical alternative delivery option used, representing ‘the most efficient form and means of government delivery’. These most efficient forms involve the private sector delivering much of the project, and experience has shown that through the use of competition, the private sector play a key role in infrastructure delivery. It would not, presumably, involve the private sector financing (or part financing) the project and would usually involve a smaller, more traditional risk transfer than might be considered under *Partnerships Victoria*.

Government officials in Ireland briefed the Committee on the differences between processes under traditional delivery and under PPP arrangements.²⁵⁸ They explained that, for their jurisdiction, a competitive tendering process followed the preparation of contract documentation with both traditional procurement and PPPs, but that a range of differences existed for each of the project phases (identification, option appraisal, statutory process, procurement, construction, operation and review).

²⁵⁴ Department of Treasury and Finance, *Partnerships Victoria guidance Material, Public Sector Comparator, Technical Note*, June 2001, p.6

²⁵⁵ *ibid.*, p.8

²⁵⁶ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Practitioners Guide*, June 2001, p.63

²⁵⁷ *ibid.*, p.63

²⁵⁸ Department of the Environment and Local Government, *A policy framework for public private partnerships*, Ireland, November 2003, p.34.
see: www.ppp.gov.ie/, accessed 19 September 2006

In Victoria, it appears that the major differences between *Partnerships Victoria* model and the traditional public sector procurement model include:²⁵⁹

- the availability of initial private sector funding for the project;
- a long term (whole-of-life) contractual arrangement;
- output based specifications;
- different competitive tendering arrangements;
- the promise of transfer of risks over this period;
- payments begin once the asset is commissioned;
- private contractor responsible for construction time and cost overruns;
- state may or may not operate the facility;
- state manages one contract over the life of the facility;
- performance standards in place, payments may be abated if services not delivered to contractual requirement; and
- useful life and handover quality defined.

These differences also result in longer term implications for infrastructure delivery choices, and bigger financial flows to pay for longer term responsibilities and risks borne.

7.5 The discount rate

One important aspect of the PSC that has proven to be contentious is the discount rate and this was raised in the report of the Review of Partnerships Victoria Provided Infrastructure. This matter is also discussed in chapter 3.²⁶⁰

The discount rate is defined in the *Partnerships Victoria* documentation as the rate used to calculate the present value of future cash flows. The rate is usually determined on the basis of the cost of capital used to fund the investment from which the cash flow is expected. This use of a discount rate is a standard part of financial evaluation for any capital public infrastructure project, and reflects the fact that amounts paid out immediately are worth more than the same amounts paid at a later time. The IPPR in the United Kingdom indicated that:²⁶¹

²⁵⁹ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Overview, July 2006*, p.5

²⁶⁰ P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, January 2004, p.26

²⁶¹ Institute for Public Policy Research, *Building Better Partnerships, The final report from the Commission on Public Private Partnerships*, 2001, p.86

A payment made later effectively costs less so these future payments have to be discounted, using the Treasury's long established six per cent real pre tax discount rate. A considerable debate has raged over whether this rate is appropriate and the conventional financing route (other things equal); a higher discount rate would favour the PFI. Some economists argue for a higher rate and some for a lower rate and some for using different discount rates for different projects. It should be noted that the private sector tends to use similar 'rough and ready' rules of thumb as the Treasurer's six per cent rate.

The IPPR recommended in 2001 that consideration should be given to reducing the discount rate used by Treasury in the United Kingdom from 6 to 5 per cent. Two years later, the United Kingdom Treasury compared the costs of finance to the private sector and government, and commented that:²⁶²

A great part of the difference between the cost of public and private finance is caused by a different approach to evaluating risk. Typically, the private sector takes account of risk by discounting future cash flow at a higher rate ... The gilt rate on the other hand does not make any attempt to calculate risks.

The United Kingdom Treasury noted that the expected value of all risks in options should be discounted in future years at 3.5 per cent per year to present value. This would reflect society's preference for consumption now over consumption in the future, rather than discounting the value of expected future cash flows at a higher rate to make a compensation for risk.²⁶³ This central point was picked up in the Fitzgerald review:²⁶⁴

The practice of evaluating tenders by discounting the minimum contract payment schedule by a CAPM based discount rate (for example, 6 per cent real or 8.65 per cent nominal) be discontinued. In its place the discounting function presently undertaken would be unbundled into two components – a risk adjustment of estimated costs and an adjustment for the time value of money to be expended. The risk adjustments (including for optimism bias and for potential contractual default or revision) would be treated as additional costs to the Public Sector Comparator and, where appropriate, to the contractual payment stream. The evaluation of tenders would discount the contract payment stream at a discount rate that reflects the time value of money, based on an estimate of the risk free rate such as the Commonwealth Bond Rate that best matches the term of the project – for example, 5.7 per cent nominal for 12 year bonds, or 3.5 per cent real. This rate would not be dissimilar to the discount rate

²⁶² HM Treasury (UK), *PFI: Meeting the Investment Challenge*, 2003 July

²⁶³ The Report cites The Green Book (2003)

²⁶⁴ P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, January 2004, p.2

presently used in these circumstance[s] by the UK Government (3.5 per cent real) based on its calculation of the Social Time Preference Rate (STPR) (UK Green Book 2003, Annexe 6).

The government did not support these recommendations made by Fitzgerald and the *Partnerships Victoria Guidance Material, Public Sector Comparator, Technical Note* suggests for example purposes that a real pre tax discount rate of 6 per cent will be applied.²⁶⁵ Although the real discount rate ranges from 5 to 8 per cent, depending on the type of project, and risk margins.²⁶⁶

Consistent with this, an Australian academic submitted to the Committee that:²⁶⁷

The central principle on which the Partnerships Victoria approach is allocated is that, as far as possible, risks should be explicitly identified and then allocated to the party best able to manage them. This principle is not applied, however, in the selection of discount rates in the evaluation of the public sector comparator.

If all risks have been identified and taken into account, the appropriate procedure for the evaluation of costs and benefits is to compute the present value using a riskless discount rate such as the rate of interest on government bonds, implying a real rate of discount of 3 to 4 per cent.

By contrast, the evaluation procedure proposed by the Partnerships Victoria documents calls for a real rate of discount of around 6 per cent. For a long lived project with returns that are stable in real terms, the effect of using a 6 per cent rather than a 3 per cent real rate of discount is to reduce the present value of benefits by about half.

7.6 Assessing value for money

7.6.1 Assessing the value for money test

A number of commentators have raised concerns relating to the value for money concept in the *Partnerships Victoria* policy. Some commentators have argued that the Victorian PSC is biased in favour of the private sector partnership path.²⁶⁸ The *Partnerships Victoria* overview documentation states that there is no presumption that

²⁶⁵ Department of Treasury and Finance *Partnerships Victoria, Guidance Material, Public Sector Comparator, Technical Note*, June 2001, p.16

²⁶⁶ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Use of Discount Rates in the Partnerships Victoria Process, Technical Note*, July 2003, p.18

²⁶⁷ Professor J Quiggin, submission no.25, p.36

²⁶⁸ For example, Dr D Hayward, as cited in R Millar, 'Preserving the myth of public inefficiency', *The Age* newspaper, 6 August 2001; K Davidson

in providing new public infrastructure and related ancillary services, the private sector is more efficient than the public sector.²⁶⁹

Some commentators have, however, been concerned that the comparator contains assumptions that in effect mean the public sector can never be as efficient as the private sector.²⁷⁰ One concern, for instance, is that the Victorian PPP guidelines mirror the United Kingdom's but disadvantage the public sector through the use of hypothetical adjustments made for matters of 'competitive neutrality'. Under the policy, such competitive neutrality adjustments remove any net advantages (or disadvantages) that accrue to a government business by virtue of being owned by government, and higher than real world costs are calculated. In commenting on a bias in favour of the private sector, one journalist stated:²⁷¹

... through the comparator process, the government strips the public sector of its natural advantages over the private sector. Governments do not have to pay taxes including land and payroll tax, stamp duty and local government rates ... and, importantly, governments can borrow money at a lower interest rate than the private sector. In the PPP value for money test, these advantages are ruled unfair. So an assortment of costs are added to the public sector's case to achieve 'competitive neutrality' with the private bids. The comparator, therefore, will always be greater than the real world cost of the public sector delivery of the project.

If the roles were reversed, the private sector would not be expected to remove its competitive advantage.

In contrast, both the New South Wales and Victorian Secretaries to Treasury have argued that government access to cheaper finance is a myth. A government's ability to borrow more cheaply is purely a function of its capacity to repay borrowings.²⁷²

As documented previously in this report, the Committee considers that there is a need to evaluate both the overall worth of projects (using a cost-benefit ratio) and the relative merit of privately financed infrastructure (through instruments such as the PSC) in a rigorous and neutral manner. It also noted that the higher cost of capital to the private sector was more a reflection of how it implicitly included project riskiness in its capital project assessments, and how the risk of government defaulting on its debt repayments was effectively zero.

²⁶⁹ Department of Treasury and Finance, *Partnerships Victoria Guidance Material Overview*, 2006, p.4

²⁷⁰ For example, Dr D Hayward, as cited in R Millar, 'Preserving the myth of public inefficiency', *The Age* newspaper, 6 August 2001

²⁷¹ R Millar, 'Preserving the myth of public inefficiency', *The Age* newspaper, 6 August 2001

²⁷² J Pierce and I Little, *Private provision of public infrastructure and services*, presentation to the Australian Council for Infrastructure Development (AusCID) luncheon, April 2002

The Committee is of the view that expert advice should be sought on the appropriate level and use of discount rates in future infrastructure projects because of its vital significance for project evaluation.

There are different methodologies and current practices should be periodically reviewed. One case worthy of examination is the consequences of the changes made to the public sector comparator in the United Kingdom, specifically:²⁷³

- the new discount rate of 3.5 per cent should be based solely on the social time preference rate;
- separate adjustments should now be applied to appraise all calculations for optimism bias and tax;
- appraisal should be conducted with rigour appropriate to the scale of the expenditure involved and the decision making stage that has been reached; and
- greater consideration should be given to the wider impact of proposals across society.

The Fitzgerald report also recommended that the PSC be reformed and acknowledged it as one factor in procurement decisions and conclusions as to value for money:²⁷⁴

The use of the PSC should be discontinued in circumstances where public provision has not been done in the past and is not a reasonable option going forward. In such circumstances the analytic comparison should be against a reference case or a range of benchmarks.

The Committee received evidence from a number of witnesses overseas that although quantitative techniques are used in value for money assessment and accounting decisions, the numbers are in reality, 'soft', with much depending on professional judgment on matters such as the differential risk of construction cost overruns and the robustness of risk transfer to the private sector. In other words, the PSC estimation process is subject to huge uncertainties, and essentially based on multiple judgement calls.

A further issue is that the PSC technique is subjective. This is in part due to the complexity and the professional nature of estimation procedures and also partly due to design. The Committee noted guidance in the *Public Sector Comparator, Technical Note* that probability valuation techniques can be used to analyse risk outcomes in the PSC, along with sensitivity analyses on cash flow and other assumptions. The PSC appears, therefore, to be a range of values rather than one robust figure characterising the project if government were to fund it. It was unclear to the Committee how this range was compared in the end with *Partnerships Victoria* financing bids.

²⁷³ HM Treasury (UK), *PFI: Meeting the Investment Challenge*, July 2003, p.81

²⁷⁴ P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, January 2004, p.31

The PSC process and subsequent decision making lacks transparency.

The Department of Treasury and Finance has advised the Committee that in Victoria, the value for money test will be applied to all *Partnerships Victoria* projects:

*There is an overriding view that all [infrastructure] projects should be considered as Partnerships Victoria partnerships, and therefore both [the public interest and value for money] tests would apply.*²⁷⁵

*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.*²⁷⁶

The practice of committing funds to the traditional delivery option prior to the receipt of bids may help avoid the problems and issues that have arisen in the United Kingdom, where PFIs have been labelled as the only option.

In Victoria, funds are committed in the budget prior to calling for expressions of interest in a PPP project.

Also relevant to the philosophy of value for money is the sense that a fair comparison is made using the PSC tool and that it is neutral in its application. The Committee was advised that the government was selective about the use of the *Partnerships Victoria* method of delivery, and that there were four instances where the policy was considered but not used. Where public private partnerships were not used, nor were traditional funding arrangements.²⁷⁷ The Committee observed that in two of these instances, no project subsequently proceeded; in another, it was easier to fund the works under existing long term lease arrangements; and in the last instance, there was insufficient market interest at the time of bids.

7.6.2 Assessing value for money results

Various submissions to the inquiry from the private sector have indicated support for the current 'value for money' approach and the PSC framework.²⁷⁸ Some of the companies that made submissions to the inquiry had also worked closely with the Department of Treasury and Finance in developing the *Public Sector Comparator Technical Note* document and were keen to see the framework applied.

²⁷⁵ Mr J Fitzgerald, Director, Commercial and Infrastructure Projects, Department of Treasury and Finance, transcript of evidence, p.8

²⁷⁶ Mr G Maguire, Assistant Director, Commercial Division, Department of Treasury and Finance, transcript of evidence, p.10

²⁷⁷ Department of Treasury and Finance, submission no.36, pp.3–4

²⁷⁸ For example, Deutsche Bank AG, submission no.19, p.4

The Australian Council for Infrastructure Development (AusCID) supported the view that in most cases the government should make the PSC, or aspects of it, available to bidders, because this would indicate to bidders the type of solutions the government is seeking and affirm that the government is committed to delivering the project if the PSC is bettered.²⁷⁹ The Queensland Government has recently announced that it intends to release a broad outline of the comparator to prospective tenderers.

Support for the current approach adopted in Victoria has been bolstered by other submissions. A submission by a Director of PricewaterhouseCoopers, which outlined a number of common ‘*misconceptions*’ regarding PPP projects, for example, argued that:²⁸⁰

- concerns over governments being locked into long term contracts was misplaced, because investments in infrastructure have always inherently involved making long term spending decisions;
- PPPs need not reduce government flexibility to change its requirements in response to policy needs, with contract ‘*flexibility*’;
- PPPs can deliver value for money in spite of the private sector’s greater cost of funds; and
- PPP contracts are not traditional adversarial contracts, but create a long term relationship based on aligned objectives between parties.

According to the IPPR (in the United Kingdom), there has been pressure on government agencies to opt for private investment. And in many cases, the cost of private bids has been very close to the comparator.²⁸¹ But, in nearly all of these cases, the private project has gone ahead. According to an article in *The Age*, the United Kingdom Treasury reportedly treats PPP projects more favourably than traditional projects, offering revenue support for a PPP project to go ahead. If the public authority chooses the traditional option, the same revenue support is not made available, therefore the PPP process in the United Kingdom is not being driven by value for money alone. There have also been some instances where a PSC has not been constructed in the United Kingdom (for example, in relation to the National Air Traffic System) and instances where the PSC had been manufactured to ensure a pre-determined answer was reached.

The Public Accounts Committee and National Audit Office in the United Kingdom have reported extensively on the mixed results of PFI projects including the PSC and value of money components and their application. They have raised a number of issues about inaccuracies associated with the comparator. The Committee is aware that the risk adjusted PSC is no longer being used in the United Kingdom, and the initial value for money decision is now based on a qualitative assessment that gives a

²⁷⁹ Australian Council for Infrastructure Development (AusCID), submission no.18, p.21

²⁸⁰ Mr D Grimsey, Director, PricewaterhouseCoopers, (seconded to the Office of the Victorian Treasurer) *Partnerships Victoria* Seminar Series, 5 June 2002, Melbourne University Private

²⁸¹ R Millar, ‘Preserving the myth of public inefficiency’, *The Age* newspaper, 6 August 2001

greater emphasis on assessing the likely value for money of PFI based on evidence from past projects.²⁸²

Judging whether value for money is being achieved through private financing of public infrastructure is difficult due to the lack of independent evaluation work undertaken to date in both the United Kingdom and in Australia. The Committee concurs with the view of Fitzgerald and other commentators²⁸³ that this needs to be addressed.

While even a short search will produce literally thousands of pages written on PPPs, there is a surprising shortage of what we might call objective research on the topic or independent evaluations of the successes and failures. Most of what is available comes from firms which earn their incomes from P3s or government agencies charged with promoting and implementing such projects. While some of this is enormously helpful, there can be no doubt that independent analyses of the strengths and weaknesses of PPPs are warranted.

HM Treasury (United Kingdom) found in its review in early 2006 that 70 per cent of non-PFI projects were delivered late compared with only 20 per cent of PFI projects; and 73 per cent of non-PFI contracts were over budget compared with 20 per cent of PFI projects (and these were due to the public sector changing its specifications).²⁸⁴ This was not the case for small information technology projects, however, where the bid costs and the inflexibility provided for in the contracts meant that they were not suitable as PFI projects.

Evidence from overseas witnesses suggested that the financial incentives provided through the contracts strongly encouraged the provision of on time infrastructure works.

The Victorian Auditor-General advised the Committee that the adequacy of the cost-benefit analysis and the public interest assessments, the development of the PSC, and appropriate risk allocations are key determinants of the outcomes ultimately received by the state from PPPs. Furthermore, based on discussions with counterparts in the United Kingdom, the Victorian Auditor-General made the following observations regarding the applications of PSCs:²⁸⁵

- the 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 be used to drive better value from private sector bids, by focusing on individual elements of bids that could be improved;

²⁸² HM Treasury (UK), *PFI: Strengthening long term partnerships*, p.35

²⁸³ J E de Bettignies and T W Ross, *The Economics of Public-Private Partnerships*, draft report, Vancouver: Sauder School of Business, University of British Columbia, 2003

²⁸⁴ H M Treasury (UK), *PFI Strengthening long term relationships*, 2006, p.16

²⁸⁵ Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.7

- data and assumptions incorporated into the comparator analysis are subject to substantial uncertainties and volatility, and care needs to be taken when assessing the results from the comparator;
- a single comparator 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, the results of the analysis.

The Auditor-General also noted the importance of the decision to proceed with a PPP being driven by value for money considerations and not by whether the arrangement will be recognised ‘*off-balance sheet*’.

A further issue in assessing overall value for money to the public is the question of high bidding costs with private financing projects. Allen looked at the tender costs as a proportion of project costs for both PFI and traditional projects.²⁸⁶ He noted that PFI tendering costs in the United Kingdom are far greater than the average tendering costs of other procurement methods, no matter what the project size, varying from a factor of three to ten times greater. For works schemes to be sustainable and cost effective in an economic sense, these higher transaction costs would need to be fully recouped.

7.6.3 Size of project investment

A further item of policy concern is the size of the project investment above which PPP projects should be considered.

The Secretary of Department of Treasury and Finance advised the Committee that some screening projects for development under the *Partnerships Victoria* policy are conducted:²⁸⁷

... there is a bit of a judgment call here. You do not wish the private sector to be bidding on projects where clearly they may not be able to beat the public sector comparator. Treasury looks at all those capital projects and picks the ones where it thinks the case is the strongest for private sector adding value and that justifies the substantial private sector investment by many parties, not just the winning bidder, to invest resources to put a business case to the government. Treasury uses some discretion when advising the Treasurer not to put forward those projects where there is a doubt that the private sector could add value, and by putting the private sector to that trouble you waste their time and money basically.

²⁸⁶ G Allen, *The Private Finance Initiative (PFI)*, Research Paper, House of Commons Library UK, p.33

²⁸⁷ Mr I Little Secretary, Department of Treasury and Finance, *Inquiry into 2002-03 Budget Estimates*, transcript of evidence, p.55

Thiess²⁸⁸ and Deutsche Bank²⁸⁹ have advised the Committee that in their view, projects should (on an individual or bundled basis) be worth a minimum of \$100 million, not \$10 million, to qualify for consideration under the *Partnerships Victoria* policy, due to the high costs associated with tendering for PPP projects.

The Committee also noted the recommendation of the Fitzgerald report that *Partnerships Victoria* projects be refocused towards projects greater than \$100 million, and those with complex, one-off or non-standard requirements.²⁹⁰ Fitzgerald's recommendation was in line with the \$50 million (Australian equivalent) level put forward by the HM Treasury (United Kingdom) when it stated:²⁹¹

The overall implication of this research into individually procured small [less than £20 million] PFI projects is that, although PFI continues to perform well in these schemes, its transaction and development costs and procurement times are disproportionately large. These factors make it difficult for small PFI schemes to consistently attain value for money unless projects can be bundled together.

While the government indicated it accepted this recommendation, the Committee noted the *Partnerships Victoria* policy has not been amended. The PPP pipeline for Victoria also indicates that it will proceed with smaller projects that are of a unique nature.

7.6.4 Size of PPP market

A further critical issue noted by Fitzgerald was the question of assumed competition and value for money. In noting recent United Kingdom research by PricewaterhouseCoopers and HM Treasury, Fitzgerald pointed out the challenges facing the Australian market.²⁹²

Given the size of the UK market, the level of investment in PPPs (£34 billion) and the number of projects so far undertaken (over 450 to date), a finding that outcomes are not as competitive as one might expect is quite significant. It should not be assumed in an immature market such as Australia, that PPP outcomes will always be competitive.

The problem of achieving a competitive bidding field is exacerbated by the make up of the Australian construction market, which is characterised by a small number of large contractors with the financial and technical capability to undertake large and complex projects. This concentration has been increasing in recent times with the

²⁸⁸ Thiess Pty Ltd, submission no.32, p.8

²⁸⁹ Deutsche Bank AG, submission no.19, p.6

²⁹⁰ P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, January 2004, Appendix A

²⁹¹ HM Treasury (UK), 2003, p.54

²⁹² P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, January 2004, p.33

acquisition of major construction companies John Holland and Thiess by Leighton Contractors (exhibit 7.1). The lack of depth in the market was also highlighted by the EastLink project, where the two competing consortia saw the Leighton companies competing against each other.²⁹³

Exhibit 7.1: PPP projects in Victoria – Successful consortia partners

Equity investor or financier	Lean contractor
ABN Amro (1) (5) (8)	Leighton Contractors (1)
Babcock & Brown (2)	Multiplex Constructions (2) (3) (5) (8)
Deutsche Bank (3)	Baulderstone Hornibrook (4) (6)
Bilfinger Berger BOT GmbH (4) (6)	Thiess and John Holland (TJH)* (7)
Macquarie Bank (4) (7)	
ANZ (4)	
NM Rothschild & Sons (Aust) Ltd (5)	
Bank of Scotland (6)	

Notes: * John Holland and Thiess are now wholly or part-owned subsidiaries of Leighton Holdings

- (1) Southern Cross Station
- (2) Showgrounds
- (3) Convention Centre
- (4) Royal Women's Hospital
- (5) County Court
- (6) Victorian Correctional facility
- (7) EastLink
- (8) Casey Community Hospital

Source: Partnerships Victoria, Projects, www.partnerships.vic.gov.au, accessed 30 September 2006

In addition, consortia short listed to provide proposals for the development of the new \$850 million Royal Children's Hospital include.²⁹⁴

- Children's Health Partnership – Babcock & Brown, Bovis Lend Lease and Spotless Services;
- Kids's Health Partnership, Bilfinger Berger BOT, Baulderstone Hornibrook, United Group Services, ISS Facility Services and Macquarie Bank; and
- Plenary Health, Plenary Group, Multiplex, Deutsche Bank, Honeywell and Medirest.

²⁹³ Standard & Poor's, *Infrastructure & Public finance ratings Public Private Partnerships – Global Credit Survey*, 2005, p.37

²⁹⁴ Hon. B Pike, MP, Minister for Health, *Pike announces children's hospital shortlist*, media release, 31 July 2006

The Committee took evidence from many witnesses overseas who emphasised that a considerable degree of competitive tension was needed in the bidding process to ensure the private sector provides its most efficient bids. If the depth of competition is not available, however, a PPP project should not proceed.²⁹⁵

In view of this, the Committee concurs with Fitzgerald's recommendation that the state should not assume that the present structure and size of the Australian PPP market is diverse and active enough to be fully competitive. This should be taken into account in the valuation of tenders, and the state should explicitly retain the right to declare a potential outcome as '*not value for money*'.²⁹⁶

The issue of '*bundling*' also deserves further consideration. If a bundling level of \$100 million was recommended, and private funding was (after independent evaluation) determined to be a truly cost effective option against traditional public funding arrangements, this would lead to positive economic flow ons for the state. If, however, private funding on closer examination was a less cost effective option compared with traditional arrangements, the bundling of many smaller projects into this \$100 million level would, in fact, simply magnify the state's potential exposure to higher repayment levels to the private finance sector.

7.7 Refinancing of PPPs

Another issue brought to the Committee's attention is that private sector parties might make additional gains from refinancing after the contract has been entered into. The Committee was briefed by officers from the United Kingdom Treasury about the considerable adverse publicity that arose from what had appeared to be huge '*windfall gains*' for private sector parties after they refinanced.

The officers advised the Committee that it is now a requirement in the United Kingdom that any refinancing gains are equally shared between the public and private sectors. And in relation to existing PFIs deals, the private sector has agreed to provide the government with 30 per cent of any debt refinancing gains.

A recent report from the UK National Audit Office identified:²⁹⁷

- debt refinancing gains (to February 2006 from PFIs) for the UK government of £137 million (GBP);
- there is now an emerging secondary equity market in PFI shares;
- refinancing provides scope for significantly increasing the investor's internal rate of return;

²⁹⁵ For example, Partnerships UK; UK Audit Commission; Flemish Expertise Centre PPP

²⁹⁶ P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, January 2004, p.33

²⁹⁷ National Audit Office, (UK), *Update on PFI debt refinancing and the PFI equity market*, 21 March 2006, pp.3–6

- certain situations are exempt from gain sharing arrangements, including corporately financed projects, projects where the base case IRR (internal rate of return assumed in the bid) has not been achieved and projects where the contractors bears the risk of increased interest rates following financial close.

The Committee understands that for two of the major Victorian projects (County Court and the Spencer Street Station redevelopment) the sponsor (ABN Amro) sold its majority interest at a profit within 18 months of signing the deal. In relation to the redevelopment of Spencer Street Station this represented a profit of \$50 million. Lessons learnt from this resulted in the next public private partnerships project, EastLink, having refinancing built in to the contract.

The Committee acknowledges that the guidance material for Standard Commercial Principles provides:²⁹⁸

- *all re-financings other than those contemplated at financial close will require government consent; and*
- *any re-financing gain is to be shared between government and the private party on a 50:50 basis provided the projected equity at the time of the re-financing (taking into account any re-financing) is above that reflected in the original base case financial model.*

7.8 Transaction costs

An issue raised by many witnesses and in submissions to the inquiry concerned the high cost of organising bids for PPP projects. This is not a situation unique to Victoria, occurring in most other jurisdictions.

It was pointed out to the Committee that PPP tendering costs are far greater than the average tender costs of other procurement methods, and this remains true no matter what the project size.

One reason for the higher cost of tendering for PPP projects is that the time taken between offering the project to the public sector and the final signing of the deal can be protracted, especially for particularly intricate and technical projects. The average time taken to complete PPP deals ranges from 11.5 months to 20.5 months (exhibit 7.2).

²⁹⁸ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Standard Commercial Principles*, July 2005, p.121

Exhibit 7.2: Various PPP projects – procurement periods

Project	Expressions of interest	Signing of contract (financial close)	Time (months)
Royal Women’s Hospital	6 November 2003 ²⁹⁹	11 April 2005 ³⁰⁰	17
Convention Centre	5 October 2004 ³⁰¹	10 March 2006	17
EastLink	1 May 2003 ³⁰²	14 October 2004 ³⁰³	17
Showgrounds	Announced 2 October 2003 ³⁰⁴	22 June 2005 ³⁰⁵	20.5
Southern Cross Station	19 July 2001 ³⁰⁶	2 July 2002 ³⁰⁷	11.5

Private consortia tendering for PPPs expend significant amounts of money developing project proposals, tendering for the project, and negotiating the complex legal and financial structures for the project.

The successful consortium for the CityLink project spent \$28 million tendering for the project to financial close. Tendering for the EastLink project is claimed to have cost \$30 million.³⁰⁸ This is not unusual as was highlighted by a Baulderstone Hornibrook director, who told the Committee that in tendering for the New South Wales schools project:³⁰⁹

We made an estimate of our proposal for the schools project – [it consists of] somewhere between 3,600 and 4,000 pages, and every word and every clause has to be consistent and linked and integrated – and it is a challenge. We are spending heaps of money, our competitor is spending heaps of money, and the Department of Education is spending heaps of money.

He also indicated that the high transaction costs discouraged some companies from submitting tenders. They were also a factor in increasing the required rate of return sought by companies on PPP projects, as they seek to recover the expenditure lost with unsuccessful tenders.³¹⁰

²⁹⁹ Department of Human Services, Royal Women’s Hospital Redevelopment Project, www.tenders.vic.gov.au, accessed 2 October 2006

³⁰⁰ Department of Treasury and Finance, *Financial Report for the State of Victoria 2004-05*, p.212

³⁰¹ Department of Infrastructure, Melbourne Convention Centre Development Project, www.tenders.vic.gov.au, accessed 2 October 2006

³⁰² Conversation, SEITA, Mr Michel De Vries, 25 July 2006

³⁰³ Department of Treasury and Finance, *Financial Report for the State of Victoria 2004-05*, p.212

³⁰⁴ Hon. R Cameron, MP, Minister for Agriculture, media release, ‘Roll up, Roll up – Bids called for Showgrounds upgrade’, 2 October 2003

³⁰⁵ Department of Treasury and Finance, *Financial Report for the State of Victoria 2004-05*, p.212

³⁰⁶ Conversation, Mr Tony Canavan, Spencer Street Station Authority, 25 July 2006

³⁰⁷ Department of Treasury and Finance, *Financial Report for the State of Victoria, 2002-03*, p.179

³⁰⁸ A Keenan, ‘Call to streamline tender bids’, *The Age* newspaper, 3 November 2004, p.9

³⁰⁹ Mr R Opiat, Director, Business Development, Baulderstone Hornibrook, transcript of evidence, p.183

³¹⁰ *ibid.*

The Committee is aware that government also incurs significant ongoing service monitoring and contract management costs. These high transaction costs mean that the PPP model will rarely be appropriate for small projects.

To ensure a unified approach to risk transfer and to reduce procurement times and costs, the United Kingdom Government is using standardised contract documentation.³¹¹

The Committee understands that most state governments are moving towards consistent tendering and contract negotiation procedures in an attempt to reduce transaction costs.

The Department of Treasury and Finance has also sought comments from major industry groups about possible actions to reduce transaction costs. This is discussed in further detail in Chapter 4.

The Committee recommends that:

Recommendation 16: **The Victorian Auditor-General periodically undertake performance audits of all major public private partnership projects to determine whether value for money is being maintained over the life of a project.**

Recommendation 17: **The value for money tools used for *Partnerships Victoria* assessment be revised to include:**

- (a) benchmarked comparisons where these are possible;**
- (b) a full range of alternative funding options (including public sector funding through the budget);**
- (c) an indication of the accuracy of the public sector comparator;**
- (d) a precise definition of the traditional public sector alternative option under consideration; and**
- (e) a publicly available explanation of how the public sector comparator is used to compare tender bids.**

³¹¹ HM Treasury (UK), *PFI: Strengthening long term partnerships*, March 2006, p.4

Recommendation 18: An independent assessment be made of the relative cost performance, efficiency and timeliness of all privately funded projects, similar to the Mott MacDonald (United Kingdom) report.

Recommendation 19: The Victorian Government make representations to the National PPP Council to arrange for an independent study into the size, structure and competitiveness of the Australian public private partnership market to determine the degree to which its diversity is sufficient to be fully competitive.

CHAPTER 8: RISK

Key findings of the Committee:

- 8.1 The complexity and sophistication of the arrangements and methods of allocating risk underpinning public private partnership (PPP) projects, has increased, over the past decade.
- 8.2 A large part of the value of PPPs rests with the ability of the government to transfer appropriate risks to the private sector at a reasonable cost.
- 8.3 *Partnerships Victoria* is predicated on the idea that the Victorian Government contracts for the provision of services rather than simply for the procurement of infrastructure.
- 8.4 *Partnerships Victoria* documentation provides guidance on ten types of risk and outlines the government's preferred position on each risk category.
- 8.5 PPP projects involve the allocation of substantially more risk to the private sector than traditional procurement.
- 8.6 Several risks are not included in the *Partnerships Victoria* guidelines, such as public safety risks, public consumer risks, environmental risks, consultation risks, transparency risks, political risks and public confidence risks.
- 8.7 Optimal risk allocation seeks to minimise both project costs and the risks to the project by allocating risks to the party in the best position to control them. The value of risks transferred is estimated and included in the public sector comparator (PSC).
- 8.8 *Partnerships Victoria* guidance material on risks is detailed. It constitutes a professional 'how-to' manual for staff, and it appears to be generally consistent with many of the long-standing principles of valuation of risk.
- 8.10 Due to the complexity of PPP arrangements, the government and consortia have high transaction costs.
- 8.11 Aligning the payment mechanism with the agreed risk allocation and the achievement of government objectives is of particular importance.

- 8.12** Some real-world risks exist that are not typically the subject of negotiation between government and private infrastructure providers. The government has to stand behind key PPP projects because it cannot allow them to fail.
- 8.13** The degree to which initial expectations of large savings from contracts differ from experience over the long term operation of the project can result in some large risks going unrecognised.
- 8.14** The valuation of risks is an area fraught with uncertainty. *Partnerships Victoria* guidelines noted that there is, in fact, a profitable market in risks, with private parties keen to assume risks for which government pays a high price relative to the likelihood or consequences of these risks materialising.

The seventh inquiry term of reference required the Committee to assess the framework for risk allocation between the public and private sectors and its application, with particular emphasis on how well risk is assessed, allocated and managed. *Partnerships Victoria* guidance material on risk allocation and contractual issues states:³¹²

Risk is the chance of an event occurring which would cause actual project circumstances to differ from those assumed when forecasting project benefit and costs. It is at the core of project profitability (for the private party) and efficiency (in delivering public sector objectives). Because management of risks holds the key to project success or failure, projects are about risks, about their evaluation and their subsequent acceptance or avoidance.

8.1 Introduction

8.1.1 Risk concepts

A large part of the value of public private partnerships (PPPs) rests with the ability of government to transfer appropriate risks to the private sector. This chapter defines risks, briefly presents the *Partnerships Victoria* policy on risks, comments on how risks are assessed, allocated and managed and assesses the *Partnerships Victoria* framework.

³¹² Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Risk Allocation and Contractual Issues*, June 2001, p.16

Risk is defined in the Australian Standard for Risk Management as follows:³¹³

Risk arises out of uncertainty. It is the exposure to the possibility of such things as economic or financial loss or gain, physical damage, injury or delay, as a consequence of pursuing or not pursuing a particular course of action. The concept of risk has two elements, the likelihood of something happening and the consequences if it happens.

The early work of Dr R Arndt for the Department of Treasury and Finance included the perspectives of the infrastructure industry.³¹⁴ At this time the industry believed that the government had a stronger bargaining position in tender processes and used its bargaining power to transfer excessive risk to the private sector. According to the industry, this risk transfer was not fully priced because of competitive pressures.

The infrastructure industry was also uneasy about entering into contracts with government when government also had the role of umpire and could change rules during the life of the contract. It also revealed concerns that negotiations were sometimes unnecessarily lengthy, that government did not appreciate the costs imposed on bidders by late release of documentation by government, and that there was little sophisticated numerical analysis in risk assessment.

The real determinant of a private investment in infrastructure policy is not how the contract looks initially, but:

- how the parties perform in practice;
- the services delivered;
- the risks borne; and
- the costs of actually bearing risks.

To determine the relative success of the private investment strategy, therefore, the whole lifecycle of contract agreement, monitoring, resolution or negotiation of any disputes or shortfalls, through to the renewal of contract arrangements, need to be acknowledged and measured.

8.2 Partnerships Victoria policy and risk allocation framework

The *Partnerships Victoria* policy is predicated on the idea that the government wishes to contract for the provision of services rather than simply for the procurement of infrastructure. In contracting for the long term provision of these services, the contract

³¹³ MAB/MIAC, Report No.22, *Guidelines for Managing Risk in the Australian Public Service*, October, AGPS, Canberra, 1996, p.10. The APS Guidelines are based on the Australian/New Zealand Standard for Risk Management (AS/NZS4360:1995)

³¹⁴ Dr R Arndt, *Private provision of public infrastructure: Risk identification and allocation project, survey report*, collaborative project, Department of Treasury and Finance, 1999, p 48

process encompasses both the provision of the initial financial support and the provision of infrastructure. Dealing with risks is a major part of this process.

The Department of Treasury and Finance explained that the government's approach to risks provided a central foundation to the *Partnerships Victoria* policy:³¹⁵

A cornerstone (of the policy) is the allocation of risk away from government in that government purchases services on behalf of the community rather than risk laden assets.

The idea is that 'government frees itself from asset based risks (including design, construction, operating and residual value risk), and becomes a service recipient. Government does not pay if the service is not delivered and payments are reduced if services do not meet the specified standards'.³¹⁶ The broad philosophy is to move risks away from government through the *Partnerships Victoria* mechanism. There is still an overriding requirement to achieve value for money through these contracts. Government may choose to self insure and bear some risks itself, or it may choose to pay a private party to bear risks. On this matter, the department's guidelines note that in practice, 'this means that government may agree to assume some risks which the private party is less well placed to manage (and consequently would charge a higher price to assume)'. These guidelines further explain that:³¹⁷

... all project risk is initially allocated to the private party. It is then a matter for government to determine, on a value for money basis and having regard to the cooperative framework of the partnership, what risks it should 'take back' to achieve an optimal risk position. The outcome of this analysis is indicated in the document calling for expressions of interest and reflected more comprehensively in the contract released with the project brief.

8.2.1 Types of risk

The *Partnerships Victoria* documentation provides guidance on ten types of risk and outlines the government's preferred position on each risk category (exhibit 8.1).

³¹⁵ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Overview*, July 2006

³¹⁶ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Risk Allocation and Contractual Issues*, June 2001, p.8

³¹⁷ *ibid.*

Exhibit 8.1: Risks identified in Partnerships Victoria policy

Risk	Explanation
Site risks	Existing structure (inadequacy), site conditions, approvals, environmental clean-up and rehabilitation (contamination, pollution), native title, cultural heritage and availability of site
Design, construction and commissioning risk	Design, construction, commissioning
Sponsor and financial risk	Interest rates pre-completion, sponsor risk, financing unavailable, further finance, change in ownership, refinancing benefit, tax changes
Operating risk	Inputs, maintenance and refurbishment, changes in output specification outside agreed specification range, operator failure, technical obsolescence or innovation, general market downturn, competition, demographic change, inflation
Market risk	General economic downturn, competition, demographic change, inflation
Network and interface risk	Withdrawal of support network, changes in competitive network, interface
Industrial relations risk	Industrial relations and civil commotion
Legislative and government policy risk	Approvals, changes in law/policy, regulation
Force majeure risk	Force majeure
Asset ownership risk	Technical obsolescence, default and termination, residual value on transfer to government

Source: Department of Treasury and Finance (2001) *Risk Allocation and Contractual Issues*, Appendix A, pp.178–191

8.2.2 Risk allocation

After risks have been initially identified in concept and assessed (determining the likelihood of risks materialising and the magnitude of the consequences), they are allocated to contract parties. The philosophy adopted in *Partnerships Victoria* in the allocation process is one of ‘*optimal risk allocation*’. Department of Treasury and Finance guidelines explain that:³¹⁸

Optimal risk allocation seeks to minimise both project costs and the risks to the project by allocating particular risks to the party in the best position to control them. This is based on the theory that the party in the greatest position of control with respect to a particular risk has the best opportunity to reduce the likelihood of the risk eventuating and to control the consequences of the risk if it materialises.

³¹⁸ *ibid.*, p.20

Allocating risks in this manner creates incentives for controlling parties to use their influence to minimise risks and achieve their outcomes in the interests of the project, (at least in concept). Risks may be borne by government, private parties, or, where no party has control over the risk, by the end consumer, if appropriate. The value of risks transferred are estimated and included in the public sector comparator (PSC), to allow a comparable value for money assessment.³¹⁹

The Risk Allocation and Contractual Issues guidelines state that as with the United Kingdom PFI, the *Partnerships Victoria* policy ‘requires a total shift in mind-set to see [public private partnership] as an opportunity to procure services, leaving the risks of ownership and operation of the asset with the private sector’.³²⁰ As part of this shift, the guidelines state that government should:³²¹

- articulate the policy objectives it wishes to achieve through the partnership;
- identify the service it is seeking from the private party and specify the outcomes and outputs of that service;
- identify the core services (if any) that government will deliver from the facility; and
- structure the most suitable payment mechanism for the provision of the private party’s service/output specifications, (identified above) in accordance with government objectives for the project.

8.3 Assessing the risk allocation framework

The *Partnerships Victoria* guidance material on risks is detailed and constitutes a professional ‘how to’ manual for staff. Most of the bulk of the risk allocation and contractual issues documented present detailed guidance and discussion on each of the ten categories of risks previously defined; key contractual issues of particular relevance to Victoria are also included. The material notes that ‘to be legally effective, the agreed risk allocation must be reflected in the contractual provisions and mechanisms’.³²² Aligning the payment mechanism with the agreed risk allocation and achievement of government objectives is of particular importance, and the material offers general guidance on this complex exercise, highlighting the need for contractual provisions to be constantly scrutinised.³²³

³¹⁹ Department of Treasury and Finance, *Partnerships Victoria*, 2000, p.10

³²⁰ UK Private Finance Panel, as cited in *Partnerships Victoria*, Department of Treasury and Finance, *Risk Allocation and Contractual Issues*, June 2001, p.19

³²¹ *ibid.*

³²² Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Risk Allocation and Contractual Issues*, June 2001, p.121

³²³ *ibid.*

The guidelines also present a sophisticated overview of ideas underpinning the PSC and detail its major financial components. Of particular interest is the inclusion of some advanced probability evaluation techniques together with simpler probability based techniques to determine the value of risks.³²⁴

Providing examples is also helpful for practitioners and the considerable guidance provided on contract management concepts is useful. The Committee considers that the *Partnerships Victoria* guidelines appear to be comprehensive and rational from a commercial perspective.

The guidelines, however, do not appear to be broad enough to be regarded as a firm basis on which the government would make a final decision on the use of private investment in public infrastructure, from either a public policy or a governance perspective. Several types of risks, for example, political risk and environmental risk are not adequately covered and essentially lie outside the commercial assumptions of the guidelines. The treatment of some risks is subject to extensive controversy and is not acknowledged and may well be handled inadequately at present. Further, the guidelines do not recognise the inherent optimism bias usually accompanying infrastructure proposals.

Some real world risks exist that are not typically the subject of negotiation between government and private infrastructure sponsors. The commentator Arndt noted that *'the concept of political risk does not sit comfortably with the legal concept of risk allocation'*, and *'it is not a negotiated risk'* when considered directly in concession deeds for projects.³²⁵ The critical political risks here are outside the contractual negotiated domain and typically go unrecognised. One academic has argued that despite the concept of risk spreading:³²⁶

The government has to stand behind these projects because it cannot allow them to fail. The cynical view is that companies know full well that it will not be their job to bail out important services. Ministers will always ride to the rescue. Under such conditions, the taxpayer meets all the costs and gets none of the benefits.

A further systemic risk not specifically identified in the framework is given by the commentators de Bettignies and Ross, that governments should always provide systems of checks and balances:³²⁷

Granting too much authority to a government PPP office to implement projects without adequate review via effective departments (and later by public auditors) risks having the private industry capture the PPP

³²⁴ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Public Sector Comparator, Technical Note*, June 2001, pp.32–33

³²⁵ Dr R Arndt, transcript of evidence, p.47

³²⁶ D Harding, 'Running the Risk of Failing Public Services', *Public Finance*, April 5–11 2002, London, p.12

³²⁷ J E de Bettignies and T W Ross, *The Economics of Public-Private Partnerships*, draft report, Vancouver: Sauder School of Business, University of British Columbia, 2003 (?)

process through its repeated interactions through the government PPP office. Both the private sector players and the PPP office will see benefits in maximising PPP activity whether all projects are in the public interest or not.

Dr Duffield reinforced this point when he informed the Committee that:³²⁸

I think when we do PPPs, take government's perspective, there is a commercial responsibility to the state; there is servicing of the community interest; there is regulation long term, and there is an aspect which I would call stewardship, which is long-term management of the state's asset. I have a personal view [that] ... to expect one individual or group of individuals to be all things without separating them out is a tough call.

This is particularly so when, as the Committee was informed by one witness:³²⁹

The problem is with the way we structure our finance and so on; most people have an incentive to make the deal happen.

A further risk not explicitly covered in the guidelines, but inherent within their document, is that of service purchasing. The underlying assumption that purchasing services through contract over a long period involves less risk than purchasing infrastructure (based on a detailed initial design in the short term) remains just that, – an assumption. The ‘*black and white*’ specification of services and signed contracts can differ from experiences throughout the contract period. Because initial expectations of large savings from contracts over the long term operation of the project can differ from experience, large risks go unrecognised. This significant issue is demonstrated by the public transport franchising experience of the Victorian Government, which saw large initial expected savings at the time of contract signing evaporate.

Optimism bias refers to the ‘*demonstrated, systematic, tendency for project appraisers to be overly optimistic.*’³³⁰ This phenomenon is not acknowledged in the guidelines. Now recognised as a worldwide phenomenon, optimism bias ‘*affects both the private and public sectors*’. It is the difference between the initial expected costs and benefits of a project and the final actual costs or ‘*out turn*’.³³¹ This applies to all infrastructure projects regardless of method of delivery.

Mott MacDonald reviewed 50 projects over 20 years in the United Kingdom, and found high levels of optimism bias. For traditionally procured projects, cost overruns recorded were 47 per cent for capital expenditure (net present value) and 17 per cent

³²⁸ Dr C Duffield, Senior Lecturer, Faculty of Engineering, transcript of evidence, p.49

³²⁹ Mr N Morris, Chief Executive, Tasman Economics, transcript of evidence, p.43

³³⁰ HM Treasury (UK), *The Green Book Appraisal and Evaluation in Central Government*, 2003, p.29

³³¹ *The Green Book: Evaluation and Appraisal in Central Government* (2002), HM Treasury (UK), presentation on launch, 22 July 2002, see: www.hm-treasury.gov.uk/media/97705/geenbool03_pres.pdf, slide 19 of 22.

for time overruns. Optimism bias involving time overruns was lowest on standard buildings and highest on standard civil engineering projects. In all cases, the effects were significant and overshadowed project evaluations undertaken.

Optimism bias suggests greater net benefits from major infrastructure projects compared with reality. And it affects capital investment decisions by government when policies require trade-offs between infrastructure investment decisions and investment decisions into other areas of public need. Such optimism bias is also crucial when, for projects such as toll roads, government is effectively committing future revenue flows from the public, with the public, rather than the government, paying the fees.

The Committee received advice that the general principle of allocating risk to the party best able to bear it was sound but the detailed treatment of risk was less satisfactory.³³² And while the government's preferred positions on the treatment of risk were supported by some witnesses, such as the Property Council of Australia,³³³ Professor Quiggin³³⁴ indicated that shortfalls occurred in the treatment of risk for construction, operation, services, demand, regulatory risk and network risk, and that optimal allocation was likely to be a mix of several standard public procurement options.

A further weakness of the assessment framework was the inability to accurately determine the degree to which dealing with only one supplier provided best value for money. Concerns about this issue are particularly critical in view of the known existence of optimism bias. In the words of one witness:³³⁵

The principle of optimal risk allocation requires the availability of a range of contracting arrangements. A single contractor model will be appropriate only in a minority of cases. For most infrastructure projects, standard public procurement procedures, with subsequent public ownership of the asset will be preferable.

The use of a risk adjusted PSC (adopting advanced probability valuation techniques) in project evaluation, as detailed in the PSC Supplementary Technical Note (July 2003, p.30), carries with it particular risks that should be explicitly acknowledged.

Whilst the application of probability based methods is conceptually sound, their proper use requires databases of empirical experience and reliable information as to their foundation. In the absence of this information and in consequent use of various assumed distributions, there is a substantial risk that such assessment methods can mask inherent uncertainties in the assessment, and result in evaluation methods and results being inaccessible to all but the official undertaking the evaluation. Moreover, the use of such methods may be subject to significant 'tuning' or manipulation to

³³² Professor J Quiggin, submission no.25, p.27

³³³ Property Council of Australia, submission no.33, p.2

³³⁴ Professor J Quiggin, submission no.25, p.32

³³⁵ *ibid.*, p.33

provide plausible or desirable results rather than assessment of strength and veracity. The use of sophisticated assessment techniques to massage broad assumptions and information of doubtful accuracy leads to results no more accurate than the initial assumptions.

Past these broad principles, the central issue here is not whether one party or other bears particular risks; the key issue is the valuation put on these risks and the price paid to parties for bearing these risks. The valuation of risks is an area fraught with uncertainty and as noted in the previous discussion of the PSC, an area in which there appears to be only a weak empirical basis of experience. The Committee was informed that different parties could easily value the same risk environment quite differently:³³⁶

Risk is a bit like beauty, it is in the eye of the beholder, so even for exactly the same set of circumstances two different parties – be they public or private sector – could come up with a different analysis on what that risk will be.

In respect to paying private parties to bear these risks, the Committee noted that the guidelines stated:³³⁷

There is in fact a profitable market in risks, with private parties keen to assume risks for which government pays a high price relative to the likelihood or consequence of these risks materialising.

In concept, the PSC aims to ensure that government is not charged an excessive risk premium. This comparator documents the value of risks on the basis of previous estimates for likelihood and consequence and enables relative value for money assessments to be established.

8.4 Risk shifting in practice

8.4.1 Evidence from outside Victoria

Experience suggests that both the government and the private sector are, in reality, poor risk managers. First, despite considerable expertise in writing contracts, developing risk assessment frameworks and applying sophisticated evaluation concepts,³³⁸ *‘the perfect contract can never be written and even if it could, performance could not be perfectly monitored’.*

³³⁶ Mr J Miller, Executive Director, Macquarie Bank, transcript of evidence, p.144

³³⁷ Department of Treasury and Finance, *Partnerships Victoria Guidance Material, Risk Allocation and Contractual Issues*, June 2001, p.21

³³⁸ J E de Bettignies and T W Ross, *The Economics of Public-Private Partnerships*, draft report, Vancouver: Sauder School of Business, University of British Columbia, 2003, p.12

One academic pointed out:³³⁹

... it seems there is a significant gap between current risk analysis techniques applied to public/private infrastructure and those recommended by researchers, mathematicians, and insurance firms. Despite the fact that the importance of risk is widely recognised, practical limitations such as time and lack of historic data appear to be very real limitations to the incorporation of rigorous and legal risk analysis into the investment decision process.

In other words, risk analysis is only as accurate as the assumptions made. And, as noted previously, the reality of real projects requires consideration of risks in both commercial and governance terms rather than in commercial terms alone. Ideally, risk bearing should be explicit and the costs involved clear, as well, as noted by Professor Hodge:³⁴⁰

... the concept of risks ought to be seen in a holistic manner covering both the commercial role of government (when it signs the contract) and its overriding 'governance' role (in which the polity protects and nurtures the public interest). After all, the public happily vote not according to whether they perceive good commercial contracts are being signed but whether they perceive the interests of the public are being properly met by government.

Evidence on the successful consideration and management of risks could be viewed in terms of policy rhetoric, the clauses in a legal contract, or the historical outcomes by observing actual behaviours of government and contractors. The most powerful of these is experience, given the potential for differences between contracts and behaviour.

Unfortunately, Australia's public sector expertise with risks in the PPP arena is not high. As Bob Sendt, (then) Auditor-General of New South Wales, advised the Committee:³⁴¹

I think one of the key risks that seems to have come out of many of the projects in New South Wales is a lack of understanding within the public sector of what risk involves and how to appropriately assign risk between the parties.

³³⁹ Dr C Duffield, *An Evaluation Framework for Privately Funded Infrastructure in Australia*, PhD thesis, The University of Melbourne, 2001, p.100

³⁴⁰ G Hodge, 'Risky Business in Public Private Partnerships', *Toward Public Value*, conference paper, Melbourne, 24 November 2003

³⁴¹ Mr B Sendt, (then) New South Wales Auditor-General, transcript of evidence, p.175

In a similar vein, the then Commonwealth Auditor-General noted that the risks associated with purchasing services as a paradigm are real. Specifically, he noted that:

The concepts underlying the outsourcing of infrastructure such as information technology (IT) are conceptually similar to PPPs in that, under a PPP contract, the emphasis is similarly on the purchase of services rather than the procurement of an asset. Consequently, lessons learnt from outsourcing initiatives raise important issues to consider in the context of PPPs, particularly in relation to accountability for results achieved, or not achieved as the case may be.

As Dr Arndt points out, *'the real world is much more complicated than any theoretical framework or model'*, and gave the following examples of risk treatment in recent projects around Australia.³⁴²

- the New South Wales Government decided to remove tolls on the M4 and M5 motorways in Sydney, but was unable to cancel the contract. A system was then put in place where motorists had tolls paid refunded by the government. While this has increased use of the facility, it is also evident that parties to the agreement did not originally contemplate this occurrence, and importantly, taxpayers have paid not only for the tolls, but also for the extra revenue accruing to the road owners due to the increased patronage; and
- the water supplied by the Prospect Water Filtration Plant in New South Wales was contaminated by certain biological organisms, and customers were forced to boil water prior to drinking. It emerged that the initial BOOT contract did not specify that these organisms needed to be treated.

An academic in the United Kingdom suggests that despite the implicit assumption of much of the private financing literature, that no risks were transferred under traditional procurement, this is clearly not the case. While it is true that recent PFI contractors have borne a wider range of risks, traditional procurement did take on substantial risks and had penalty clauses as incentives for delays. He also made the comment that where changes were requested by a client in traditional projects, it was easy to quantify the additional costs required based on the detailed design information that already documents all elements of the job, and it was a straightforward exercise for government to see if it was being overcharged. In a PFI project without this breakdown in costs, however, it was more difficult to challenge figures that the PFI contractor might come up with, and this resulted, in his view, in a real danger of being overcharged.

Further, construction contracts have typically included a contingency of around 10 per cent, and this is likely not to have differed between privately financed projects and traditional ones. He suggests the major difference is that in traditional projects this contingency was at the client's disposal, whereas under a PFI project, that money does

³⁴² Dr R Arndt, *Private provision of public infrastructure: Risk identification and allocation project, survey report*, collaborative project, Department of Treasury and Finance, 1999, p.3

not appear to be explicitly catered for in the risk transfer calculations. Overall, he suggests that with risk being valued on a mostly subjective basis, this could lead to over estimation of risks, and hence over optimistic expectations of real benefits being achieved through such arrangements.

The influential *Economist* magazine noted that despite the United Kingdom Government embracing the idea of PPPs with enthusiasm,³⁴³

With the effective re-nationalisation of RailTrack this week, many are now asking if there are limits to the transfer of risk from public to private sector. In the wake of the RailTrack debacle, there is widespread concern that PPPs have not transferred risk to the private sector, and that the extent of the residual liability left on the government's books might not be obvious for several years.

The RailTrack case is complex but the important issue is that the House of Commons Public Accounts Committee decided there were limits to the transfer of risk from public to private sector, and described the rescue as a 'bail out'. The Committee 'condemned the fact that the taxpayer had been left to pick up the tab for a flawed deal that failed to transfer the risk'. Such judgements followed an earlier change in emphasis in Britain putting ³⁴⁴ 'less emphasis on transferring risk to the private sector and stress[ing] instead the value of PPPs in mobilising public sector expertise for big projects'.

The Committee heard that the M2 contract in New South Wales (like Victoria's CityLink contract) 'precluded any government from taking action which reduces the flow of tolls, and compensation has to be provided'. And in contemplating the question of whether the costs of bearing such network risks are different if the government owns a road project compared with the private sector owning the project, it also heard that:³⁴⁵

For roads, I would argue that the risks that the government faces are lower because it controls the rest of the network. It can direct traffic 30 kilometres away, away from or towards the tollgate depending on signage, the length of stop lights, lane marking – all sorts of things. The private sector, knowing it cannot control the traffic flow as well as it should to be an owner of the road, charges for that risk.

³⁴³ 'Public v Private', *The Economist* Global Agenda, 26 March 2002
see: <http://courses.wcupa.edu/rbove/eco343/021Compecon/U.%20K/020326privat.txt>, accessed 19 September 2006

³⁴⁴ R Vincent 'New doubts over tube PPP uncertainty comes as Treasury shifts emphasis of PPPs away from transfer of risk', *Financial Times* newspaper, 28 October 2001, p.1

³⁴⁵ Mr T Harris, journalist and former New South Wales Auditor-General, transcript of evidence, p.133

The implication from this witness, therefore, was that too much had been paid for the decision for the private sector to inappropriately bear such network risks.

In the provision of vital services, for example, health, hospitals, education, prisons, courts, public transport, policing and water, risk cannot realistically be fully transferred because it is ultimately left with government. In the final analysis, the community and its citizens hold the government responsible for the provision of such basic human goods and services.

8.4.2 Evidence from Victoria

The Committee found that quantitative empirical evidence is extremely thin and as one witness noted:³⁴⁶

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 actually occurred and document who has borne what [risks] 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 ...

There were, however, a number of useful case study observations presented, and furthermore, many opinions and judgements on success.

The Victorian Auditor General informed the Committee that:³⁴⁷

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, which had the substantive effect of reverting the major financing risks back to the state (for example, the Victorian Government Infrastructure Program and the World Congress Centre).

This report noted previously the advice of the Department of Treasury and Finance that lessons had been learned from the excessive risk transfer and excessive focus on lowest cost that featured in some projects, between 1990 and 1999, for example the Latrobe Regional Hospital and Port Phillip Prison.³⁴⁸

³⁴⁶ Professor G Hodge, transcript of evidence, p.59

³⁴⁷ Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.2

³⁴⁸ Mr G Maguire, Assistant Director, Commercial Division, Department of Treasury and Transport, transcript of evidence, p.5

The Victorian Auditor-General concurred with this view in his evidence to the Committee. He stated that:³⁴⁹

The nature of these [PPP] arrangements, including the risk allocation between the public and private sectors, has substantially evolved over the last decade. This reflects the increasing development and maturity of private investors, and their willingness to accept certain levels of risk.

As investment markets deepened and the prevalence of private sector involvement in the provision of public infrastructure world-wide increased, over the past decade the sophistication of such arrangements has increased, and so too has the risk allocation. Investors are now more willing to accept operational and demand risks than at any time in the past. This is reflected in such arrangements as the Melbourne CityLink project and the regional water infrastructure projects.

In commenting about the government's ongoing responsibilities in the infrastructure arena, the Auditor-General argued that a key challenge of PPP arrangements 'is to establish appropriate risk allocation, effective management and adequate oversight, which ensure that the public interest is protected'.³⁵⁰ In other words, the whole arena is still a significant challenge.

The Auditor-General noted that PPPs such as the:³⁵¹

Latrobe Public Hospital and the Metropolitan Women's Correctional Centre, were established in a highly competitive environment, with tenderers participating in a selection process with the view to entering the Victorian market, and submitting low-cost proposals incorporating aggressive assumptions regarding available cost efficiencies ... While the original arrangements placed considerable risk with the private sector and allowed the government to 'walk away' from the arrangement ... in each case the government decided to take over ... principally due to its underlying obligation to provide the related public services.

The Auditor-General also noted that 'there are a number of later PPPs that incorporate greater risk allocation to the private sector and overall appear to be operating quite successfully, such as the Melbourne CityLink'.³⁵²

Submissions from the private sector cited risk transfer from the public to the private sector as a major benefit to government of PPP projects.³⁵³ Some organisations such as the Property Council of Australia also advised that they support the government's

³⁴⁹ Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.2

³⁵⁰ *ibid.*

³⁵¹ *ibid.* p.3

³⁵² Mr W Cameron, (then) Victorian Auditor-General, submission no.13, p.3

³⁵³ For example, Australian Council for Infrastructure Development (AusCID), submission no.18; and ABN Amro Australia Ltd, submission no.23

current policy position on risk allocation.³⁵⁴ Other private sector organisations have made observations about the translation of policy into practice with Hyder Consulting stating, for example, that:³⁵⁵

... the axiom that risk should be placed where it can best be managed in order to achieve best value is well understood and often quoted. However, it seems rare for this stance to be translated into the final contract documents. The public sector usually pushes more risk onto the proponent than is consistent with best value.

There may be a number of reasons for this, as outlined in the submission from Hyder Consulting:³⁵⁶

First, market forces have dictated that many of the projects awarded to date have been bid in a highly competitive environment. In these circumstances proponents have been willing to accept risks that should clearly be owner risks, to secure the deal. This applies particularly in the PPP environment where bid costs are high; there is no prize for coming second. The downside (from the government perspective) of a proponent accepting inappropriate risks, is that the contract is likely to run into trouble, with consequent ramifications for all parties.

*Secondly, PPP projects are typically delivering a public service, and the client's agents are public servants. The culture within the public sector is generally risk averse. Public servants do not get rewarded for taking risks. This is not intended as a criticism, but as a comment on the way the world is. If best value is to be achieved, then this issue needs to be recognised and addressed.*³⁵⁷

The Institution of Engineers Australia advised that:³⁵⁸

While it is recognised that the Partnerships Victoria documentation includes a substantial segment on risk allocation, it is noted that the approach taken is that risk transfer equates to risk management, which is far from the truth, and that the risks itemised in the risk matrix are presented as solely financial or 'time lost' risks.

We have previously noted that several risks are not included within the *Partnerships Victoria* guidelines. The Victorian Auditor-General in a presentation stated that:³⁵⁹

³⁵⁴ Property Council of Australia, submission no.33, p.2

³⁵⁵ Hyder Consulting (Australia) Pty Ltd, submission no.12, p.2

³⁵⁶ *ibid.*

³⁵⁷ *ibid.*

³⁵⁸ Correspondence from the Institution of Engineers Australia – Victorian Division, 8 July 2002

³⁵⁹ Mr W Cameron, (then) Victorian Auditor-General, IPAA Breakfast Seminar, Presentation, 3 October 2000, p.6

One thing is clear about PPPs and that is that the political risks are not transferred through PPPs, and neither is the public interest lessened. Other risks include public safety risk, public consumer risk, environmental risk, public consultation risk, transparency risk and public confidence risk. The dominant theme is that while services might be outsourced effectively, some risks cannot. There is therefore a need to look more carefully at the practices of assessing and allocating risks as well as the historical evidence on how well risks have indeed been transferred in Victoria.

On the first matter, the Institution of Engineers Australia advised the Committee that:³⁶⁰

Generally high level risk identification and allocation is done well for Victorian major projects. However qualitative risk analysis, including probability calculating, consequence analysis and risk mitigation, is poorly done.

A range of judgements in terms of risk can be applied to the Victorian experience. Critics of the Victorian guidelines argue that the general principle of allocating risk to the party best able to bear it is sound. However, the detailed treatment of risk is less satisfactory. The presentation of such a long list of risks raises the danger of '*not seeing the woods for the trees*'.³⁶¹

Professor Quiggin advised the Committee that in terms of the Melbourne CityLink project, '*an estimate of the excess cost may be obtained by comparing the present value of toll revenue to be levied over the value of the project, which appears likely to be around \$4 billion, with the construction cost, around \$2 billion*'.³⁶² He further states that: '*the gap of \$2 billion between the construction cost of the CityLink project and the tolls paid to the private consortium is, in part, compensation for the real costs of risk misallocation*'.³⁶³ Most others³⁶⁴ evaluated the Melbourne CityLink project more positively in terms of the treatment of risk arguing that the Melbourne CityLink project saw a range of risks transferred to the private sector and included independent review mechanisms. This structure has ensured that the significant commercial pressures to close agreements for PPPs did not result in compromising engineering and safety quality. Deacons law firm informed the Committee in respect to CityLink that:³⁶⁵

³⁶⁰ The Institution of Engineers Australia – Victorian Division, submission no.29, p.5

³⁶¹ For example Professor J Quiggin, submission no.25, p.27

³⁶² Professor J Quiggin, submission no.25, p.47

³⁶³ *ibid.*, p.11

³⁶⁴ Dr R Arndt, Dr C Duffield, and Professor Hodge

³⁶⁵ Deacons law firm, submission no.14, p.4

The full risks other than direct government action against the tollway, were transferred and accepted by the private sector. When problems arose in the construction of the Burnley tunnel, the problem remained with and was settled by the private sector with no call on the taxpayer.

In addition, they argued that the Victorian Government has instituted high standards of probity and accountability, suggesting that Treasury has an in-depth understanding of the issues relating to the allocation and management of risk in PPP projects.³⁶⁶

In terms of Berwick Hospital, Thiess commented that some documents were not released until midway through the short tender period, resulting in unnecessary stress on the tender process.³⁶⁷

The Berwick hospital tender is an example where some documents are not to be released until midway through a short tender period of 11 weeks, and the information that has to be compiled and supplied is voluminous.

With regard to the Latrobe Regional Hospital, the Victorian Auditor-General's Office found that the BOO model effectively transferred a significant proportion of the financial risk to the private sector.³⁶⁸ Substantial operating losses within a year of operations, however, resulted in an inability of the private sector consortia to make efficiency gains originally assumed and *'ultimately, the step-in provisions set out in the agreement were exercised and the hospital's operations were transferred to the public sector'*.³⁶⁹

The Fitzgerald report did not present any quantitative assessment of risk performance for Victorian PPPs. The precise extent of risk transfers and relative value for money of risk arrangements cannot, therefore, be established.

Commenting on Victoria's approach to risk assessment, however, Fitzgerald noted that:³⁷⁰

Consistent with the UK reforms to its PFI policy, there would be benefits from Victoria moving to an approach to risk assessment that builds upon an empirical base, such as that undertaken in the Mott McDonald Report, but also includes other risk factors such as contract default and forced revision.

³⁶⁶ Deacons law firm, submission no.14, p.4

³⁶⁷ Thiess Pty Ltd, submission no.32, p.13

³⁶⁸ P Barrett, *Public-Private Partnerships – Are there gaps in public accountability?*, Australasian Council of Public Accounts Committees, 7th Biennial Conference, presentation, Melbourne, 3 February 2002, p.16.

³⁶⁹ *ibid.*

³⁷⁰ P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, January 2004, p.25

The Committee strongly concurs with this assessment and notes the disappointing lack of empirically based risk estimations, valuations and reporting to date.

There is a need for government to develop further expertise to properly assess risk and that attention be given to the long term retention of project management knowledge within the public sector.

This is similar to the experience in other jurisdictions such as the United Kingdom, with the Auditor-General advising the Committee:³⁷¹

A further issue that emerges from these long term ‘outsourcing’ arrangements is that, over time, there is a loss of expertise in the effective oversight of these arrangements, given that the state may no longer be involved in areas similar to those subject to PPPs and therefore individuals responsible for oversight functions may not fully appreciate the associated management issues. 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.

The Auditor-General nevertheless advised 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 a government’s duty of care), reflecting the public sector’s underlying responsibilities associated with public sector service provision. The Auditor-General also stated that the risk allocation principles embodied in recent Victorian frameworks acknowledge this important issue and promote the allocation of risks to the parties best able to manage them.³⁷²

Regarding the concern that the government would inevitably carry risks despite the initial commercial contract, ABN Amro advised the Committee that:³⁷³

For existing PV projects, like the County Court project, Spencer Street³⁷⁴ Station project and Berwick Hospital project, it is unlikely they will ever need a public bailout.

According to ABN Amro, this was because most of the project risk is carried during the building phase, a large proportion of capital investment is made up-front, the operating and maintenance costs are lower than initial capital costs and risks, and the essential service risks are retained by the government.³⁷⁵ On the issue of the provision of essential services and associated risks, the Institution of Engineers Australia advised the Committee that *‘the public perceives that governments ultimately carry*

³⁷¹ Victorian Auditor-General’s Office, submission no. 13, p.5

³⁷² *ibid.*

³⁷³ ABN Amro Australia Ltd, submission no.23, p.18

³⁷⁴ Later renamed as the Southern Cross Station

³⁷⁵ ABN Amro Australia Ltd, submission no.23, p.18

*the responsibility for ensuring that essential services are provided.*³⁷⁶. Deacons law firm reinforced this view:³⁷⁷

Core public functions will remain within government under the current Partnerships Victoria policy. This is a recognition .. that, whatever the commercial arrangements reached, government will always have a duty either at law as a non-delegable duty, or as a matter of public policy to step in to remedy service failures. This was evidenced by the service difficulties at the Metropolitan Women's Prison and the Coronial findings relevant to the Port Phillip Prison.

Concern over the lack of genuine risk transfer was also clearly evident in academic literature and the media. For example, an article in *The Economist* stated that:³⁷⁸

The underlying problem with all these projects is that they are as important as they are expensive. PFI [private finance initiative] deals are supposed to transfer risk from the public to the private sector. But with so much at stake politically, the government cannot afford to let them fail. One way or another, the railways have to work and the underground has to run. This makes it impossible to genuinely transfer risk from the public to the private sector, which undermines the purpose of PFI.

The validity of this statement has been shown internationally and in other jurisdictions. From a commercial perspective, the greater the risks taken by any sector, the greater the expected financial return. Thus, if the private sector genuinely takes on significant risks, it should expect to receive financial returns commensurate with these risks. And so for the public sector.

The matrix of risk identification, assessment, valuation, allocation and management is overshadowed not by the logic and concepts espoused, but by the reality of the price paid for either sector to bear allocated risks. The Committee considers that there is currently a gap between the concept of best practice and best practice in reality. Thiess put it succinctly when it advised the Committee that:³⁷⁹

The intent of Partnerships Victoria is to be admired. However, a lingering concern is that both government and private sector participants retain unrealistic expectations of the risk allocation outcomes.

This gap between concept and practice is also a risk when it comes to matters of new, innovative financing arrangements. Critics point out that few government activities have failed as regularly or incurred as large losses as financial innovation.³⁸⁰ To the

³⁷⁶ The Institution of Engineers Australia – Victorian Branch, submission no.29, p.5

³⁷⁷ Deacons law firm, submission no.14, p.4

³⁷⁸ 'Enron-on-Thames: Railtrack and British public finance', *The Economist* magazine, 30 March 2002

³⁷⁹ Thiess Pty Ltd, submission no.32, p.12

³⁸⁰ For example Professor J Quiggin, submission no.25, p.40

degree that innovative financing or innovative lending practices can reduce overall costs, they deserve support. But to the degree that such financial re-engineering leads to artificiality, circumvention of proper project evaluation procedures, or more fashionable arrangements from a policy perspective, they ought to be seriously questioned, and if necessary, rejected. In the end, the public must rely on government for its stewardship and to ensure that the old maxim ‘caveat emptor’ is adhered to. This area clearly warrants further independent research. The need for both more and higher veracity independent investigations into the net benefits of private investment in public infrastructure is best summed up by the commentators de Bettignies and Ross, who noted:³⁸¹

Supporters claim that PPPs represent a true organisational innovation for the efficient delivery of public services. Opponents argue that they are an ideologically driven plan ... It is time for more independent research to determine the true benefits and costs of public private partnerships.

The Committee recommends that:

Recommendation 20: **The Victorian Government make representations to the National PPP Council to arrange for independent research to be undertaken on the degree to which discount rates should include a component for risk, and the size of this component.**

³⁸¹ J E de Bettignies and T W Ross, *The Economics of Public-Private Partnerships*, draft report, Vancouver: Sauder School of Business, University of British Columbia, 2003

CHAPTER 9: ACCOUNTING FOR PUBLIC PRIVATE PARTNERSHIPS

Key findings of the Committee:

- 9.1** There is no Australian accounting standard or definitive guidance material on accounting for public private partnership arrangements.
- 9.2** In the absence of authoritative guidance, reliance has been placed on Australian Accounting Standard AASB117, *Accounting for Leases*, and on guidance material issued by the Heads of Treasury Accounting and Reporting Advisory Committee. The guidance material reflects the principles detailed in the United Kingdom Reporting Standard FRS5, *Reporting the substance of transactions: private finance initiatives and similar contracts*.
- 9.3** The International Accounting Standards Board has issued a series of draft interpretations seeking comments on an accounting model for PPP arrangements. The draft interpretations favour a ‘*control*’ approach where the party to the arrangements, that is deemed to control the assets, is to record the assets in their financial reports.
- 9.4** The draft interpretations rely on a new definition of control in contrast to existing accounting standards. If the residual interest in an asset passes to the government at the end of the concession agreement, the government should be considered as controlling the property on completion of construction. This concept is in contrast to the ‘*risks and rewards*’ approach embodied in the United Kingdom standard FRS5, currently recommended by Heads of Treasury in Australia and which often results in the private operator being deemed as controlling the assets.
- 9.5** The majority of submissions on the draft interpretations received by the International Accounting Standards Board did not support its proposed concept of control. The concept was commonly seen as too simplistic, and therefore may not properly address the substance of complex commercially negotiated arrangements.
- 9.6** The draft interpretations issued by the International Accounting Standards Board only reflected the accounting treatment from the view of the private operator and did not take into account a public sector perspective on an appropriate accounting treatment.

- 9.7** A *'rights and obligations'* approach, where the respective rights and obligations of each party are scrutinised to determine the respective assets and liabilities of each party, merits further consideration.
- 9.8** The Committee acknowledges that the International Accounting Standards Board will ultimately determine the new International Financial Reporting Standard for PPP arrangements. The Committee, however, encourages the Department of Treasury and Finance in conjunction with other interested parties within Australia to further encourage the Board to examine a *'rights and obligations'* approach prior to formalising a new accounting standard that will apply to the Victorian public sector.

9.1 Background

*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.*³⁸²

Public private partnerships (PPPs) invariably take one of the following basic forms:

- the private sector provides the capital investment with the public sector purchasing specified services from the contractor that meet specified quality standards. An example includes the construction and operation of private prisons;
- the construction is undertaken by the private sector, which recovers its capital and operating costs through direct charges to users. Tollways are a common example of this type of arrangement. Public sector involvement can include land acquisition, provision of certain assets such as roadworks and planning, licensing and other statutory procedures; and
- projects are undertaken as joint ventures, whereby the cost of projects cannot be fully recovered through charges on end users. The government will provide a part subsidy, possibly in the form of a contribution of assets up-front and/or a service payment in addition to user payments.

Irrespective of the form of the arrangements, a major consideration with PPPs is how they should be accounted for and disclosed in public sector financial statements and budgets. There are no Australian accounting standards that deal specifically with accounting for PPPs. In the absence of such accounting standards, there is currently no

³⁸² Mr G Maguire, Assistant Director, Commercial Division, Department of Treasury and Finance, transcript of evidence, p.2

definitive guidance available either from the government or the private sector as to how PPP assets and obligations should be accounted for, although Australian governments support the principles outlined in the United Kingdom Standard FRS5.

As an interim measure pending the development of authoritative guidance, reliance has been placed on Australian Accounting Standard AASB117 *Accounting for Leases* because most PPP arrangements, with the notable exception of user pay agreements, have the characteristics of a lease agreement.

Leasing arrangements are classified as either operating leases or finance leases. Depending on which party is defined as substantially having all the risks and benefits incidental to ownership, that party will record the leased asset in its financial report, offset by a finance lease liability. Where the lessor effectively substantially retains the risks and benefits, the lease will be recorded as an operating lease in the financial reports of the lessee.

The accounting standard on leases was introduced prior to the development of PPPs and does not specifically deal with such arrangements, which are often very complex in terms of identifying the extent of risks borne by the government and the operator. In the experience of the Victorian Auditor-General's Office, a number of arrangements previously classified as operating leases have subsequently been reclassified as finance leases, following detailed reviews of the accounting assumptions underlying the classification of leases. Reclassifications have also occurred since the introduction of the Australian equivalent of International Financial Reporting Standards. The reclassifications have been brought about by the inclusion in the standard of additional criteria defining a finance lease as where the lease term is for the major part of the economic life of the asset and where the leased assets are of a specialised nature suited to the needs of the lessee. This additional criteria has resulted in operating leases for various projects such as prisons, the County Court and water treatment plants subsequently being regarded as finance leases by the Auditor-General.

A range of PPP arrangements do not strictly comply with the existing definitions of operating and finance leases contained in the lease standard. Further, there is a need for the introduction of a new international accounting standard covering PPP service contracts, commonly referred to as service concession arrangements.

This situation is complicated in that the Auditor-General's Office and government agencies have adopted the principles detailed in the United Kingdom reporting standard FRS5 *Reporting the substance of transactions: Private finance initiatives and similar contracts*. The model financial report for Victorian Government departments for the reporting period ended 30 June 2005 endorses the use of this standard where the PPP arrangement does not fall within the scope of the Australian leasing standard AASB117.³⁸³

³⁸³ Model Financial Report for Victorian Government departments for reporting period ending 30 June 2005, p.viii

Substantial work to determine guidance on the accounting treatment of PPPs has been undertaken by a Sub-Committee of the Heads of Treasury Accounting and Reporting Advisory Committee (HoTARAC). The Sub-Committee included representatives from the various Departments of Treasury and Finance, the Australian Accounting Standards Board (AASB) and the Australasian Council of Auditors-General.

The Sub-Committee recommended the adoption of the United Kingdom reporting standard FRS5.³⁸⁴ Guidance material for government agencies on the standard was issued by HoTARAC in January 2004 – *Additional Guidance on the Application of FRS5 methods to determine control (ownership) of Infrastructure Assets used in the Australian Public Sector*. This information is based on FRS5 and adopts a ‘risk and rewards’ approach, in contrast to the ‘control’ approach proposed by the International Financial Reporting Interpretations Committee (IFRIC). Due to the current international uncertainty about how to account for PPPs, the Committee understands that the major accounting firms are reluctant to provide authoritative advice or guidance to the Department of Treasury and Finance on accounting for PPPs.

Subsequent to issuing the above guidance, the IFRIC, which is responsible to the International Accounting Standards Board (IASB), issued a series of draft interpretations that sought to determine the accounting model for PPPs. Comment on the proposals was sought internationally and responses were due by May 2005.³⁸⁵ A further draft paper titled *Service Concession Arrangements – discussion summary and flowcharts*, was issued by the IFRIC in December 2005. This paper sought to further clarify the IFRIC’s attitude regarding the party that should recognise the infrastructure projects associated with service concessions as an asset.

The IFRIC determined at its meeting in March 2006 that in light of comments received about the initial series of draft interpretations, a revised draft would be prepared for further meetings in 2006. The eventual outcome of this exercise will be the adoption by the International Accounting Standards Board of a new international reporting standard dealing with the accounting treatment for PPPs. Under Australia’s current sector-neutral standard setting regime, this new standard will become mandatory and will be implemented by the Victorian Government across the public sector.

Of some concern to the public sector is that the proposed new accounting standard focuses solely on the treatment of service concessions and PPP assets in the financial reports of the private sector operators, despite its impact on the financial statements and budgets of the public sector. The Committee is aware that the International Public Sector Accounting Standards Board is attempting to set up an international project to examine PPP accounting arrangements from a public sector viewpoint, following concerns about the IFRIC proposals on control.³⁸⁶ The Committee considers that such

³⁸⁴ Department of Treasury and Finance, Accounting Policy Update, edition 9, January 2006, p.2

³⁸⁵ International Financial Reporting Interpretations Committee Draft Interpretation, D12 – Service Concession Arrangements – Determining the Accounting Model, D13 – The Financial Asset Model and D 14 – The Intangible Asset Model

³⁸⁶ International Public Sector Accounting Standards Board, update 4, April 2006, p.1

an exercise is critical to ensure that any new standard meets public sector expectations on accountability for PPPs.

9.2 Which party records the asset?

The fundamental issue associated with accounting for PPP assets is which party (that is, the government or the private operator) records the asset in its financial reports? Under the concept of control, actual ownership of the asset does not automatically mean that the owner will record the asset. The party that accepts the majority of risks and derives economic benefits from the asset will, in most cases, record the PPP asset in its financial reports. Notwithstanding this concept, three methods are available to determine the party who records the asset. Each method is open to different interpretations, creating potential for inconsistent accounting treatment of similar arrangements.

9.2.1 Control

The Australian Accounting Standards Board's *Framework for the preparation and presentation of financial statements* was implemented on 1 January 2005 and acknowledges that *'the substance of transactions or other events is not always consistent with their legal or contrived form'*. Such circumstances must be accounted for and presented in accordance with their substance and economic reality, and not merely in their legal form.

This is often the situation with PPPs. In the case of toll roads, for example, legal ownership of the land usually rests with the government and the land is subsequently nominally leased to the operator. Under the concession arrangement, however, the economic benefits in the form of user charges (tolls) invariably flow to the tollway operator. In turn, the toll revenue is used by the private operator to repay borrowings associated with the construction of the tollway. Current practice means that the asset is recognised in the books of the private operator, on the basis of control, because the private sector operator receives the economic benefits in return for assuming the majority of the risks associated with the project.

The framework supports the above concept and further states:³⁸⁷

In determining the existence of an asset, the right of ownership is not essential, for example, property held on a lease is an asset if the entity controls the benefits which are expected to flow from the property.

³⁸⁷ Australian Heads of Treasury Accounting and Reporting Advisory Committee, response to the International Financial Reporting Interpretations Committee Draft Interpretation, D12 – *Service Concession Arrangements*, p.6

An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.

The Committee observes that in most circumstances where the cost of construction of PPP assets is recouped by the operator from user charges such as tolls, the framework clearly suggests that the asset should be recognised by the operator rather than by the government.

In contrast, the draft document released by the IFRIC states:³⁸⁸

The Grantor (government) should be considered to control a property owned by the operator when the Grantor:

- *controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them to, and at what price; and*
- *will control, through ownership, beneficial entitlement or otherwise, the residual interest in the infrastructure at the end of the concession agreement.*

In effect, the draft IFRIC document states that if the government has the power to regulate the services provided and will assume ownership at the end of the contract (which may be for periods of up to 50 years), the asset should be recognised by the government in its annual financial report. The IFRIC view, if adopted, establishes totally new concepts of control that are not provided for in existing accounting standards and concepts.

Responses to the draft IFRIC document invariably did not support the above definition of control for a range of reasons (discussed later). Despite the IFRIC's assertion that its definition of control was consistent with the framework's definition, HoTARAC's response to the draft document disagreed, pointing out that:³⁸⁹

- *design and construction of the asset is the responsibility of the operator. Given this degree of control, the asset should be recognised by the operator; and*
- *the definition of control by IFRIC is very simplistic, whereas PPP arrangements are typically very complex, particularly in respect of defining all risks and benefits. A party cannot be exposed to risk unless they have the ability to mitigate the risk. Accordingly, if the*

³⁸⁸ International Financial Reporting Interpretations Committee, D12 – *Service Concession Arrangements – Determining the Accounting Model*, p.6

³⁸⁹ Australian Heads of Treasury Accounting and Reporting Advisory Committee, response to the International Financial Reporting Interpretations Committee Draft Interpretation, D12 – *Service Concession Arrangements*, pp.7–18

majority of the risks were assumed by the operator, with the operator mitigating those risks as far as possible, then the operator would be regarded as having control of the asset in return for the benefits available.

The Committee also observed that the private sector operator will invariably enter into substantial borrowings to finance the construction of infrastructure assets. If the IFRIC proposal is adopted, this would create an anomalous situation. The private sector operator would be disclosing a very large liability representing borrowings in its financial reports, with the asset for which the borrowings were undertaken being separately disclosed in the financial reports of government. The private sector operator would need to recognise a receivable in terms of its contractual right to recoup the cost of the asset from users. Measurement of the receivable, which could be described as either a financial asset or an intangible asset, would be particularly difficult given that toll revenue is largely unpredictable. And it would be unlikely for the government to provide a guarantee as to the receivable because the revenue risk would be seen as being borne by the operator.

The IFRIC document asserts that the government exercises control over the assets through its regulatory powers. In practice, the concession arrangement invariably allows the operator considerable discretion as to how future economic benefits may be derived, for example, an operator may have the ability to sublet part of the asset to other commercial operators. The regulatory powers that can be exercised by the government are invariably restricted to emergency powers only in restricted circumstances, or regulatory powers imposed on private sector operators with a monopoly, such as the generation of electricity or the setting of health benefit premiums. Regulatory powers of this nature do not affect the day to day operations.

While the Committee is unable to offer an opinion on whether the IFRIC document complies or conflicts with the framework, the issues raised by HoTARAC must be addressed by IFRIC if a credible accounting standard is to be issued. The Committee would be concerned if the IFRIC adopted concepts that conflicted with those contained in the framework.

9.2.2 Risks and rewards

The *'risks and rewards'* approach is embodied in the United Kingdom standard FRS5. It is also currently the preferred approach recommended by the Department of Treasury and Finance where a PPP arrangement does not fall within the scope of the current Australian leasing standard.

The IFRIC decided against using a *'risk and rewards'* approach as applied under the leasing standard, because it considered that such an approach leads to complexities and inconsistencies in lease classification. It also considered that the approach could

be difficult to apply to service concession arrangements, particularly where users paid for the services provided and recovery of the cost of the asset was contingent on use.³⁹⁰

The *'risks and rewards'* approach involves a detailed analysis of all the risk factors to be borne by the government and the operator. The party bearing the majority of the risks will record the asset in its financial reports.

Risks to be evaluated include:

- demand risk – demand for the asset may be less or more than predicted due to factors such as demographic changes or a downturn in economic conditions;
- design risk – property may not meet contractual requirements due to design faults;
- third party revenues – patronage may be less than expected, resulting in a shortfall in revenue to meet construction costs;
- nature of property – includes design faults and operational problems;
- penalties for non-availability – facility may become temporarily unavailable for a range of reasons, resulting in a reduction in payments to an operator by the government;
- potential changes in relevant costs – operating costs escalating beyond projections;
- obsolescence – technology becomes obsolete, requiring expensive upgrades; and
- residual value risk – asset value at expiration of concession agreement could be either less or more than depreciated value.

Once the risks to a particular project are identified, a qualitative assessment of the possible timing of risks, the likelihood of risks occurring, and the consequences of risks eventuating is undertaken. This exercise results in an allocation of risks between government and the private operator, and cash flow modelling for each risk. Other potential risks not capable of meaningful measurement are also recognised. The FRS5 method does not take into account certain other major risks such as construction risks, planning risks and/or site risks because they are not considered to have a direct effect on the economic benefits to be derived from the property, and because they are the responsibility of the construction company.

The Committee has reservations about this approach. Experience has shown that although planning, site risk and construction risks are assigned to the contractor, the state invariably assumes responsibility for the completion and operation of such projects in the event of default by the contractor, because of its duty of care to provide

³⁹⁰ International Financial Reporting Interpretations Committee Draft Interpretation, D12 – *Service Concession Arrangements*, p.16

such facilities and services to the public. This scenario occurred, for example, in the case of the Latrobe Regional Hospital.

There is no doubt that a '*risk and rewards*' approach is very complex, and because judgements about the identification and allocation of risks are often subjective, inappropriate accounting treatment may occur. Conversely, because the '*control*' approach proposed by the IFRIC is very simplistic, it may not necessarily identify the substance of commercially negotiated arrangements and may lead to inappropriate recognition of assets and liabilities.³⁹¹

Despite its complexities, the accounting profession and other interested parties in their submissions to the IFRIC overwhelmingly preferred a '*risk and rewards*' approach because it is more likely to identify the economic substance of the PPP arrangements and the appropriate accounting treatment. Further, a comprehensive assessment of risks must be undertaken to identify the entity that assumes the majority of the risks, thus identifying the controlling entity. In other words, the concepts of '*control*' and '*risks and rewards*' are not mutually exclusive as the draft document suggests; they are complementary, and control cannot exist without risk exposure.

9.2.3 ***Rights and obligations***

This approach is based on proposed major revisions to the leasing standard AASB117. The existing leasing standard is currently closely aligned to many PPP arrangements. The IASB has tentatively agreed that accounting for leases should be based on an analysis of the assets and liabilities that arise from contractual rights and obligations.³⁹²

A discussion paper on the proposed new leasing standard is yet to be released by the IASB. The Committee understands, however, that the standard would not only determine which party discloses the physical asset, but would also focus on the respective rights and obligations of each party to a leasing arrangement by '*unbundling*' the arrangements to determine the respective assets and liabilities of both parties.

The most important right is the right of the operator (lessee) to use or exploit the leased property to obtain economic benefits. The projected economic benefits embodied in the asset would be capitalised in the books of the operator, although it is unclear as to what measurement basis would be used to value the assets. The major liabilities of the operator would be the borrowings involved in the project. The government in many of these arrangements would be seen as having a '*reversionary right*', where control of the asset would revert back to the government at the end of the lease.

³⁹¹ Department of Treasury and Finance, *Financial Reporting*, Update, edn 8, July 2005, p.5

³⁹² International Accounting Standards Board, Research Project – *Leasing*, project update, October 2005

Construction of a tollway is a good illustration of this concept. The government usually acquires the land, the value of which is written off as a state asset once the concession arrangement is entered into, and the operator assumes control of the land for the length of the concession period. The legal ownership of the land will remain with the government, but it will not assume control of the asset along with the tollway until the concession arrangement expires. Under the existing concept of control the operator would *'de-recognise'* the asset at that stage. Conversely, the government would recognise the asset, probably at fair value and reflecting future economic benefits. An alternative valuation method could be depreciated replacement cost, ignoring the land value, where market value data is not available.

Recognition of an asset at the end of the concession period could have a distorting effect on the government's financial reports. Under the rights and obligations approach, the intention is for the government to progressively recognise the emerging asset many years before it actually takes control of it. Conversely, the operator would presumably amortise the asset over the period of the concession agreement. Under this arrangement the progressive take-up of the asset by the government would avoid the distorting effect of recognising potential billion dollar assets overnight.

The Committee understands that the above principles have been accepted by the Heads of Treasury (HoTARAC), although practice in terms of the progressive measurement of the emerging assets is still to evolve. The proposed introduction of the new international reporting standard on leases could provide some guidance on valuation methodology.

The Committee noted that HoTARAC's response in its submission to the IFRIC endorsed a *'risk and rewards'* approach, but stated that the IFRIC should investigate a rights and obligations approach prior to making any financial decision on a new accounting standard for PPPs.³⁹³

9.2.4 Opposition to IFRIC draft proposals

The Committee acknowledges the widespread opposition to the IFRIC proposals, largely on the basis that the *'control'* approach is too simplistic and does not address a range of factors:

- the IFRIC definition of *'control'* assumes that the government has the power to regulate operations. This assertion is incorrect, apart from in emergency situations and for other mandatory requirements such as building standards and occupational health and safety requirements;
- the IFRIC draft assumes that the operator does not have a right of use but in practice, operators can have considerable discretion as to use, including options

³⁹³ Australian Heads of Treasury Accounting and Reporting Advisory Committee, response to the International Financial Reporting Interpretations Committee Draft Interpretation, D12 – *Service Concession Arrangements*, p.17

such as sub-leasing, refusal of access to government in the event of payment default, additional services and restrictions on the disposal of the assets;

- the IFRIC draft places the government in control of the asset but in some PPP arrangements, the government will not actually assume control for 30 or 50 years. The government's take-up of an asset on completion of construction without the ability, in many instances, to directly derive economic benefits from the asset would distort financial reports;
- although it could be argued that the government has a right to future economic benefits on expiration of the concession arrangement, these benefits are incapable of measurement so far in advance;
- to raise venture capital, the private operator would need to be seen to be controlling the asset on completion of construction. Under the IFRIC proposal control of the asset would be with the government, despite the operator assuming most of the risks in return for the economic benefits. Such a situation contradicts the concept of control under existing accounting standards. The removal of an asset from the accounts of the operator would also have serious commercial consequences for operations and for the financial industry. With such a large liability for borrowings without a corresponding asset, the net equity of the company could be seen to be negative and technically insolvent;
- the IFRIC draft has not provided detailed information to explain why the *'risk and rewards'* model is not appropriate, despite the fact that to determine control, an analysis of risks and rewards is essential; and
- the IFRIC draft asserts that the operator only manages an asset that is controlled by the government. Operators in fact often have wide discretion as to the design, construction and operation of an asset, all of which have a significant bearing on which party gains the benefits and bears the risks.

Other major concerns raised in the submissions included:

- the draft IFRIC papers only considered the accounting entries from the perspective of the operators, not the government, a major omission that must be addressed. Irrespective of the deemed transfer of risks seen to be borne by the private sector, in the event of a PPP project and/or the operator collapsing, the government will take back control of the project given its duty of care to the public. This draft does not recognise this overriding factor;
- although disputed by IFRIC, its definition of control conflicts with the principles for the preparation of financial reports embodied in the AASB's *Framework for the preparation and presentation of financial statements* issued by the Australian Accounting Standards Board on behalf of the Australian Government. The potential for conflict would need to be resolved before a standard dealing with accounting for PPPs was issued.

The Committee also noted that the Urgent Issues Group of the Australian Accounting Standards Board was so concerned about the draft interpretations that it was suggested to the International Accounting Standards Board that the IFRIC's work on the interpretation draft be terminated, and in its place, the AASB commence work on a comprehensive project as a matter of urgency.³⁹⁴

9.3 Conclusion

Responses to the IFRIC draft demonstrate strong opposition to the '*control*' approach, with a '*risk and rewards*' approach being preferred. The principles surrounding the '*rights and obligations*' approach appear to have considerable merit and may well reflect a compromise with the added advantages of recognising emerging assets as well as taking into account all assets and liabilities of the respective parties. As previously referred to, the '*risk and rewards*' approach, which has been endorsed for use within Australia, does not take into account all major risks that could arise from contractual obligations. Measurement of emerging assets will require refinement under such an approach.

Given the diversity of opinions expressed about a proposed accounting standard for PPPs, it appears premature for a new accounting standard to be issued in the near future, particularly given the pending development of a new leasing standard. The '*rights and obligations*' approach to determining accounting for PPP arrangements is a good option for this complex area of accounting and merits further consideration. Accordingly, the Committee encourages the Department of Treasury and Finance, in conjunction with other interested parties within Australia, to encourage the International Accounting Standards Board to further examine this option prior to formalising a new International Financial Reporting Standard, which would be applicable to the Victorian public sector.

The Committee will view with interest further developments on this important issue, especially given the impact of these multi million dollar developments on state finances and the potential for assets and liabilities of the state to be misrepresented in financial reports. At the date of this report, there had been no further developments on the new standard.

³⁹⁴ Submission from the Urgent Issues Group of the Australian Accounting Standards Board, 3 June 2005, p.6

CHAPTER 10: LOCAL GOVERNMENT AND PPPS

Key findings of the Committee:

- 10.1 Some Victorian local councils provided evidence that they had either been involved in or looking at public private partnership projects.**
- 10.2 Local government has identified a shortfall in the amount of funding required to meet its infrastructure requirements.**

10.1 Introduction

Victoria's 79 local councils are responsible for maintaining infrastructure estimated to be worth \$37 billion.³⁹⁵ The local councils provide and maintain infrastructure such as local roads, bridges, footpaths, water and stormwater drains, waste disposal and public buildings, parks and recreational facilities.

Despite significant spending by local government in Victoria on constructing, improving and maintaining its assets, there is a significant gap between the public's expectations about the quality and variety of available local government assets and its capacity to meet these expectations. In 2002, for example, the Auditor-General released a report on the management of roads by local government that assessed the condition of existing road infrastructure and identified a \$1.4-\$2.75 billion deficit for maintenance and renewal of ageing infrastructure.³⁹⁶ And the Municipal Association of Victoria (MAV) recently calculated an annual infrastructure spending shortfall of \$310 million for Victorian councils over the next five years.³⁹⁷

Local government in Victoria has annual revenue of \$4.7 billion, more than 55 per cent of which it raises from rates.³⁹⁸ Two-thirds of the remainder comes from grants from the Victorian Government (\$547.93 million³⁹⁹) and the federal government.

³⁹⁵ Municipal Association of Victoria (MAV), fact sheet Council responsibilities, see: www.mav.asn.au, accessed 10 August 2006

³⁹⁶ Victorian Auditor-General's Office, *Management of roads by local government*, June 2002, p.51

³⁹⁷ Municipal Association of Victoria, *Local Government Cost Pressures*, fact sheet

³⁹⁸ Municipal Association of Victoria, 'Councils under pressure to increase rates', media release, 1 July 2006

³⁹⁹ Municipal Association of Victoria, *Overview of the 2006-07 State Budget*, p.7

Councils have the power to borrow money to enable them to perform their functions.⁴⁰⁰ However, before entering into a partnership they are required to receive approval from the Minister for Local Government and the Treasurer.⁴⁰¹

10.2 Local government experience with PPPs

In 2004, the MAV commissioned PricewaterhouseCoopers to investigate and assess the feasibility of establishing a central borrowing authority for local government and to look at approaches for addressing infrastructure replacement. The report concluded that there was no unmet demand for funds by councils in Victoria. It also reported that the market for council borrowings was largely competitive, the current level of demand for council finance was being met, and that a separate central borrowing facility was not required. The report recommended an advisory service for councils be established to leverage the current competitive market for council financing in Victoria.⁴⁰²

The Committee understands that the MAV developed a supply agreement with a major international financial consulting firm in 2005⁴⁰³ to provide specialist financial advisory services on infrastructure financing the non-metropolitan councils in Victoria.⁴⁰⁴

The Committee understands that a few local governments in Victoria have considered or are pursuing the PPP model:

- Cardinia Council was proposing a PPP arrangement that included the development of new civic offices and commercial development of the shire's land in the Pakenham central business district.⁴⁰⁵ This was to be undertaken by a consortium of architects and financiers led by Rothschild's Bank. The withdrawal of a major co-tenant has meant that it is no longer financially feasible for the council to continue as the sole lessee of the building, and the project will now not proceed.⁴⁰⁶
- Melbourne City Council is a partner with the Victorian Government in the PPP project for the Melbourne Convention Centre development and associated commercial works. The council will contribute \$43 million to develop the precinct and build a footbridge linking the north and south banks of the

⁴⁰⁰ *Local Government Act 1989*, s.144

⁴⁰¹ *Local Government Act 1989*, s.193 (5C) provides details of the level of investment by councils that requires approval by the Treasurer and the Minister for Local Government

⁴⁰² Referred to in an article by A Beresford-Wylie, G Watts and V Thurairaja, *Financing local government infrastructure: the Australian experience*, p.12

⁴⁰³ Ernst & Young

⁴⁰⁴ Referred to in an article by A Beresford-Wylie, G Watts and V Thurairaja, *Financing local government infrastructure: the Australian experience*, p.12

⁴⁰⁵ Quoted in an article in *Infrastructure and privatisation*, 11 July 2006.

⁴⁰⁶ Manager of Governance and Communication, Cardinia Council, email, received 24 August 2006

Yarra.⁴⁰⁷ Since the contract covering this project has still not been released, the full extent of council involvement is unknown.

- Banyule Council is looking at a PPP arrangement to undertake a redevelopment at its civic offices that will involve commercial and residential developments with new community facilities. The council will contribute \$35 million and the state government \$12.8 million towards the \$85.4 million project.⁴⁰⁸
- Geelong Council is considering various funding options, including the PPP model, to build a convention centre.

One academic indicated that common PPP applications in local government could include:⁴⁰⁹

- property development including local government offices;
- car parks, land swaps and mixed development, for example, residential, commercial and community;
- waste collection and management;
- waste water treatment;
- child care and play group facilities, libraries and community education and community services;
- marina and special purpose facilities;
- public buildings;
- franchising of public transport including light rail, buses, monorail and interchange facilities
- roads and road maintenance;
- information technology;
- social housing and aged care; and
- street lighting.

The Committee is aware that at least one investment banker, Macquarie Bank, has indicated its interest in pursuing community partnerships with local government. This would involve the PPP model being used to undertake development or redevelopment on sites such as civic buildings, swimming pools, sporting arenas, golf courses, and caravan parks that are controlled by councils.⁴¹⁰

⁴⁰⁷ *Partnerships Victoria* website, Melbourne Convention Centre Development: Project summary see: www.partnerships.vic.gov.au, accessed 2 September 2006

⁴⁰⁸ Banyule Council Greensborough Project Launch, August 2006.

⁴⁰⁹ Profession M. Regan, Australian Centre for Public Infrastructure, University of Melbourne, quoted in a presentation entitled 'Are Public Private Partnerships Successful in Local Government?'

⁴¹⁰ Referred to in an article by A Beresford-Wylie, G Watts, and V Thurairaja, *Financing local government infrastructure: the Australian experience*, p.13

Because there is no guidance material that specifically covers local government and PPP projects, local government needs a framework that ensures a high degree of transparency, probity and integrity. In particular, the costs for the council over the life of the project and the risks to be transferred need to be transparent.

Both the local and state governments need to carefully weigh the cost and benefits of councils using these complex alternative funding arrangements.

CHAPTER 11: CONCLUSION

The Committee has been able to review the findings in the Review of Partnerships Victoria Report and in various Auditor-General reports on certain aspects of public private partnership (PPP) projects. It has also had the opportunity to discuss the merits or otherwise of the provision of infrastructure using PPP arrangements with various financial analysts, lawyers, consultants, public servants, parliamentarians, community groups, academics, industry bodies and construction firms, both in Australia and overseas.

In the absence of public documentation, the Committee cannot conclusively state whether or not PPP policy is generally delivering value for money over the life of projects compared with traditional procurement methods.

The Committee noted the comments contained in the Fitzgerald Report that on the basis of his access to documentation that the eight *Partnerships Victoria* projects examined had:⁴¹¹

... the potential to demonstrate innovation of design, certainty of timing and cost, and the delivery of a whole-of-life approach to facility maintenance.

Also:

... using the methodology of comparing their cost to a Public Sector Comparator, each of the eight projects has been declared, at the time the contracts were entered into, as being equal to or better value than the option of public sector provision.

The Committee's review identified a range of concerns that need to be addressed by the Victorian Government. It found that certain overseas jurisdictions – notably the United Kingdom and British Columbia – had taken steps to address many of the criticisms about concepts such as the public sector comparators, high discount rates, and the premiums to be paid for the transfers of risk to the private sector that are used in these arrangements.

The *Partnerships Victoria* policy embraces the concept that the private sector can often deliver public infrastructure services more cost effectively than government and offer short and long term innovation. This concept is yet to be conclusively proven when all factors are taken into account. The *Partnerships Victoria* policy acknowledges that although the cost of borrowing by government is lower than the private sector, the discount rate used should reflect the risk of the project that is assumed by the private sector, not the government's borrowing rate.

⁴¹¹ P Fitzgerald, *Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer*, Growth Solutions Group, Melbourne, January 2004, p.17

However, current international practices, which reflect improved knowledge about the valuing of risk, have resulted in the United Kingdom reducing discount rates for PPP projects to 3.5 per cent with a risk adjustment to cash flow.

The Committee observed from its review of certain PPP projects that despite paying large premiums for the assumption of risks by private sector consortia, it has been common practice for certain risks to revert back to government without any adjustment to the discount rate.

A build own operate model was applied to the Mildura Hospital and the Melbourne County Court and was based on a concept contained in the *Partnerships Victoria* policy, whereby the government only needs to purchase services from the private sector and not the infrastructure, despite having paid for the building under the leasing arrangements with the developer. At the expiration of the lease, ownership of the building remains with the developer.

The Committee considers policies that treat multi-million dollar purpose built government funded assets as disposable early in their life span need to be revisited by the government.

There is no question about Victoria's need for new infrastructure. The Committee acknowledges that it is a difficult and challenging task for any government in providing infrastructure to determine the appropriate level of investment to fund the hospitals, schools, roads and other essential infrastructure Victoria will require in the future.

The early PPP arrangements were devised in such a way that in return for the private sector providing the infrastructure, the repayment of construction and maintenance costs was achieved through the government entering into operating leases. With the advent of the Australian equivalent of International Financial Reporting Standards, most of these earlier financial arrangements need to be classified as finance leases, representing long term debt to be met by future governments.

There is substantial evidence to indicate that most PPPs result in infrastructure being delivered on time and within budget, with some exceptions. The Southern Cross Station, for example, ran more than 12 months behind the scheduled completion date and the third party builder incurred a substantial loss.

The Committee acknowledges that the *Partnerships Victoria* policy in most instances provides for the use of a public sector comparator, where bids from the private sector are compared with the estimated cost of constructing projects within the public sector, after allowing for the allocation of risks between the private and public sectors.

The Committee has reservations about the reliability of the public sector comparator because of its theoretical approach to estimating and comparing costs, particularly in relation to the valuation of risk.

The Treasurer has acknowledged that scope changes and budget and time overruns have occurred in projects procured under traditional means. These problems were primarily attributed by the Treasurer to the failure to identify and manage projects risks at all stages of a project's life cycle.⁴¹² The government has recognised these problems and implemented the Gateway Review Process in 2003. This has had some success in resolving issues that delay projects and in ensuring that infrastructure is delivered in a more cost efficient manner.

The biggest barrier to determining the benefits or otherwise of PPPs has been the lack of public information for these projects, although some improvements have occurred. New accounting standards require leases previously recorded as operating leases to now be classified as finance leases, with the corresponding disclosure of both the asset and the debt liability. Nevertheless, the International Accounting Standards Board is still to finalise a new accounting standard for PPPs. Previous efforts have proven unsuitable to governments worldwide because the draft accounting standard focused on disclosure in private sector financial reports.

The Committee considers that public accountability needs to be improved within Victoria in a range of areas such as the prompt disclosure of contracts on the government's website and providing Parliament with a schedule of repayments to consortia. The Committee is concerned about the use of '*commercial in confidence*' to prevent full disclosure of details such as the public service comparator, the risks to be transferred, the total amount of payments (often what is included in the lengthy complex contract is a formula rather than actual amounts), and contracts that are only released publicly months after the financial close has been agreed.

The Committee is also concerned that because of the high cost of preparing bids, only a small number of consortia are bidding for major PPP projects, which raises issues whether there is sufficient competition to ensure government gets a good deal.

The Committee has made 20 recommendations to improve the *Partnerships Victoria* policy and significantly strengthen the governance arrangements for PPP projects. These recommendations are also seen as contributing towards the government ensuring that PPPs provide value for money over the life of the project.

This report was adopted by the Public Accounts and Estimates Committee at its meeting held on 29 September 2006 in Meeting Room 4 at Parliament House, Melbourne.

⁴¹² Address to the Australian Infrastructure Council by Hon. J Brumby, MP Treasurer, 3 July 2003, p.14

APPENDIX 1: ACRONYMS AND ABBREVIATIONS

AASB	Australian Accounting Standards Board
BAFO	Best and Final Offer
BOO	Build Own Operate
BOOT	Build Own Operate Transfer
BTO	Build Transfer Operate
CAPM	Capital Asset Pricing Model
CBA	Design Build Finance and Operate
D&C	Design and Construct
DBFO	Cost Benefit Analysis
FOI	Freedom of Information
HoTARAC	Heads of Treasury Accounting and Reporting Advisory Committee
IASB	International Accounting Standards Board
IFRIC	International Financial Reporting Interpretations Committee
IPPR	Institute of Public Policy Research
LSE	London School of Economics
NAO	National Audit Office
PFI	Private Finance Initiative
PPP	Public private partnership
PSC	Public Sector Comparator
VfM	Value for Money

APPENDIX 2: SUBMISSIONS RECEIVED

Name of individual/organisation	Submission number
ABN Amro Australia Limited	23
Agility Management Pty Ltd	16
Australian Council for Infrastructure Development	18
Australian Education Union – Victorian Branch	34
Brad Neal, Mr	9
Cavan Group Pty Ltd	1
City of Boroondara	11
City of Melbourne	8
City of Whitehorse	20
Deacons law firm	14
Department of Treasury and Finance	35
Department of Treasury and Finance	36
Deutsche Bank AG	19
G Lloyd-Smith	7
Hyder Consulting (Australia) Pty Ltd	12
Institution of Engineers Australia – Victorian Division	29
Manningham City Council	10
Monash University – Privatisation and Public Accountability Centre	31
Moreland City Council	22
Mornington Peninsula Shire	27
Municipal Association of Victoria	30
National Express Group (Australia) Pty Ltd	21
Property Council of Australia	33
Property Council of Australia	37
Quiggin, Professor John	25
SGS Economics & Planning Pty Ltd	2
Shire of Campaspe	6
Tasman Economics	3
Thiess Pty Ltd	32
Tourism Task Force, The	28
Transfield Pty Ltd	15

Report on private investment in public infrastructure

Victorian Auditor-General	13
Victorian Council of Social Service	24
Victorian Trades Hall Council	5
Wilson, Dr Simon	17
Wyndham City Council	4

APPENDIX 3: LIST OF INDIVIDUALS AND ORGANISATIONS PROVIDING EVIDENCE

30 April 2002 – Melbourne

Mr J Fitzgerald, Director, Department of Treasury and Finance
Mr G Maguire, Assistant Director, Commercial Division, Department of Treasury and Finance
Mr R Walker, Assistant Auditor-General, Victorian Auditor-General's Office
Mr S Mitsas, Director, Statewide and Central Agencies, Victorian Auditor-General's Office
Dr R Arndt
Mr N Morris, Chief Executive, Tasman Economics
Mr A Wade, Economic Consultant, Tasman Economics
Associate Professor J Wilson, Chairman, Institution of Engineers Australia
Mr K Mathers, National Vice President and Principal, Ken Mathers and Associates, Institution of Engineers Australia
Dr C Duffield, Senior Lecturer, Faculty of Engineering, University of Melbourne, Institution of Engineers Australia
Professor G Hodge, Director, Centre for Privatisation and Public Accountability, Monash University
Mr D Shepherd, Business Development Manager, Transfield Pty Ltd
Mr H Fischer, (then) Executive General Manager, Project Development, Transfield Pty Ltd
Mr A Haggart, Partner, PricewaterhouseCoopers
Mr M D'Elia, Director, Project Finance, PricewaterhouseCoopers

15 August 2002 – Melbourne

Mr T Cave, General Manager, Major Projects Delivery, Department of Justice
Mr J Charleson, Deputy Secretary, Corporate Services, Department of Justice
Mr G Campbell, Partner, Maddocks

20 August 2002 – Melbourne

Mr G Joyce, Graeme Joyce Pty Ltd
Dr A Smith, Director, Melbourne City Link
Ms M Baker, Melbourne City Link
Ms C Hilder, Director, Policy, Australian Council for Infrastructure Development

24 September 2002 – Melbourne

Mr P Kennelly, Research Officer, Australian Education Union, Victorian Branch
Mr D Johnson, General Manager, Victoria, Thiess Pty Ltd
Mr J Myers, Head of Business Strategy, National Express Group
Ms S Gandur, Head of Communications, National Express Group
Ms C Smith, Chief Executive Officer, Victorian Council of Social Service
Ms C Atkins, Policy Analyst, Victorian Council of Social Service

22 October 2002 – Brisbane

Mr S Drabsch, Executive Director, Queensland Department of State Development
Mr T Crane, Principal Project Officer Infrastructure Partnerships Task Force, Queensland Department of State Development
Mr L Scanlan, Auditor-General, Office of the Auditor-General of Queensland
Mr P Shipperley, Assistant Auditor-General, Office of the Auditor-General of Queensland
Ms K Cossart, Executive Officer to the Auditor-General, Office of the Auditor-General of Queensland
Ms G Grace, General Secretary, Queensland Council of Unions
Mr R Tooth, Manager, Project Development Unit, Department of Health
Mr D Jay, Director, Capital Works Branch, Department of Health
Mr L Ford, Deputy Director-General, Department of Main Roads
Mr G Vidas, Director, Public Private Partnerships, Department of Transport
Mr D Skinner, Executive Director, Project Development Office, Department of Main Roads
Mr K Beattie, Assistant Executive Director, Strategic Policy, Department of Main Roads

23 October 2002 – Sydney

Mr T Harris, Journalist, Australian Financial Review, and former Auditor-General, New South Wales
Mr J Miller, Executive Director, Macquarie Bank
Mr M Lilley, Division Director, Macquarie Bank
Mr J Tripodi, MP, Chair, New South Wales Parliament, Public Accounts Committee
Ms K Hodgkinson, MP, New South Wales Parliament, Public Accounts Committee
Mr I Glachan, New South Wales Parliament, Public Accounts Committee
Dr C Sheil, Visiting Fellow, University of New South Wales School of History
Mr R Sendt, Auditor-General, Audit Office of New South Wales
Mr A Whitfield, Deputy Auditor-General, Audit Office of New South Wales
Mr R Opiat, Director, Business Development, Boulderstone Hornibrook
Ms D Gattelari, Corporate Communications Manager, Boulderstone Hornibrook
Mr D Graham, Acting Director, New South Wales Treasury
Ms B Archer, Principal Financial Analyst, Private Projects Branch, New South Wales Treasury

24 October 2002 – Canberra

Mr K. Davidson, Staff Columnist, *The Age*
Professor J. Quiggin, Australian Research Council Senior Fellow, School of Economics, ANU
Mr M Watson, Group Executive Director, Australian National Audit Office
Ms T Long, Director, Performance Audit Branch, Australian National Audit Office

7 August 2003 – Sydney

Private briefing

Mr J Barrett, Secretary, Australian Constructors Association
Mr W Napier, Partner, Freehills
Ms F Gates, Managing Director, Head of Infrastructure, DB Capital Partners

27 January 2004 – Melbourne

Mr J Fitzgerald, Director, Department of Treasury and Finance
Mr G Maguire, Assistant Director, Commercial and Infrastructure Projects, Department of Treasury and Finance
Mr R Bartlett, Policy and Public Affairs Analyst, Property Council of Australia
Mr B McNamara, Chair, Planning and Infrastructure Committee, Property Council of Australia
Mr P Oppenheim, Managing Director, Head of Infrastructure Capital, ABN Amro
Ms C Hilder, Director of Government Affairs, Australian Council for Infrastructure Development

11 March 2004 – Melbourne

Mr J Cain, Executive Director, Major Projects Victoria, Department of Infrastructure

15 December 2004 – Melbourne

Private briefing

Mr P Fitzgerald, Reviewer of *Partnerships Victoria* Provided Infrastructure

Overseas witnesses

22 September 2003 – London

Ms M Eagle, MP, Parliamentary Under Secretary of State and Minister for Disabled People
Mr J Stewart, Chief Executive, Partnerships UK HM Treasury
Mr O Robbins, Head of Corporate and Private Finance Team, HM Treasury, Partnerships UK HM Treasury
Mr S Byrne, Private Finance Unit, HM Treasury, Partnerships UK HM Treasury
Professor A Pollock, Chair of Health Policy, Health Services Research Unit, University College London

23 September 2003 – London

Mr D Finlay, Head of PFI Development, National Audit Office

Mr N Carey, Audit Manager, National Audit Office

Mr P Maltby, Research Fellow, Public Private Partnerships, Institute of Public Policy Research

Mr M Lipson, Director of Schools and Leisure, Public Private Partnerships Programme (4Ps)

Mr O Robbins, Head of Corporate and Private Finance Team, HM Treasury

24 September 2003 – London

Mr S Harris, Head, International Financial Services, The PPP Export Group International Financial Services London

Mr N Singru, Consultant, Halcrow Group Limited, The PPP Export Group International Financial Services London

Mr S Klein, Divisional Director, Currie and Brown Consulting Limited, The PPP Export Group International Financial Services London

Mr T Treharne, Director, KPMG Corporate Finance, The PPP Export Group International Financial Services London

Mr D Wright, Director, PPS Solutions Limited, The PPP Export Group International Financial Services London

Mr R Miller, Director, BDO Stoy Hayward, The PPP Export Group International Financial Services London

Mr D Webster, Head of Infrastructure Advisory, Infrastructure Finance Group, The Royal Bank of Scotland, The PPP Export Group International Financial Services London

Ms L Grist, Director, The PPP Forum

Ms O Tai, Public Relations Manager, The PPP Forum

Mr C Smith, Partner, Energy, Transport and Infrastructure Department, Ashurst Morris Crisp, The PPP Forum

Mr D Nelligan, Solicitor, International Finance Department, Ashurst Morris Crisp, The PPP Forum

Mr I Wootton, Partner, Infrastructure, Government and Utilities, PricewaterhouseCoopers

Mr P Davies, Partner, Corporate Finance Transport, PricewaterhouseCoopers

25 September 2003 – Dublin

Mr J Perry, Chairman, Committee of Public Accounts and Joint House Services Committee

Mr J McGuinness, Vice Chairman, Committee of Public Accounts and Joint House Services Committee

Mr S Ardagh, Committee of Public Accounts and Joint House Services Committee

Mr D Boyle, Committee of Public Accounts and Joint House Services Committee

Mr P Connaughton, Committee of Public Accounts and Joint House Services Committee

Mr J Curran, Committee of Public Accounts and Joint House Services Committee

Mr J Dennehy, Chairman, Joint House Services Committee

Mr S Fleming, Committee of Public Accounts and Joint House Services Committee

Mr J Higgins, Committee of Public Accounts and Joint House Services Committee

Mr M Noonan, Committee of Public Accounts and Joint House Services Committee

Mr B O'Keefe, Committee of Public Accounts and Joint House Services Committee

Mr P Rabbitte, Committee of Public Accounts and Joint House Services Committee

Mr D Dignam, Principal Clerk of the Committee, Committee of Public Accounts and Joint House Services Committee

Mr J Purcell, Comptroller-General, Office of the Comptroller and Auditor-General

Mr J Buckley, Secretary and Director of Audit, Office of the Comptroller and Auditor-General

Mr E Kearns, Head of Public Private Partnership Unit, Central Public Private Partnership Unit, Department of Finance

Ms C O'Brien, Deputy Head of Communication, Central Public Private Partnership Unit, Department of Finance

Mr P Keating, National Secretary/General Manager, Impact Trade Union

29 September 2003 – Paris

Mr G Ganser, National Audit Manager, Auditor-General's Office

Mr B Licour, Special Advisor, Asia International Affairs Department, Veolia Environment

Mr B Poignant, International Finance Project Director, Veolia Environment

Mr J Bitterlich, Executive Vice President, International Affairs, Veolia Environment

Mr N de Sanit Pulgent, Principal Public Accounts Auditor and PPP specialist, Inspecteur General des Finances, Ministry for Economy, Finance and Industry

Ms S Lagumina, (Legal Affairs) Assistant to the Under Secretary of Public and International Rights, Inspecteur General des Finances, Ministry for Economy, Finance and Industry

Mr T Reynaud, Assistant to the Director of Public Rights, Inspecteur General des Finances, Ministry for Economy, Finance and Industry

30 September 2003 – Paris

Mr H Marion, MP, Vice President, Standing Finance Committee, French National Assembly (Parliament)

Mr B Marcincal, Secretary, France, Australia Friendship Group, French National Assembly (Parliament)

Mr R McInnes, Senior Vice President and Chief Financial Officer, Thales Group

1 October 2003 – Brussels

Ms P Clarke, Officer, EPSU Secretariat, European Federation of Public Sector Unions, Australian Embassy and Mission to the European Union

Ms N Gordon-Smith, Acting Head of Australian Mission, Brussels, Australian Embassy and Mission to the European Union

Mr D Pyne, Minister, Counsellor (Agriculture), Australian Embassy and Mission to the European Union

Dr J Barbara, Third Secretary, Australian Embassy and Mission to the European Union

Mr G Plancquaert, Senior Advisor, Flanders Expertise Centre on Public Private Partnerships

Mr S Steppe, Junior Advisor, Flanders Expertise Centre on Public Private Partnerships

Mr R Bruyninckx, Junior Advisor, Flanders Expertise Centre on Public Private Partnerships

2 October 2003 – Brussels

Mr V Pedret Cuscó, Principal Administrator, Sectoral Policy Unit, Energy and Transport Directorate-General, European Commission

Dr R Ridolfi, Principal Coordinator, Regional Policy Directorate-General, European Commission

Mr R Plassman, Secretary General, European Centre of Enterprises with Public Participation and of Enterprises of General Economic Interest (CEEP)

Ms I Reichert, Director, European Centre of Enterprises with Public Participation and of Enterprises of General Economic Interest (CEEP)

3 October 2003 – The Hague

Dr A Betting, Deputy Director, Financing Directorate, PPP Knowledge Centre

Mr D Loschacoff, PPP Knowledge Centre

Mr J P Schaay, PPP Knowledge Centre

Professor Dr G Dewulf, School of Business, Public Administration and Technology, Department of Construction Process Management, University of Twente

Assistant Professor Dr M Bult-Spiering, University of Twente

Mr A de Jong, Executive Vice President, Board of Management, VolkerWessels

Mr G de Jong, Member of The Netherlands Court of Audit, The Netherlands Court of Audit

Dr F H Hock, Audit Manager, The Netherlands Court of Audit

Mr J Vos, Deputy Audit Director, The Netherlands Court of Audit

Dr K van Keulen, Bureau of Public, Private Sector, The Netherlands Court of Audit

6 October 2003 – Vancouver⁴¹³

Mr N Hann, Managing Director, Macquarie North America

Mr T Mack, Associate, Corporate Finance, Macquarie North America

Mr L Blain, President and Chief Executive Officer, Partnerships British Columbia

Ms M Laudan, Senior Communications Consultant, Partnerships British Columbia

Mr S Daub, Communications Coordinator, Canadian Centre for Policy Alternatives

Ms S Fuller, Researcher, Canadian Centre for Policy Alternatives

Ms N Chambers, Researcher, Canadian Centre for Policy Alternatives

Mr M Lee, Research Economist, Canadian Centre for Policy Alternatives

Mr S Klein, Director (BC office), Canadian Centre for Policy Alternatives

Mr D Marshall, Resource Researcher, Canadian Centre for Policy Alternatives

Mr K Reynolds, Canadian Union of Public Sector Employees (CUPE), Canadian Centre for Policy Alternatives

Mr A Greer, Transport Economist, Canadian Centre for Policy Alternatives

Ms C Karkhairan, Office Manager, Canadian Centre for Policy Alternatives

⁴¹³ Ms D Green, MP, at no cost to the Committee was authorised to take evidence from a number of officials in British Columbia

APPENDIX 4: SUMMARY OF REPORTS ON OPERATIONAL PPP/PFI PROJECTS IN THE UK

Summary of findings and recommendations from selected reports of the National Audit Office and the United Kingdom Public Accounts Committee on operational PPP/PFI projects

2001

National Audit Office 2001, *Managing the relationship to secure a successful partnership in PFI projects*, HMSO, London

At the time this report was published, there were more than 400 signed private finance initiative (PFI) contracts. The report aimed to highlight key issues that authorities need to consider when developing and managing relationships with service providers. The key question it sought to answer was whether authorities manage their PFI relationships to secure a successful partnership.

The survey included authorities and contractors responsible for managing 121 PFI projects where contracts were let before 2000. Various other public sector bodies were also surveyed. The response rate was 90 per cent from public authorities and 75 per cent from contractors. The topics surveyed relevant to the review of operational projects were the relationship with the contractor, building blocks for a successful partnership, contract management mechanisms, staffing of the contract management function, administration of the contract, learning from others, and actual performance.

Key findings relating to the operational phase:

- most authorities consider that their PFI projects deliver good value for money although there was a decline in satisfaction since the contracts were let;
- the public sector needs careful project management and close management of the relationship with contractors to ensure value for money;
- most relationships with contractors are good;
- development of a successful relationship will be assisted by the right contractual framework, which will include allocating risks correctly and clearly defining areas of service quality;
- although most authorities were satisfied with the risk allocation in their contract, only two-thirds of contractors felt the same way;
- more than half of the authorities had made deductions for poor performance;

- there was evidence that authorities and contractors were using performance review processes to bring about positive changes in the way services were delivered;
- authorities had limited experience in using benchmarking;
- dealing with change was a significant issue; the change mechanism had been used in 55 per cent of projects with change procedures;
- having staff with the right skills is critical to good contract management; this includes a thorough understanding of the project and an ability to build effective relationships with contractors;
- there was considerable variation in the extent of the training provided; there was also difficulties in achieving staff continuity;
- contractors believed there should be better training for public sector staff;
- most authorities and contractors believed that governance arrangements were working well;
- some contractors said they were unable to be innovative due to the fixed views of departments;
- three-quarters of contractors thought authorities had adopted an appropriate approach to contract monitoring, although some thought the authority had become too closely involved; and
- both parties need to review their relationships on a regular basis to establish how they can be improved and maintained.

Recommendations relating to the operational phase:

- the public sector should consult with users about their level of satisfaction with services;
- projects should be approached in the spirit of partnership, which requires an understanding of each other's business and a common vision of how the two sides can best work together;
- authorities should consider contract management at an early stage in the procurement;
- appropriate contractual procedures for dealing with change should be built into the contract;
- a contract management staffing plan should be developed during the procurement stage;
- authorities and contractors should consider how their relationships will be managed before contracts are let;
- authorities should regularly reassess their relationship with the contractor and the value for money from the contract; and

- Office of Government Commerce should publish further guidance on contract management and facilitate workshops.

House of Commons Committee of Public Accounts 2001, *Managing the relationship to secure a successful partnerships in PFI projects*, forty-second report of session 2001-02

- better evaluation of PFI projects in progress is needed;
- post-implementation reviews are particularly important for projects where perceived value for money had declined since contract award;
- twenty-three per cent of authorities surveyed considered there had been a decline in value for money in PFI projects after contract letting; only half of these had benchmarking and open book accounting;
- a low proportion of contracts provided the authority with a share in refinancing gains;
- concerns had been raised about the high charges for additional services;
- fifty-eight per cent of authorities made performance deductions; the report concludes that many authorities are therefore not getting the services they require;
- staff continuity is desirable for continuity of knowledge;
- there are still gaps in the guidance and training about managing PFI projects as distinct from how to negotiate them at the outset; and
- there are significant shortcomings in authorities' training in contract management.

Recommendations relating to the operational phase:

- authorities should ensure that value for money is maintained over the life of a project;
- contractors should expect to lose their investment in PFI projects when things go wrong and to be rewarded reasonably when things go well;
- the public sector should not insulate the contractor from the consequence of the risk that it has been paid to take on;
- staff responsible for managing PFI projects must be equipped with the appropriate skills;
- very little information is available about the returns that private sector partners earn on PFI projects; a review should be undertaken by the Office of Government Commerce;
- there should be a proper handover from the procurement phase to the operational phase; and

- the public sector needs to be more commercially aware.

2002

Audit Scotland 2003, Taking the initiative: using PFI projects to renew council schools

This study examined the nine schools' PFI contracts that had been signed to date. It aimed to help inform the debate on the initiative and examine whether the Scottish deals delivered value for money. It also hoped to identify lessons for future procurements. Of the procurements examined in this study, only three were in the operational phase.

Key findings relating to the operational phase:

- councils, pupils and teachers generally welcome the improved accommodation and levels of service that had become operational thus far;
- there is no systematic sharing and development of staff skills and knowledge in the area of PFI schools procurement and project management;
- councils and the private sector appear to have managed the Transfer of Undertakings (Protection of Employment) effectively with due consultation with staff involved;
- private finance initiative contractors are providing a satisfactory facilities management service;
- deductions for service failures in the first year of operation were low, at 0.2 per cent of the total value of payments;
- cleaning services are equivalent in standard to the service delivered before PFI; and
- once contract terms have been agreed, the arrangements tend to promote a collaborative approach to problem solving rather than an adversarial relationship.

Recommendations relating to the operational phase:

- councils should share information such as unit construction costs and operating costs actually experienced by individual projects;
- schools should be involved in developing the specification to minimise dissatisfaction later in the project;
- councils should gain early feedback from users on the quality of the facilities;
- each council should have a commissioning and monitoring regime that tests and confirms the accuracy of the provider's reports; and

- councils should consider in advance the best options for addressing serious under-performance if it should materialise, particularly during construction.

2003

National Audit Office 2003, *The operational performance of PFI prisons*, TSO, London

This study looked at 21 prisons, seven of which were operational PFI prisons, two were privately managed prisons and 12 were public sector prisons that were used as comparators. Evidence for the report was gathered by examining the PFI contracts, visiting the prisons, surveying prison officers and prisoners, and carrying out semi-structured interviews.

Key findings relating to the operational phase:

- the operational performance of PFI prisons against contracts has been mixed;
- most PFI prisons have had problems when they first opened, but with one exception, have improved;
- amending PFI contracts to reflect changing priorities is difficult;
- the private sector has brought benefits to the prison service;
- competition has been important for improving management and conditions for prisoners; however, as bids have become increasingly competitive, there appears to be evidence that private contractors and successful in-house bid teams are struggling to meet standards of performance;
- the use of PFI has introduced innovation, mainly in the recruitment and deployment of staff and in the use of new technology;
- a key innovation has been in promoting a more constructive staff/prisoner relationship;
- the level of financial deductions is not necessarily an accurate indicator of performance; and
- prisoners in PFI prisons feel they are shown greater respect and treated better than in public prisons.

Recommendations relating to the operational phase:

- the Prison Service should share its measurement techniques with other government departments;
- the number of performance measures should be reviewed;
- the quality and collection of performance data in the public sector should be improved;
- the link between performance and financial deductions should be monitored closely;
- greater flexibility should be introduced into earlier PFI contracts as priorities have changed;
- the system of performance measurement should be sharpened;
- the role of the Controller should be enhanced; and
- good practice initiatives in the day-to-day operation of prisons should be shared between the public and private sectors to a greater extent.

Audit Commission 2003, PFI in schools: the quality and cost of buildings and services provided by early private finance initiative schemes, Belmont Press, London

The purpose of the study was to review what PFI contracts were delivering in the schools sector by the end of 2001, and users' experience of those schools during the first half of 2002, by comparing them with schools provided through traditional procurement. The study was undertaken in 2003 when more than 500 primary and secondary schools were already part of PFI deals signed or currently in procurement (67 schemes in all). The report examined whether the first buildings were of good quality, what the schools' users thought about these buildings and services, and their costs. To do this, the report compared the PFI funded schools with traditionally procured schools within the same local authority. Information was gathered from Local Education Authorities (LEAs), schools and private consortia members.

The Audit Commission visited nine LEAs across England and Wales with PFI schemes that had been delivering facilities management services for at least a year. A Market and Opinion Research International survey based on a design evaluation tool developed by the Construction Industry Council was also sent to a range of pupils and staff in 18 newly built schools – 10 traditionally built (59 people) and eight PFI built (35 people).

Key findings relating to the operational phase:

- no statistically significant differences between PFI and other schools in the costs of building maintenance, grounds maintenance, water and sewerage or fuel were identified;
- the average costs of cleaning and caretaking are higher in PFI schools, but this was probably because of higher levels of service required by the contract;
- there was a poor understanding of the furniture, fittings and equipment needs of the users;
- there had been little service innovation;
- bidders had underestimated the vandalism risks;
- many contracts did not anticipate the need for many small variations rather than large ones;
- contract clauses do not allow for streamlined, cost efficient and rapid processing of high-volume, small-value transactions;
- there was a mixed picture on the number of payment mechanism deductions and the payment mechanism was not always rigorously enforced;
- there was a mixed response to the helpdesk – some users saw this as a loss of control by the school head;
- some saw facilities management services as more responsive due to a good specification; and
- private finance initiatives should improve with time as lessons are learned.

Recommendations relating to the operational phase:

- contracts should be managed from the start of the procurement so that all parties see themselves as partners, not adversaries or competitors;
- there should be agreement of and commitment to a shared vision;
- there should be regular dialogue between the parties and open sharing of all relevant information;
- it should be recognised that boundary/interface issues should be dealt with constructively;
- contracts should have a governance structure that engenders public confidence and involves stakeholders;
- regular external reviews of the scheme should be commissioned to measure the degree to which the agreed outcomes are delivered;
- there should be more work to ensure that performance deductions are a proper reflection of the impact of the non delivery of the service;

- contract terms should not be so elaborate that management time required in putting arrangements in place and then monitoring them outweighs the return in service improvement;
- the public sector should get better information on whole life costs and financial information on the cost of the schemes; and
- there should be more support for LEAs to become informed clients so that there is a level playing field for negotiating, contracting and dispute resolution.

2004

National Audit Office 2004, *London Underground: are the public private partnerships likely to work successfully?*, TSO, London

This report examines whether the tube deals are likely to work successfully in practice. It focuses on whether performance is likely to improve, whether there are key success factors in place for the partnerships to work, and whether there are any constraints on the success of PPPs.

Key findings relating to the operational phase:

- performance against benchmarks to date is mixed, and it will take time and good information to determine whether performance will improve;
- the deal is clearly specified and understood in general and the parties are building a good relationship, but it is unclear whether the oversight mechanisms in the contracts will be sufficient;
- an independent arbiter can review the contract every seven years and as a result, price and scope can change;
- availability performance was very volatile during the period of shadow running;
- performance was uneven in the first year;
- parties have entered into the spirit of partnership, and monitor and review the partnership regularly; and
- it is too early to determine if parties will promote innovation and a whole business approach.

Recommendations relating to the operational phase:

- the department should avoid a complete *'hands off'* approach to oversight;
- London Underground should maintain its knowledge base and benchmark the private sector proposals to make sure they offer additional works at a fair price; and

- London Underground should maintain accurate, regular and consistent information from each infrastructure provider company to make sure they have good information about whether the re-pricing in seven years time represents good value for money.

2005

Cambridge Economic Policy Associates 2005, *Public private partnerships in Scotland: evaluation of performance*, Report for the Scottish Executive

The report was commissioned by the Scottish Executive to further its understanding of the performance of PPP projects in Scotland. The aims of the research were:

- to provide an initial assessment of the relative costs and benefits of PPP procurement compared with traditional procurement, and of the underlying causes of good and bad performance; and
- to assess the potential merits of centrally collecting additional performance monitoring information and other data to inform future PPP performance evaluations and provide recommendations on what data should be collected.

Questionnaires were sent to each authority responsible for a live PPP project (that is, health boards, councils and the Scottish Executive) covering 69 operational projects. The questionnaires were supported by interviews with private and public sector contacts for a sample of the projects.

Key findings relating to the operational phase:

- ninety-one per cent of respondents rated *'availability'* as *'good'* or *'very good'*, with 90 per cent considering availability meets or exceeds expectations;
- soft facilities management was rated *'good'* or *'very good'* by 71 per cent of respondents, although 85 per cent said that this service met or exceeded expectations;
- cleaning is a particular problem due to the buoyancy of the employment market;
- hard facilities management was rated *'good'* or *'very good'* by 57 per cent of respondents, and 69 per cent considered this service met or exceeded expectations; *'poor'* ratings were mainly due to the slow resolution of snagging issues;
- it is too early to draw conclusions about the impact of PPP on longer term maintenance;

- issues were raised about the interaction between hard and soft facilities management providers;
- respondents did not think that services were better or worse because they were PPP projects;
- no evidence was found that PPP operators delivered a better or worse standard of serviced than the public sector;
- several authorities were surprised by the input required on their part;
- public private partnership contracts are seen as less flexible than non-PPP contracts;
- making changes to the contracts was time consuming and slow, therefore the public sector sought to wrap up a number of changes in a single negotiation;
- changes are rarely incorporated into the unitary charge mechanism because of the complication of agreeing the financial impact;
- works' costs for contract changes are perceived as expensive in the absence of the ability to tender these;
- authorities noted that in the case of operational risks, ambiguities in the contract drafting made it unclear where risks lie and presented opportunities for risks to shift;
- interaction between hard and soft facilities management in the health sector, and the risks associated with the needs of different user groups, are not always clearly defined in the contract; and
- the majority of relationships between authorities and contractors are good and both parties recognise the advantages of developing a long term partnership.

Recommendations relating to the operational phase:

- there should be further work to assess whether costs quoted by PPP partners reflect an allowance for maintenance and renewal;
- authorities should ensure that formal feedback systems such as user surveys are part of the contract process wherever possible;
- there should be further work to review whether contractual remedies relating to snagging provide adequate incentives for contractors to resolve the issues;
- best practice guidelines should be issued for hard facilities management provision; and
- there should be further work to examine how to enhance flexibility without losing the benefits of PPP, focusing on areas such as health, where there are issues.

4Ps 2005, Review of operational PPP and PFI projects

The 4Ps undertook a review of 30 operational PPP and PFI schemes during 2004-05 over a period of six months. The purpose of the review was to answer the question *'are PFI contracts working in terms of providing improved public services?'* The review took the form of interviews with key stakeholders including the local authority project or contract managers, the private sector representative, and users of the services, for example, head teachers and tenants. The study did not cover any health projects or any projects covering non- local government functions. The main focus of the review was to determine whether services were being delivered in line with the approach set out in the service specifications, how effective the payment mechanism was, and how the contract was being used in the delivery of the services. The report also raised the issues of handover to the operational team, including contract monitoring arrangements, partnership relations, satisfaction and benefits realisation, and change management, but the findings dealt with mobilisation and developing new partnerships, output specifications, the payment mechanism and the contract.

Key findings:

Partnerships:

- users rate services more highly than the local authority;
- partnerships are working;
- service providers are delivering services on time, to budget and within the specification;
- service providers feel that they are contributing to the delivery of local services;
- there was a feeling that there had been a smoother implementation than with traditional procurement;
- different local authorities had different experiences;
- many local authorities had underestimated the scope and costs of contract management; and
- long term issues should be taken into account during the procurement stage.

Payment mechanism and output specification:

- there is room to improve the development of the output specification and the performance monitoring regime and payment mechanism in some sectors;
- there were few examples of genuine innovation but some new ways of working had been developed; and

- service providers are providing a high level of delivery against the service specification.

Contract:

- parties should try to work together to resolve difficulties;
- minor changes had been made to contracts;
- variations are being costed high; and
- there is a need for greater understanding by the private sector of local authority processes.

National Audit Office 2005, *PFI construction performance*, London

This report covers the construction performance achieved in PFI projects up to the end of 2002. It focuses on three key areas of construction: price certainty for projects; timing of construction delivery; and the quality of design and construction. The background information was gathered by surveying 38 projects that were complete or due to be completed by the summer of 2002, according to the original timetable.

Key findings relating to the operational phase:

- research shows that projects are delivering to price;
- most managers are satisfied with the design and construction of the building;
- twenty-eight of the 37 projects were delivered on time or earlier than specified; and
- user surveys will help with the development of future projects.

Recommendations relating to the operational phase:

- departments should carry out user surveys as part of their post-contract evaluation to gather information about how well an asset is operating and to identify problems and issues that the departments can pick up and discuss with contractors.

2006

National Audit Office 2006, *The termination of the PFI contract for the National Physical Laboratory, TSO, London*

Background

On 31 July 1998, the Department and Laser – a special-purpose company jointly owned by Serco Group plc and John Laing plc – signed a 25 year PFI contract. Under the contract, Laser would build and manage new facilities for the National Physical Laboratory (NPL) comprising 16 linked modules containing more than 400 laboratories, and replacing many existing buildings.

The planned cost of the new buildings was approximately £96 million, financed mainly by loans from the Bank of America, NA and Abbey National Treasury Services plc (the lenders). The department would pay Laser a unitary charge of £11.5 million (1998 prices) a year once the new buildings were ready. The charge would be increased annually by a factor based on the increase in retail prices. At the end of the contract, the charge would cease and ownership of the buildings would pass to the department.

As the building continued, problems emerged, which translated into delays to the completion of all phases, which for three phases amounted to nearly four years. Because construction of the new laboratories took longer than planned, Laser could not afford to complete the new facilities.

In precarious financial position, Laser proposed a negotiated termination of the contract, which the department considered would achieve a better outcome than relying on its termination rights under the contract. The termination was the first termination of a major PFI contract in which there were serious non-performance issues.

The termination of the PFI contract for the NPL can be directly attributed to deficiencies in John Laing plc's original design for the new buildings. The department identified concerns about the design, but during the procurement, the department considered Laser would overcome these concerns and so did not insist on Laser demonstrating its design could work. Following the award of the contract, the department did not seek to resolve its concerns by imposing a design solution on Laser because it wanted to ensure that responsibility for meeting its specification remained unambiguously with the private sector. The department's aim was to maximise incentives for the private sector to solve any problems, avoid costs falling on the taxpayer, and (initially) keep the value of its building off its balance sheet.

Key findings:

- the department identified concerns about the design at several stages;
- during procurement, the department was of the view that its concerns about the design were surmountable;
- the procurement competition was weak and the department therefore had little scope to use competitive tension to encourage Laser to improve the technical quality of its bid;
- commercial opportunities to exploit surplus land further reduced the effectiveness of competition;
- the department wanted to ensure that the private sector remained unambiguously responsible for delivering satisfactory output;
- the principles of the PFI put considerable emphasis on transferring risk to the private sector for three main reasons:
 1. to provide strong incentives for the private sector to control risks;
 2. to pass each risk to the party best able to manage it; and
 3. to encourage innovation and flexibility by giving the service provider discretion to determine how best to provide the service specified by the public sector.
- by procuring the new facilities through an output-based specification, the department sought to transfer design risk to the private sector;
- balance sheet treatment was a major influence on the department's procurement process;
- the department retained continuity in the project team;
- the department's estimate of the costs to procure the PFI contract, to manage its obligations during the construction phase, and to meet its residual responsibilities increased from £30 million to £53 million;
- the department reworked its cost-benefit analysis and concluded that despite the increase in the costs of its residual responsibilities, the project was still value for money;
- since awarding the contract to Laser in July 1997, the department has spent nearly £9 million on advisers;
- the department avoided compromising its contractual position
- as problems evolved the department set limits to its partnering role;
- by refraining from issuing variations, the department avoided compromising its contractual position on design responsibility;
- the department kept its options under review;

- the termination sum was reasonable within the terms of the contract;
- all parties got less from the project than they had hoped; and
- when the new facilities are completed the department expects them to meet its requirements.

House of Commons Committee of Public Accounts 2006, *The BBC White City 2 development*, Twenty-fourth report of session 2005-06, February 2006

Background:

- Land Securities Trillium financed and developed White City 2 under a 30 year partnership deal with the BBC (British Broadcasting Corporation), which also covered property services at 48 other BBC locations;
- the bid was £210 million, £31 million more than the other short listed bid; other benefits were savings across the BBC. Two buildings were completed on time (in October 2003) and the last was ready in January 2004, three months ahead of schedule;
- the BBC purchased Land Securities Trillium's interest in White City 2 in March 2005 to allow refinancing of the project;
- the original contract had included a provision to share in refinancing benefits, but the way the project was financed meant the BBC was unlikely to secure a share in the benefits; and
- the financial mechanism also meant the BBC was unable to calculate the return to shareholders, although the contract included a provision to cap the return at 30 per cent, which was higher than typical rates of return for deals like this.

Key findings:

While the project was completed on time, several aspects constitute risks to the value for money of the BBC's investment. The BBC entered a deal where the potential return to the private sector was excessive, where it couldn't be sure of sharing refinancing gains, and where it bought out the partner less than five years into the 30 year deal. The cost exceeded the amount approved and there were significant variations.

Specific findings:

- during the course of the project, £60 million in additional costs were identified, an increase of 29 per cent;
- after signing the contract, the BBC made 300 variations to the scheme;
- the BBC sublet space to a commercial subsidiary at a cost lower than the cost to the BBC;
- because of the way the project was financed, the BBC did not know whether the return to shareholders was within the limit specified; the BBC was unlikely to share in the refinancing benefits;
- the BBC's plans to cut staff and move others to Manchester increased the risk of under-utilisation of space and technical capacity;
- more than two years after the Energy Centre was completed, the space for combined heat and power installation is not being used and the BBC is paying for empty space;
- the BBC did not follow public sector good practice in several important respects; and
- the Comptroller and the Auditor-General's work is providing fresh insights into the BBC's use of public money; this work is being done under arrangements that end in 2006.

Recommendations:

- whole-of-life costs should be assessed and made available to the board before a project proceeds;
- there is a need to better integrate design and construction to reduce the risk of changes after the contract is let;
- the BBC's licence fee money should not be used to subsidise commercial subsidiaries;
- public bodies should share gains from refinancing and recognise the need to link finance to the project;
- the BBC should not hold onto property it does not need or which cannot be used cost effectively;
- the Energy Centre empty space and vacant office space has cost about £1 million a year; the BBC should put unused space to productive use as soon as possible;
- the BBC would benefit from drawing on Treasury and Office of Government Commerce guidance material; and

- the Comptroller and the Auditor General should have a continuing role in monitoring the BBC.

House of Commons Committee of Public Accounts 2006, *NHS Local Improvement Finance Trusts (LIFT)*, Forty-seventh report of session 2005-06, July 2006

Background:

- the Department of Health launched the Local Improvement Finance Trusts (LIFT) in 2000 to address long standing under-investment in primary care facilities; this investment had previously been supplied through private ownership by general practitioners, the private sector and the National Health Service (NHS),⁴¹⁴
- a national joint venture, Partnerships for Health, was established between the United Kingdom Department of Health and Partnerships to oversee and invest in LIFT. The local joint venture companies (LIFTCo) are 20 per cent owned by Partnerships for Health, 20 per cent by stakeholders in the local health economy,⁴¹⁵ and 60 per cent by a private sector partner;
- the LIFT scheme aims to attract £1 billion of private investment by 2010; the department provided start-up funding of £195 million;
- total capital value of the first tranche of 42 schemes was £711 million, with an average building costing £5 million;
- the first LIFT building opened in autumn 2004; 51 had been established across England by December 2005. These joint venture companies have exclusive rights to develop in their local areas over 25 years, using a standard procurement process and subject to value for money tests;
- Although the partners in the LIFTCo contribute equity, about 90 per cent of the capital is provided through debt;
- The properties are owned by LIFTCo and income is earned through rent from tenants such as Primary Care Trusts, GPs, pharmacists and Local Authorities;
- tenants in LIFT buildings lease under Lease Plus Agreements, which cover the whole lifecycle cost of the building; LIFTCo as the landlord is responsible for

⁴¹⁴ Primary care is the care provided by people normally seen when they first have a health problem. It might be a visit to a doctor or a dentist, an optician for an eye test, or a trip to a pharmacist to buy cough mixture. NHS Walk-in Centres, and the phone line service, NHS Direct, are also part of primary care. All of these services are managed by local Primary Care Trusts (PCT)

⁴¹⁵ Primary Care Trusts, local authorities and general practitioners who wish to take a shareholding

maintaining the premises to an operational standard throughout the life of the asset. Rent increases are limited to the retail prices index (RPI),⁴¹⁶ and

- On the basis of a report by the Comptroller and the Auditor-General, the Committee examined whether LIFT to date has been implemented effectively.

Key findings:

- other than through LIFT, Primary Care Trusts have limited sources of public funds for developing new premises. The alternative is for Primary Care Trusts and general practitioners to commission a private contractor to develop premises they can then lease, which is not always feasible in deprived areas;
- it is more expensive to provide new, purpose-built premises than to continue with the existing buildings;
- the higher cost of new premises, whether through LIFT or by commissioning contractors, could displace other primary care spending;
- Primary Care Trusts in some areas subsidise other tenants to take space to encourage them to participate in LIFT;
- the department and Partnerships for Health have not yet developed a mechanism for evaluating LIFT even though the deal has commenced;
- there is no explicit provision to target cost reductions over time;
- under the Lease Plus Agreement, the LIFTCo is responsible for all repairs and maintenance;
- new methods of care leading to centralisation of services can result in access problems for patients; and
- the effectiveness of strategic partnering boards is crucial to the performance of LIFT.

Recommendations:

- when preparing business cases for LIFT projects, Primary Care Trusts should compare the cost of LIFT to the costs of alternative procurement routes, and make explicit the implications for spending on other primary care facilities;
- where Primary Care Trusts are paying substantial subsidies to make LIFT affordable to other organisations, there should be a business case to support the value of the subsidy; the expected benefits should also be made transparent;

⁴¹⁶ The Retail Prices Index is an average measure of change in the prices of goods and services bought for the purpose of consumption by the vast majority of households in the United Kingdom. It is compiled and published monthly. Once published, it is never revised

- the department and Partnerships for Health should work quickly and publicise the underlying mechanism and methods so that a meaningful quantitative evaluation of the value for money of LIFT and its schemes can be made;
- in light of the experience in the local LIFT area, strategic partnering boards in consultation with the LIFTCo should set cost reduction targets for new projects, and there should be an annual review of progress against targets once buildings are operational;
- since there is no threshold level for minor building alterations in the standard LIFT contract, some tenants are frustrated that they cannot procure minor alterations without prior consent and without going through a time consuming and bureaucratic process. Partnerships for Health should consult with the private sector partners and agree on reasonable threshold levels;
- location and access issues should be given priority by Primary Care Trusts who should liaise with other relevant parties; and
- Partnerships for Health should help Primary Care Trusts and local authorities (where relevant) develop a framework for appraising the effectiveness of boards.

House of Commons Committee of Public Accounts 2006, *The refinancing of the Norfolk and Norwich Hospital*, Thirty-fifth report of session 2005-06, May 2006

Background:

- the Norfolk and Norwich Hospital NHS Trust (the Trust) let one of the first PFI contracts to a consortium – Octagon – in 1998;
- just two years after the new hospital opened, Octagon refinanced the project and increased its investors’ rate of return three times the level predicted when bidding for the contract;
- the Trust only received 29 per cent of the refinancing gains despite taking on substantial new risks following the refinancing;
- this outcome was achieved by Octagon increasing its borrowings by 53 per cent (from £200 million to £306 million) and using the increased funds to accelerate the financial benefits to the investors. After other adjustments, the total refinancing gain was £116 million;
- Octagon retained £82 million of the gain, increasing investors’ internal rate of return from the predicted 19 per cent to 60 per cent;
- in securing the right to receive £34 million of the gains, the Trust accepted that the money it would have to pay to end the contract early could increase by up to £257 million because its termination liabilities are related to the amount of Octagon’s outstanding borrowings; and

- the Trust also agreed to extend the PFI contract from 34 years to 39 years, and to receive its share of the refinancing gains over the life of the contract rather than as an immediate payment.

Key findings:

The opportunity for large refinancing gains on this early PFI does not seem to have been seriously considered as part of the original deal negotiations. The Trust further contributed by accepting that, should it wish to end the contract early, its liabilities could now include all the additional borrowings.

Specific key findings:

- Octagon's investors' internal rate of return more than trebled following the refinancing;
- this refinancing produced a balance of risks and rewards between the public and private sectors, which even for an early PFI deal is unacceptable;
- the Trust secured the right to retain only £34 million (29 per cent) of the resulting £116 million gain;
- the Trust did not consider the possible impact of the refinancing gains before awarding this PFI contract;
- following the refinancing, the Trust could have to pay \$257 million more if it needs to end this PFI contract early;
- the Trust agreed to extend the contract by five years to maximise refinancing gains;
- the Trust is receiving its gains from refinancing over 35 years, whereas the investors took their benefits immediately;
- this project shows an authority too readily agreeing with refinancing proposals when more robust negotiation could have produced a better outcome;
- by entering into an early contract in the emerging hospital PFI market, the Trust incurred additional financing costs; and
- there is no central data on PFI construction cost inflation or the impact of government building programs on public sector building costs.

Recommendations:

- staff managing PFI contracts should be trained to understand refinancing issues and should appoint experienced advisers to assist in robustly negotiating refinancing; and
- the Treasury should provide an annual assessment of the effect of construction cost inflation on public building projects, including the effects on PFI projects and a comparison with private sector experience to better manage the future PFI program.

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