

CORRECTED VERSION

PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

Private sector investment in public infrastructure subcommittee

Inquiry into private sector investment in public infrastructure

Melbourne – 15 August 2002

Members

Mr R. W. Clark

Ms S. M. Davies

Mr T. J. Holding

Mr P. J. Loney

Mr G. K. Rich-Phillips

Mr T. C. Theophanous

Chairman: Mr P. J. Loney

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Executive Officer: Ms M. Cornwell

Research Officer: Ms C. Williams

Witnesses

Mr T. Cave, General Manager, Major Projects Delivery; and

Mr J. Charleson, Deputy Secretary, Corporate Services, Department of Justice.

The CHAIRMAN — I declare open this hearing on private investment in public infrastructure. I welcome Mr Tim Cave and Mr John Charleson from the Department of Justice. To begin with I invite you to take the subcommittee briefly through the way the public–private partnership (PPP) for the County Court was put together. Perhaps you could go back over the things you mentioned in passing during our tour of the County Court about some of the risk allocation challenges you were faced with and how you dealt with those.

Mr CAVE — It is a big question. I start by saying that the County Court project was actually started prior to my involvement. I came along at the point in time when we were selecting a short list of bidders from an expression of interest. Then I took the project through the tendering phase, or the bidding phase as we call it in these types of projects, as a no. 2 to Mr Tony Wilson. Upon our selection of preferred bidder we had a period of time, which I should say the government changed. This current government approved the project to proceed and at that point in time Mr Wilson, due to ill health, ceased to be the project director and I took over. I took the commercial arrangements through the contract negotiation to contract execution and represented the state in terms of the construction and transitioning of the building, and now I am the contract administrator on the facility.

The facility has always been set up for some degree of public–private partnering, and I say that in its generic sense. There has been between the two governments some differing in the level of partnering in relation to the delivery of services. At the end of the day the project is owned by a private owner and it provides the information technology (IT) services in the facility in terms of the ongoing service to court users and also the update and refresh of the IT products in the building, to an agreed budget; it also provides the building management services in the facility, which relate to the movement of people around the facility and the manning of the security around the entrance of the facility; and, lastly, it provides the facility management services, which relate to maintaining the airconditioning, the lifts, and the building services.

The state, on its side, provides the court administration, obviously the regulatory and legislative functions, --being the judiciary and their support staff-- but also the judicial support. The Victorian Government Reporting Service continues to provide the court reporting. That involves confidential court information, and of course the government decided that should be continued by the Victorian Government Reporting Service. Also the security in the custody centre is being provided by a public sector corrections provider, being CORE, and that was done for the purposes of maintaining the duty of care of prisoners in the court. That is the split of services in the court.

In terms of risk transfer, I would like to provide the subcommittee with a document — I have a copy for each member — which I suppose talks about the outputs, first of all, achieved on the County Court project and then moves into the issue of how in my mind we achieve an optimum outcome for the state, and for that matter, for the public sector. The subcommittee is probably aware that the County Court partnership is regarded as a successful public–private partnership. You might find some public–private partnerships of less success, but it is generally considered that the County Court is a successful one. I shall just walk you through the reasons why that is the case.

The County Court was completed on time, with the completion date on 23 May 2002. That alone makes it a success, particularly if you look at some of the other public infrastructure around the state at the moment. It was completed to a 23-month accelerated construction program. It was completed to budget, to the extent that there was ERC-approved funding and we did not have to go back to the ERC to achieve any more funding at the end of the day. There were some minor modifications that the department accepted in its own right without referring back to Treasury for more funding. In terms of the building itself there was another \$100 000-odd sought. I have explained that that was to do with issues around improving the quality of the building, which were accepted by the interdepartmental steering committee and which were funded by the department. I will give the subcommittee more details on that if it is interested.

There was a parallel project running next to the County Court project called CJEP — criminal justice enhancement project — which provides a common database across the courts, police and corrections. In order to interface with that project we needed to update the in-court technology, and I have explained to the subcommittee about the flat-faced screens and other courtroom technology that I mentioned on our tour. That cost another \$287 000.

Mr THEOPHANOUS — What was the overall budget?

Mr CAVE — The overall capital budget of the facility was \$138 million. It has been publicly stated as \$140 million just to round it off, but it was closer to \$138 million. Then there was the external sculpture. I think before you came along, Mr Theophanous, I was explaining to the other two members that it would be useful to have an external symbol on the building. We went thirds with the builder and the owner and paid \$25 000 each to put that female figure out the front, which has become a bit of an icon, or a bit of a statement for the building. I am

saying that in terms of success that variations to the project cost 0.004 per cent of the capital cost in terms of modification, which I might say is an astonishing outcome.

There were a couple of funding issues that I shall refer to a little bit later when we get to the risk and what we have learned from the project. As to value for money, it was slightly under the public sector benchmark for the project — only very slightly under. The public sector benchmark was developed before my involvement, but also under the previous government's guidelines for the infrastructure investment policy for Victoria, and that took no account of the adjustment for risk. It took no account of the fact that the private sector was assuming a large amount of project risk and that risk could have been reflected in its price to us.

The public sector benchmark is supposed to assume the state accepting all risk, and therefore under this current government's guidelines there is an adjustment to the public sector benchmark upwards to account for the state's acceptance of risk. So if we had taken that into account, my rough ballpark estimate, which I will not be held to in any way, shape or form, is that it would have probably pushed it another 3 per cent or so higher, which suggests to me that the bid would have actually been 5 per cent under the benchmark, which is an acceptable amount.

Mr CHARLESON — It might be useful to just say something about how the benchmark is constructed and its equivalent in the Partnerships Victoria policy, which is the public sector comparator.

Mr CAVE — I am not quite sure of the subcommittee's level of education, and how I should pitch the presentation.

The CHAIRMAN — I think the subcommittee is generally reasonably acquainted with the concept of public sector comparators.

Mr CAVE — It was based on a capital build price plus the costs of the services to be delivered by the state and the private sector. It then assumed that the public sector delivered those services; that, of course, is a recurrent stream, but the capital cost is converted to a recurrent stream. The whole lot is then net present valued back into the day's dollars. Then we do the same with the bids as they come in. The idea is that the bids may demonstrate that private sector involvement with the specified private sector services is cheaper than if the public sector had built and operated all of it itself.

The CHAIRMAN — Is there a view then about getting a sufficient range of bids to get a fix on that?

Mr CAVE — The normal view is a balance between getting enough quotes to ensure you get the market properly tested but not have too many quotes such that the market does not take your project seriously. It is like any type of project: the general prevailing trend is to start with a short list of three. The previous projects I have been involved in have all had a short list of three, but it can be four.

The CHAIRMAN — So are they invited to tender, or is it an open tender?

Mr CAVE — There is a public expression of interest sought from which you select a short list. It can cost the private sector \$1 million to put a bid together on a complex building like this. They need to put enough in there that you can get to move to a contractual position. Even the very big banks and national construction companies that become involved in these big projects would balk if there were, say, half a dozen tenderers and they had a one-in-six chance of getting it. They put in an expression of interest which indicates their interest in the project, and on a range of criteria they are carefully narrowed down to a short list. For instance, on the prisons project at the moment that is the process that has been gone through, and that itself is a very technical evaluation of capability.

The CHAIRMAN — So in a general sense the number of tenderers can be critical to whether you get a successful response. In terms of what you are saying, if you get 6, 8 or 10, it could actually be counterproductive to the process.

Mr CAVE — Yes. We are starting off with a public advertisement. We are putting out a request for expressions of interest — -- sometimes it is called an expression of capability. At that level any consortium can respond. Can I say that we normally ask for a consortium: we normally want to know who the financier is, who the builder is, and which operators will be involved in providing the private sector facility services. A consortium may be a similar one that has bid on another project and got on well together, or they can mix and match. There are a range of probably up to eight construction companies that are big enough to handle projects of this size. Increasingly banks and financial institutions are becoming very interested in this type of deal. It has been a growth industry. If I compare it to the early 1990s when it was a very new thing for the private sector to be involved in, for

instance, private prisons and things like that, now there are probably a dozen financial institutions out there — and I am talking on the international scale — that would be interested in financing a project like this.

Mr THEOPHANOUS — Why did you choose a build, own, operate scheme and not a build, own, operate and transfer (BOOT)scheme?

Mr CAVE — The choice of project delivery is a Government decision, but you have hit the crux of the matter here. Under our arrangements the contract is completely silent as to what happens beyond 20 years. That decision was taken for a number of reasons.

Mr THEOPHANOUS — Who owns the property at that point?

Mr CAVE — The building is owned by the private owner of the facility.

Mr THEOPHANOUS — They continue to own the building?

Mr CAVE — That is right.

Mr THEOPHANOUS — I need to get this right. The money was put in by the state government?

Mr CAVE — Yes.

Mr THEOPHANOUS — One hundred and thirty-eight million dollars?

Mr CHARLESON — No, the state government contracted to provide a lease payment, a recurrent stream of funds for the private builder and, to some extent, operator, to build and operate the building for a 20-year period, so that the capital amount of \$138 million was not put in by the state government. That was put in by the Liberty group, the consortium that built the facility.

Mr CAVE — It might be a good idea if we put something up on the whiteboard to explain it to you. Would you like me to do that, or would you like me to explain it?

Mr THEOPHANOUS — I am happy for you to do that. Perhaps if we can continue to ask questions: that must mean that there is an annual payment from the state, a recurrent cost to the state?

Mr CAVE — That is right.

Mr THEOPHANOUS — How much is that?

Mr CAVE — I think year 1 is somewhere between \$16 million and \$18 million, depending on what our usage is.

Mr THEOPHANOUS — So the contract in broad terms is 18 times 20, is that correct?

Mr CAVE — Yes, but you would need to discount to net present value into today's dollars. Obviously \$18 million in year 20 is not going to be worth what it is now. There is the CPI scale to be applied to that.

Mr CHARLESON — But also a discount rate of about 8 per cent which I think is the discount rate used in government for net present value calculations. It is also, as Tim said, slightly dependent on the usage.

Mr THEOPHANOUS — To assist the committee to come to grips with whether it was a good deal or not, obviously in the \$18 million that is paid annually there is a component which is the cost of maintaining the capital value of the property that has been built here. One would have to then ask the question, had the state built the property and owned the property, what would be the relative cost. Obviously the operating cost would be a lot cheaper than \$18 million per annum if it was owned, but there is the initial capital cost in building the building.

Mr CAVE — It is getting a little bit technical here, but what we assume is that the state has to borrow money at the Treasury risk-free rate, which in those days was 8 per cent. These days it is 6 per cent. Treasury still has to go to a bank or funding source to borrow the money to build it. This is under a traditional procurement model if the state did it itself. So we set out a 20-year stream of funding. We assume a 20-year stream of funding based on the capital cost of the facility. On top of that we add what it would cost the state to operate the facility itself and a facility management cost on top of that.

Mr THEOPHANOUS — Are those numbers available?

Mr CAVE — That is what we are talking about being the public sector benchmark. We then go out to the private sector and say, ‘Can you come back, over a 20-year period’ — because that was the period that the state wanted to do the contract for — ‘with a cheaper financing arrangement than that?’.

Mr CHARLESON — Obviously we do not disclose the public sector comparator or benchmark to the private sector proponents because we want to ensure that we get the most competitive bids from them.

Mr CAVE — So they come back in a competitive environment and then we look for a bidder that no. 1 is cheaper than the public sector benchmark and, to the extent that there is more than one bidder cheaper than the public sector benchmark, we go with not necessarily the cheapest but the best commercial arrangement, and design arrangement, I might add, that is put together. That is done through a very comprehensive evaluation process.

Mr THEOPHANOUS — Do you have figures on what the annual cost would have been had the scheme been a BOOT scheme — how much different to the \$16 million to \$18 million it would have been?

Mr CAVE — If the private sector had priced it as a BOOT scheme it would have been substantially more expensive.

Mr THEOPHANOUS — On an annual basis?

Mr CAVE — Yes. On the face of it the public sector can borrow money cheaper than the private sector can. We have a AAA rating. Most project financing on this type of deal would be AA at best. So they are going to pay more interest than us if it is purely debt driven. But what we asked for in this project is an equity contribution. We ask for a long-term view on equity, so in effect debt has only driven the funding for this project probably by around two-thirds. So two-thirds is borrowed money. The rest has been put in by the owners of the building or by other investors. The major owner of this building is Challenger International. It is an annuities financing company. It has money in this facility for which we are not paying any return for 20 years. That money is a long-term investment and is in effect a risk investment that we will continue for a second 20 years, because over the 20 years we will have paid off this facility for the company and it will totally own it.

Mr THEOPHANOUS — Except that in 20 years’ time the state will have paid the equivalent of \$360 million on present day values and will still not own the building.

Mr CAVE — That is not the case. We would have paid them back enough to amortise their debt on the debt portion of it and a small return on some of the equity. Some of the equity is in there with no return on it.

The CHAIRMAN — The equivalent of \$138 million present day value.

Mr THEOPHANOUS — It depends what proportion of the \$18 million is dedicated to operating costs.

Mr CAVE — That is right, sorry. You asked me the total in terms of the lease. I would have to provide you with that information, and it is available. The full analysis is available. But all I am saying is that analysis has been done and it did show that over a 20-year span it was cost effective for the state to go with the private ownership.

Mr THEOPHANOUS — I put it to you that I do not think there is a lot of risk for the contractor after 20 years. There is going to be a need for courts in 20 years’ time.

Mr CAVE — Yes.

Mr THEOPHANOUS — It is doubtful that the state would have another option other than this one at that point that would be cost effective, so I do not see it as a great risk from the contractor’s point of view. Indeed, further to that, the contractor might be in a fairly strong position to up the ante to a significant price increase at that point. What would you say to those comments?

Mr CAVE — I would say that is the financial or commercial position that the private sector has taken, and that is the risk they are taking.

Mr THEOPHANOUS — My point is it is not much of a risk.

Mr CAVE — I am not in a position to comment on what might happen in 20 years, but what could happen is we could be completely regionalised. IT could have had a major breakthrough, and our reliance on IT in the court system means that we might need a building only half this size or rooms half this size. We may all want to go across to Docklands. There are a number of possible scenarios in 20 years' time where a building like this in the middle of the CBD could be a dinosaur. I am not saying that will happen, but the point is that that risk lies with the contractor, and the state has agreed that that is the length of the contract it wants. The reason that we did not take options, for instance, is that implies some obligation later on. If it was going to be a risk issue, we wanted it to be completely a risk issue. In terms of your comment about what happens at the end of 20 years — —

Mr THEOPHANOUS — I am not sure about your comment. An option is an option, or it is not an option. If it is an option, doesn't an option mean that the contractor is obligated also at that point to offer the building up? That is what an option is.

Mr CAVE — I believe there are commercial reasons why the contractor would want to retain the state as the lessee. The building, as I have already told you — and you may have missed my initial comments — can only be described as a purpose-built facility. It has 14 lifts in it. It has a mini-prison underneath. The building is set up for courtrooms. It would cost the contractor a very large amount of money to convert it to other commercial uses. It is in their interests to continue with us after 20 years. I would be suggesting that the state at year 17 would be entering into negotiations for a further contract so that it did not put itself into a vulnerable position at year 20 where it went into negotiations. It would start negotiations early, and on that basis I think you would find that both sides would be wanting to come to a resolution. It would only be a matter of price.

At the end of the day, we can move to another site and do the same deal in that day's dollars as we have done now and get a brand new building exactly like today, all conditions being equal. The argument that we would want to stay here is just based around the fact that we have built this building in a strategic location in the legal precinct. If it was anywhere else, it would probably be swayed in our favour. They would have really no option, and also there is the traditional nature of the court in the sense that it is unlikely to want to move. It certainly moved across the road.

The CHAIRMAN — You could for the sake of argument mount the reverse argument too, that the fact of having a 20-year contract with no overshoot gives the state flexibility at the end of that time to say, 'Well, the court system is now different and we want to deliver in a different way', or whatever.

Mr CAVE — I was couching it in risk terms; you are putting it in a much more positive slant, and that is probably a better way to explain it.

Mr THEOPHANOUS — I have another appointment.

The CHAIRMAN — On that issue of risk, rather than the broader risk we have been talking about, the ownership risk, et cetera, as we were walking around you explained with the IT and the ceremonial court, for example, how risk had been shared there. Could you go through that again for the record to give an example of some of the risk allocation sharing arrangements that have been entered into?

Mr CAVE — It is a shame Mr Theophanous has had to leave, but I think there are other benefits for the arrangement that we have where we have taken a 20-year view and the private owner has taken a longer-term view, if you like, in the sense, as we were discussing before, in that we have a building and the owner is very keen to maintain its relevance for us so that we will want it beyond year 20. If this building were allowed to run down and not be kept such that it was attractive to the state, we would be less inclined to want to continue beyond year 20 or renew the contract. So in order to do that they have agreed that the commissioning tests on this facility will become the availability tests on the facility. We test this building to accept it at the start on all the building services and therefore those tests become the availability tests. That in effect keeps the building services side of it in as-new condition for the full 20 years. That is to ensure that our level of satisfaction is maintained over the period.

There are a number of risks associated when the private sector is the owner of the facility and the public sector is operating services in the facility. This is apparent here. It is probably even more apparent in the private prison type of environment, where in you will have the situation where the private sector will own and maintain the facility but the public sector will operate the facility. There are important interface issues there which have not yet been fully addressed because of the stage of the project but which are being addressed now.

Mr CHARLESON — Just in response to the question, I think what Mr Cave was alluding to during our tour was the fact that the private sector accepted the risk of acquiring the in-court IT technology, installing the

technology and ensuring that on day 1 it was properly interfaced with the Department of Justice's broader information technology environment, and somebody could come in and press the button and it would all work.

Having been responsible for a number of IT installations I can testify that that is a considerable risk. Things very seldom go as smoothly as that with IT installations: there is normally some delay, some glitch in the system, or some lack of functionality from day one. That is an example of the risk allocation which is inherent in the Partnerships Victoria policy — that we as the purchaser of the output, if you like, of an IT system, did not have to concern ourselves with the thing operating properly from day one because it was a risk accepted entirely by the private provider.

In an ongoing sense, looking into the future, because our public sector people will be operating it, the Victorian Government Reporting Service will have to ensure that our operators are fully trained and that there are enough of them. So we accept the risk of the ongoing operation of it, but the actual installation, acquisition and delivery of it was the private sector partner's risk. I think that addresses that question.

Mr RICH-PHILLIPS — In the circumstance where you have a building with a 40-year life against a specification for a 20-year usage, has it required a premium from the government to have a building that is in effect overbuilt in respect of your specifications?

Mr CHARLESON — Paradoxically, the reverse is the case. This is where this tension comes in that we touched on when Mr Theophanous was here, I think. On the one hand, had the government said, 'At the end of 20 years you hand the building over to us, you have no further equity in it', and we both walked away from it, we would have had to pay a premium for that circumstance. What we have gone into is a situation where both parties — that is, the government and the Department of Justice as the agent of the government, and the consortium, the Liberty group — have an opportunity to prolong the relationship to the benefit of both parties, depending on what sorts of circumstances pan out over that 20-year period.

As Mr Cave said, things might change entirely and we might be at the other end of town or whatever. But it provided sufficient incentive for the private provider, the private partner, to take that 40-year view of the world on the basis that it has presumably made a judgment that there is a fairly strong likelihood of its being able to continue in the relationship with the government to run this building as a County Court. It seems odd; it is a paradoxical situation.

The CHAIRMAN — Just to follow on from that question, is that then a factor of the tenderer or the brief? Did the brief seek a 20-year period and an allowance for 40 years, or did it seek 20 years straight out and a tender might have come in saying, 'We will give you 20, but we will actually build a building with a 40-year life'?

Mr CAVE — The brief sought the arrangement that we are describing to you. We did ask for a long-term equity contribution. It specified 20 years; it might have given an option on 25 years, but there is not a lot of difference between those two situations; and it specified the type of risk transfer we were seeking. The private sector responded in kind.

Can I say that some bids that came back which were effectively fully debt funded — because some of them came back and ignored the opportunity for equity that we proposed to them — were more expensive simply because they had to pay more money back to the bank, plus interest, over the 20-year period; and on that basis they were blown away by somebody who was willing to put equity in there and leave it for 20 years with no return. That was not a large part of it, but it was in the region of 10 per cent part of it. They were entirely banking on the increased capital value of the facility at the end of the 20-year term.

Mr CHARLESON — To clarify that, it would also be the strong prospect of being able to continue to lease the building to the government to run a court in, because it is obviously purpose built.

Mr CAVE — Their view is for the following 20 years, not the first 20 years.

Mr RICH-PHILLIPS — How prescriptive was the expressions-of-interest stage? Did you say it had to be a build, own and operate, or did you give them the build, own, operate and transfer option?

Mr CAVE — No. In fact those sorts of terms are not used. It is sort of being replaced by the public-private partnership notion of a continuum of involvement. Even a traditional procurement can be seen as a public-private partnership. As a design and construction component we can have a private sector builder, right through to full build, own and operate thing. Where we were on the continuum, if you like, is that we asked that the

consortium be formed and that it give consideration to an equity provider. We are talking about five or six years ago and I cannot even remember what the terminology was, but certainly the message was provided of that type of arrangement being made.

Mr RICH-PHILLIPS — It was fairly broad, though.

Mr CAVE — Yes.

The CHAIRMAN — That is an interesting question. To follow that through, the question is how it comes down to saying that this one is structured in this way and, say, Spencer Street is a transfer? Does that come from the bidder or again from the brief?

Mr CHARLESON — I think the art in this is not to prescribe the brief in such a way that you are going to cut off creative opportunities for creation and innovation brought to the brief by the proponents. But on the other hand, without reinventing history, had we been in a situation where all our proponents had delivered up to us something that was at odds with the fundamental underpinnings of our expression of interest, we would have then had to go back to the drawing board, I would imagine, and have made a decision about whether we would proceed on a slightly different basis based on what the market could deliver. So it gets back to your question before about the extent to which we are dependent on what the market can provide. My answer to that is that we are quite highly dependent.

Obviously if there is not a mature market or the capability within the marketplace to provide these sorts of products and deliver in this sort of structural way the government has to make a decision as to whether it will go ahead on terms expressed by the marketplace and therefore modify some of its own expectations, or whether to walk away from the whole thing. In this case, fortunately that decision was not necessary because the market responded very positively and the outcome has been very positive. But you can envisage a situation where the government seeks through an expression of interest process a structure for delivery of services which is equity based and the market just does not like the look of what is on offer, cannot raise the capital or whatever it is, and we would then have to go back to the drawing board.

The CHAIRMAN — I was coming at it slightly differently. To put it in very simple terms, on any given project — just a hypothetical project — could you get in your bid responses where one bidder proposes a scheme of a particular nature, another bidder proposes a BOOT scheme and yet another proposes a third way, and you can then sit down and look at which one provides best value?

Mr CAVE — Yes, but it would depend how you framed the project brief. This is not at the expression of interest stage. At the expression of interest stage you are just asking people for their capability to be able to deliver. We are actually talking about a project brief. You usually specify what the government's preference is, and that is on the advice of Treasury, which runs the Partnerships Victoria (PV) process.

The CHAIRMAN — Is it tremendously prescriptive to the extent that the government will say at the end of that time it does or does not wish to own the building?

Mr CAVE — The government will make a call on whether or not it wants the building. In my experience I would say that the government in those cases has made a call on whether it wants the building at the end of the period, and that in turn has driven the products that the finance market was able to use. With the County Court, because we encouraged long-term equity in the facility, they were able to tap a financial market product, being the long-term annuities market, which looks at financing all products for a 15-year life or longer — superannuation, annuities and things like that. That provided them with a capability, and it was innovative for this type of project that they found that market. That is why they were able to win the project: because the other bids that came up were more traditional debt type ones.

Mr RICH-PHILLIPS — Just by way of background, was this site previously occupied by the County Court?

The CHAIRMAN — By the ABC, I think.

Mr CAVE — By the ABC and the Peter MacCallum hospital.

Mr RICH-PHILLIPS — So was it just a case of the successful tenderer purchasing this site and then commencing?

Mr CAVE — No, we gave it to them on a 99-year lease, which is unusual.

Mr RICH-PHILLIPS — Can you give us some background on the circumstances of that? Is that always going to be the case with any bidder, or was this what this particular consortium wanted?

Mr CAVE — I suppose because of the direction in which the government wanted to place this project, which is what we have been talking about, we needed to be able to give the private sector the feeling of ownership of the site such that it could attract the long-term financing that we were talking about. At the same time, to sell them the site would have possibly impeded our ability to access the site in an emergency. You need to remember that we are running a court here, and one of our critical issues has always been that we have a responsibility to the community to always make sure we can provide a seamless court service. The contract reflects that — the lease provides for emergency access for the state in order to be able to maintain court services. So a 99-year lease has that dual role, if you like.

Mr RICH-PHILLIPS — Was this particular site chosen prior to expressions of interest?

Mr CAVE — It was put out as something like a prospective — I cannot remember the term, but a less stronger word than ‘preferred’ — site. It was certainly nominated as a possible site, but other sites were encouraged. There was a move that they be in the legal precinct, and there was a bid that came back on a another site. That bid was short-listed and subsequently dropped out. We had four short-listed; that one dropped out, and we ended up with three, all of which were for this site.

Mr RICH-PHILLIPS — Would that alternative bid have required the government to purchase that site and then lease it to the tenderer had it been successful?

Mr CAVE — We did not get far enough down the track, because it was at the expression of interest stage, to explore that option.

The CHAIRMAN — Thank you for your time, Mr Cave and Mr Charleson. It has been very useful for the committee. Thank you also for the tour of the building earlier; it was of great interest.

Witnesses withdrew.

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Witness

Mr G. Campbell, Partner, Maddocks.

The CHAIRMAN — I welcome to this hearing Mr Greg Campbell, a partner with Maddocks. Thank you for giving us your time today. To commence, I will give you the opportunity if there is anything in particular that you would like to outline to the committee in terms of your experience and views about public–private partnerships (PPP) and how they are and perhaps should operate.

Mr CAMPBELL — I will spend a couple of minutes telling you of my background and why I have an interest in public–private partnerships. I am a partner at Maddocks, which, as you probably know, is a well-known firm in local government as well as the government sector. I am responsible for the construction practice, so I have been involved in major construction projects. The firm made a decision at the end of 1999, going back nearly three years and prior to the introduction of the Partnerships Victoria policy that we needed to be looking at public–private partnerships. One of the drivers for us was our very large local government client base, so I will talk a little about local government, but not just about local government.

We were seeing what was happening in the United Kingdom, in particular in the local government sector. Our view was that to keep abreast of innovative things that were happening elsewhere in the world we needed to at least get on top of what was happening and be in a position to advise our clients on the pros and cons of PPPs and contracting structures in the event that local government got interested in PPPs.

As it has turned out, if anything, we are assisting through education of our clients to tell them about PPPs. What we have done, as well as establishing a group and recruiting people with public–private partnerships experience, is we have an associate firm in the UK, and two of us went to the UK for two months last year and worked with the projects team at McRoberts in Scotland on several projects, one a well-known project called the Glasgow schools project — and if you have not heard of it I am sure you will. At the time MacRoberts were finishing off the Glasgow schools project. They were the lead advisers for the successful consortium. At the same time the Edinburgh schools project was proceeding as well. That was another very large education project.

In addition, we have run a number of seminars. We have had one of our senior lawyers seconded to the Department of Treasury and Finance for the last six months in the infrastructure and projects group of the commercial division of the department, working on Partnerships Victoria policy issues, as well as advising on project issues as a development executive.

Again, part of what we have been trying to do is establish ourselves in the PPP market. We are now advising the consortium led by Baulderstones for the current prisons projects. The consortium has submitted an expression of interest for the two prisons to be run by the Office of the Correctional Services Commissioner. That is our only current Partnerships Victoria project that we are advising on.

Around town we are seeing perhaps a bit of a lull in enthusiasm for PPPs at a government level, but certainly going back two years we saw PPPs as a method of delivery of infrastructure services that would become more popular both in the public sector and in local government. I think it is too early to say whether it will. If you look at what is happening in the UK — and I do not know how familiar you are with how large the PPP industry is in the UK —

The CHAIRMAN — I have spent some time there talking to them.

Mr CAMPBELL — I was at a conference in July. Partnerships UK put out a map and so did the Bank of Scotland illustrating the number of PPP projects that had been done and also current projects, which demonstrates in a diagrammatic way what an intensive industry it is in the UK. So to a large extent I suppose we are looking at what is happening in the UK. The Australian market is different. Australia is a federation. We are governed by states. The UK has a national government and has had a national policy.

If you take the UK, between 1992 and 1997 there were only 15 private financial initiative (PFI) projects that got to financial close. It was regarded as not a particularly successful policy for the first five years of its life. It was not until the Blair government took over and appointed Sir Malcolm Bates to run an inquiry and then restructured the way PFI was being conducted in the UK that things started to take off. So perhaps what has happened in Victoria and elsewhere in Australia is that state governments are learning from the experiences in the UK and perhaps not falling into some of the same traps that the UK fell into in those first five years of the PFI policy.

I do not want to focus only on local government, but it is a particular interest of ours. The City of Wyndham did an aquatic centre as a build, own, operate and transfer (BOOT) project about four years ago, but I generally say there is no local government in Australia that we know of that has done a PPP project of the type we are talking about. Certainly none has been done under Partnerships Victoria. The Partnerships Victoria policy does not formally

cover local government, although Treasury would, I believe, encourage local government to look at Partnerships Victoria's policy and encourage local government to consider it as a method of delivery of infrastructure services. But I think our view is that local government is again some way off before it sees the benefits.

Having said that, we are advising two council clients in Victoria at the moment on possible road projects as PPPs, so it was encouraging for us that there are local authorities that see some advantages of PPPs and are at least prepared to look at them. We have also spoken to one other council client about possibly doing libraries and aquatic centres as PPPs, but there are real issues for local government, not the least of which is critical mass. I do not know who you will speak to, but funders like the Commonwealth Bank will probably say they do not want to look at projects under \$90 million or \$100 million in value of payments over the life of the project. The policy, as you are probably aware, has a minimum. The minimum threshold is \$10 million net present value (NPV) of payments. I think everybody will say that is too low — \$10 million NPV is not going to produce the kind of project that the market is going to be interested in. But even if you get projects of the \$20 million and \$30 million value in local government, it is still going to be very difficult to attract people into the market, particularly banks, but probably contractors as well, particularly if there are larger projects around.

Transaction costs and transaction times are issues that are going to affect whether local government chooses this method of delivery or not. Perhaps over the next 12 months we are going to find out whether the clients we are dealing with at the moment are prepared to embark on a PPP or whether it is politically too difficult or whether they see the transaction costs as being too high.

I was in the UK for two weeks in July. I went to visit Portsmouth City Council. Portsmouth currently has out to the market the first local government highway infrastructure project in the UK. Although there have been a lot of local government PFI projects done in the UK, no local authority has done a highways maintenance contract. The Department of Transport has in the UK, but no local authority, so it has a project out at the moment. If you know Portsmouth, it is to upgrade and maintain their whole highway infrastructure, including all of the infrastructure that relates to the roads — footpaths, street lighting and so forth. They are estimating somewhere around £220 million to £250 million.

I got a pretty detailed briefing from them. They are not sure it is going to deliver to them the value for money that they had anticipated. They are measuring it against their reference project to see whether they are going to get value for money, but that is an example. They are still finding their way in the UK on things like local government highway maintenance projects, so there is not a lot we can benchmark off in the UK when we are looking at highways maintenance projects.

Mr RICH-PHILLIPS — What is Portsmouth's interest in undertaking PFI? Is it just financial benefit or does it see other benefits? I have a particular interest in roads because one of the local councils in my electorate, which may be one that you are advising, is also looking at a BOOT project for road projects, so I am interested in Portsmouth.

Mr CAMPBELL — That is probably Cardinia, is it?

Mr RICH-PHILLIPS — It is.

Mr CAMPBELL — Just digressing, next month we have got the technical adviser from Mott MacDonald who advised the council on that project coming out, and we are jointly running a seminar with them for local authorities in Victoria on long-term infrastructure maintenance contracts. He is going to no doubt tell us more about the project; understanding what happens in local government in the UK. To say UK local government is forced to pursue PFIs is putting it too strongly, but they always have to look at PFI. They get PFI credits. The drivers for PFI in the UK are a bit different to here in that there has been a high degree of underinvestment in infrastructure, also in local government. In a sense there has been here as well, but perhaps not to the same extent as the UK. They are aiming to increase the standard of their infrastructure. They are looking for value for money.

What I was told with respect to Portsmouth is it is their third PFI project. They have had a very successful schools project. Probably my reading of what has happened in the UK is that the education sector is one of the more successful sectors where PFI has been used. Their words to me were, 'We have just done a school using the traditional method of procurement — that is, engaged a designer ourselves and engaged a contractor — and it has been a disaster'. A year later they then did a private finance initiative school and said they would never go back to a traditional procurement after that. So they had a glowing view of the success they had in the education sector, and that then led them to see if they could emulate that success in another area.

The CHAIRMAN — Can I just get you to define the traditional procurement? Are you saying that that is done entirely within the public sector, so it is like a public works department build, or is it a public sector design, contract and private build under public supervision?

Mr CAMPBELL — When we give our seminars, when talking to local government we try to distinguish up front between the two models. Within the PPPs — public–private partnerships — you have to understand it is quite a different model for the delivery of services. The traditional way is for councils to engage architects and engineers to design a facility, say, a library; they will then go to tender and engage a contractor; when it is finished the maintenance then becomes their obligation for the life of the facility. Compare that to a PPP, which encompasses all of those things.

The CHAIRMAN — So is it about the control of the project?

Mr CAMPBELL — When you are comparing between — —

The CHAIRMAN — Traditional procurement and the other. When you are talking about traditional, you are not talking about what occurred here 20 years ago, where you had a public works department which would do the whole build, are you?

Mr CAMPBELL — No. Traditional procurement is the way you would normally go about it. We have historically gone about procuring projects through contractual relationships with designers, separate contractual relationships with builders, and then separate contractual relationships with maintenance contractors.

Mr RICH-PHILLIPS — And then you hand over the cheque and you own the place.

Mr CAMPBELL — Yes, and then you either get capital funding, if it is a local authority, or you go and borrow yourself.

The CHAIRMAN — I just wanted to make sure whether our understanding of the traditional procurement was the same, given that we are talking about a different jurisdiction.

Mr CAMPBELL — So the driver in Portsmouth was the fact that they had been successful with PFI; the Council obtained PFI credits, which somehow assists their funding from the government. No local authority had done a highway maintenance project before, and so they were advised and they considered it was appropriate for them to try it. I was there when they got all the bids in; the bids came in for higher amounts than they had anticipated, and that is why they had reservations about whether they would get value for money. If the council cannot satisfy itself that it is getting value for money from the private sector bids, they will scrap the project and go back to traditional procurement or back to the way they have traditionally done it, which is their own in-house engineering team contracting out all these services.

Mr RICH-PHILLIPS — One of the local authority interests here is the ability to build X kilometres of road more by funding it through PPPs and the ability to bring forward a lot more roadworks than doing it in the traditional way. Was that a factor in Portsmouth?

Mr CAMPBELL — That was not so much a factor in Portsmouth. What the project involves is a five-year plan to upgrade existing roads. One of the problems they have is that the road infrastructure is in a poor state. How do they fund an upgrade? They came up with a five-year plan to upgrade the roads, but they built it into a 25-year concession, which involves the upgrade over five years and then the ongoing maintenance over the 25-year life of the concession, and they actually pay for that over 25 years instead of having to pay for it up front. So they get their roads rehabilitated as of the start of the contract or over a period, but they do not actually pay for it up front.

The CHAIRMAN — You were saying there is not much take-up of PPPs in Victoria, although I know there are a couple who are looking at it. Is that because it is relatively new? Are there any identifiable impediments at the local government level that lead to that situation? Why has local government been, if you like, slow to take it up?

Mr CAMPBELL — I think lack of knowledge of PPPs — and not just PPPs. To digress for a moment, one of the other things that has occurred in local government in the United Kingdom is that PFI has, if you like, forced local authorities to become more sophisticated in the way they look at the delivery of services: they have to look long term; they have to look at the whole-of-life costing for any facility. But when they are developing the project brief for the facility they have to develop an output specification to suit their needs over the life of the

project. Unlike what they would do under traditional procurement they actually have to think ahead and develop their outputs in a very sophisticated way. That is a significant cultural change from what currently occurs. In Victoria it has not generally been done that way, with few exceptions. So you then have to convince or educate people that there are different ways of doing it: you can look at long-term contracts.

We went through the compulsory competitive tendering (CCT) process in Victoria in the early 1990s. That started to focus people on outsourcing, but even until then most local government services were provided by day labour, by works labour, and long-term maintenance contracts were not considered. Going through the CCT process forced municipal councils to look at the way they delivered services. That has changed, and we now have “best value” enshrined in Local Government Act; and the United Kingdom has as well. We have taken that from the UK Local Government Act, but its approach to best value in local government is again much more sophisticated than our approach in Victoria, because best value is very much seen as a driver for local government PFI.

If you look at section 208C of the Victorian Local Government Act it talks about going to the private sector and having to look at value for money. In the United Kingdom they actually look at that and take it seriously, and they say one of the options they must be looking at therefore is PFI because they will not know if they are achieving best value until they look at these other methods of procurement. I just do not think we have got that far yet in local government in Victoria. But that is not the only impediment.

The CHAIRMAN — If we compare the situation here with that in the United Kingdom, local government in the UK is bigger and has much broader responsibilities.

Mr CAMPBELL — It does, yes.

The CHAIRMAN — It has much broader responsibilities for the delivery of all sorts of things, and generally would operate on much bigger budgets, particularly compared with some of our smaller councils such as the Borough of Queenscliffe.-- It is hard to imagine that it would ever have a project of \$10 million. How much would that be a consideration?

Mr CAMPBELL — In terms of volume it is, but what we have focused on in looking at the UK is the kinds of projects that we can compare to projects here. Whereas UK local authorities have done school projects, police stations and fire stations, we have not dismissed them but our local authorities in Victoria do not have that role. So we have looked at recreation centres, libraries, office accommodation, road projects and other similar projects where the local authorities here have the same functions.

One issue I have mentioned already is critical mass. One of the other problems in local government is that unless the project is big enough you are not going to get interest in the marketplace and you are not going to justify the transaction time, and particularly the transaction costs. That is a hard issue. Local government in the UK has dealt to some extent with that by “joined-up” projects — that is a term used in the UK where councils get together. So you have bundled projects where one authority or one government department bundles a number of schools together, and councils have joined up together and have done projects under one contract, but covering more than one municipal district. That is something that I think local authorities here should look at, particularly out of the city centre. So on highway maintenance projects you might put three or four councils together and have one contract.

The CHAIRMAN — It would seem to me that another factor in local government particularly is the sophistication with which the local government bureaucracy is able to identify, assess and allocate the risk that may be inherent in any particular project. It seems to me that if you are talking about value for money the sophistication with which you can identify your risk and correctly allocate it is critical to your value-for-money outcome.

Mr CAMPBELL — Yes.

The CHAIRMAN — What is your view of the relative sophistication of local government bureaucracies in that area?

Mr CAMPBELL — As a generalisation I would say there would not be that many local authorities that would have the expertise and experience — in fact there would be very few — to be able to conduct one of these projects without external advice. You can say that about government departments and agencies as well: there are not many government departments and agencies that have people on hand with the expertise and experience to do these sorts of projects.

The CHAIRMAN — But the state government probably has the resources to put together a unit that would then work with the outside people

Mr CAMPBELL — That is a critical issue. What happened in the United Kingdom was that the PPPs were put together. Have you heard of it?

The CHAIRMAN — Yes.

Mr CAMPBELL — In fact I was speaking to the acting CEO there back in July, and I think you were going to have a visit there. The 4P's will say is that it is the local government-funded organisation set up primarily to advise and assist local authorities in PFI projects. Their brief is broadening out as well. I did not finish saying earlier that in the United Kingdom one of the things that PFI has done is made councils become more sophisticated in the way they approach projects. Again, what the 4P's will say is that they are now no longer focusing just on PFI projects but their brief is broadening out to just better, more efficient procurement generally. That has happened at national government level as well in the UK, so far as I can gauge. The Office of Government Commerce in the United Kingdom is now looking much more broadly than just PFI projects; it is looking at efficient procurement generally in government. It is saying that part of what has caused that is the PFI policy; it is looking in a much more sophisticated way at how things are procured and how much more efficiently things can be procured using different methods. There are a number of new initiatives in the UK and new procurement initiatives that are being tested at the moment.

The CHAIRMAN — I was going to come back to your remarks about the \$10 million minimum in Victoria. The committee has received a number of submissions that raise that \$10 million minimum. Firstly, in your view, is it a disincentive; and, secondly, in the local area if it were lifted to something like \$100 million, how would that affect the local government sector?

Mr CAMPBELL — It would be difficult to see where a \$100 million local government project will come from. We can see \$30 million or \$40 million local government projects, or even a bit more, such as road projects, but \$100 million for local government is a huge project.

The CHAIRMAN — What I am getting at is that if financiers are saying, 'We really require projects of that size in order to make the financing viable or to make it worth our while to go into the project', can you set a level of, say, \$30 million for local government and still be viable with them?

Mr CAMPBELL — I do not think it is just that, though. I think if you had the deal flow the views of banks and contractors would change. If there were a developed market in local government for PPPs where there was a continuous flow of projects I think this \$100 million or \$90 million issue would drop considerably.

The CHAIRMAN — So it is a volume issue?

Mr CAMPBELL — Yes, it is a volume issue. There are other things that hang off that, such as the transaction costs, which are a problem. They are big costs. There is a big cost for the private sector and transaction costs for the public sector. It is probably too early to say to local government, 'You need to look at standardisation of documents', but that is something that will need to be looked at some time to try to reduce transaction costs. The UK has come a fair way in standardisation now, but that would be a significant disincentive for local government here.

The CHAIRMAN — Do big costs alter significantly according to the value of the project?

Mr CAMPBELL — No. That is the problem. When I was in the UK we were working on a police station for the Nottingham City Council. It actually started at £12 million, and they cut part of the project out and it ended up as £5 million. The view was it just was not worth proceeding with. The legal costs that were being incurred on that project were no different to an £80 million project. You have to go through the same work whether it is \$30 million or \$100 million.

The CHAIRMAN — On a \$10 million project the price of the bid could represent 10 per cent of the contract?

Mr CAMPBELL — Yes.

The CHAIRMAN — Whereas at \$100 million it is 1 per cent.

Mr CAMPBELL — Banks will be saying the benefits are not there. They do not want to be bidding for one \$20 million project unless there are other projects coming up where they would expect to win one and recoup some of their costs, but I think the likes of the Commonwealth Bank, Macquarie, will still be up well above \$50 million. I think some of the more aggressive new banks in Australia like the Bank of Scotland and the Royal Bank of Scotland, where they are used to funding PFI at a lower level, may well take an interest in \$30 million or \$40 million.

Mr RICH-PHILLIPS — Has the introduction of Partnerships Victoria streamlined some of those processes? Is it more uniform now across the state sector at least, compared to the previous ad hoc —

Mr CAMPBELL — In the sense that it has reduced costs?

Mr RICH-PHILLIPS — I guess reduced costs by making the processes the same.

Mr CAMPBELL — They are substantial guidance documents and they give a fair degree of certainty of process, so that helps both the public sector and the private sector to understand how you move forward with one of these projects. However, if you talk to the unsuccessful bidders on Spencer Street station, for example, they will say that they are hurting. There is a two-day conference on at the Hilton Hotel at the moment. Some comments have been made there about bid costs, not just Spencer Street but bid costs generally and what the private sector is spending. So even though you have the Partnerships Victoria guidance documents, private sector bidders are still spending huge amounts of money.

Mr RICH-PHILLIPS — Was there anything in particular about Spencer Street?

Mr CAMPBELL — Spencer Street was run through to commercial close or contract close with two bidders, so both the successful and unsuccessful bidders were pushed to complete documentation. That means they had to have a fully developed design. They had to have all financing in place. They had to have all contract documentation in place, which would have meant not just the project agreement between the state minister and the successful consortium, but all the subcontracts would have to have been in place to get to commercial close, and they were told on that day that they were unsuccessful, so they have spent thousands of dollars getting to that point. That is a difficulty. Any of the private sector people you speak to will say that is a real concern.

The CHAIRMAN — What is the alternative though, and still from the state perspective how do you have a process which has adequate tender probity?

Mr CAMPBELL — Even for tender probity reasons, you do not have to run two bidders through to the final point. The UK uses a best and final offer (BAFO). If you come from a short list of four, that list will come down to two generally as a BAFO, and then you put your best and final offers in and there will be a selection of a preferred bidder. The preferred bidder will then be taken through to commercial and financial close. So the last two will say they have a 50 per cent opportunity of getting the job. They will put a lot of effort in, but they do not have to put every document in place. Funding will have to be settled, but all their contract documents do not have to be completely finalised because they are not being taken through to commercial close.

The CHAIRMAN — What is the history then in the UK between best and final offer and contract close? What sort of variation is there between those two points?

Mr CAMPBELL — I do not know the figures. Are you saying generally once a preferred bidder is selected after BAFO are they the ones that the contract is entered into with?

The CHAIRMAN — No, I mean in terms of the cost, if you like. If I have a best and final offer of \$200 million, for example, I then go through to contract close, and through those discussions and the detailed documentation et cetera I say, 'Well, hang on a minute. This is actually going to require variation, and I am now going to have to price this at \$250 million', or whatever.

Mr CAMPBELL — You would have to ask a bidder. I would be guessing. I would be looking at what they do not have to do. If you go through BAFO as a bidder, and you do not get selected as the preferred bidder you will not have to pay your lawyers to finalise all the contract documents.

The CHAIRMAN — I am looking at it from the other side, though, from the state's view, about what it ends up in final pricing.

Mr RICH-PHILLIPS — How much variation you will have?

Mr CAMPBELL — It will not be much. The only difference is that you are dealing with two bidders, so the state's lawyers and commercial advisers will be looking at two bids instead of one bid through to financial close, but that will not be a huge increase.

The CHAIRMAN — That is not the costs I am talking about. What I am saying is — and maybe it does not happen — if at best and final offer you have two bidders, and one has bid \$220 million and the other \$200 million and you take the \$200 million, is that then the firm price for delivery and you are then just talking about the detail after that?

Mr CAMPBELL — Absolutely.

The CHAIRMAN — Or can the \$200 million — —

Mr CAMPBELL — If you get to BAFO you will have already agreed on the exact contract that you are entering into, the price, and there is not a lot more to agree to. It is really up to the successful — —

The CHAIRMAN — That is what I was asking. Does that represent maximum exposure to the state?

Mr CAMPBELL — Yes. And if you are inviting people from the private sector to speak to you — bidders — I am sure this will come up. It is more a private sector cost issue, but it affects the policy generally, because if you have got disgruntled contractors or banks in the marketplace and they are not going to bid for projects because it is too expensive, it is going to affect the development of your deal flow and the success of the implementation of the policy.

The CHAIRMAN — You would need a reasonable level of documentation still, though, at that stage if you were operating on value for money rather than lowest cost? You can actually ascertain what the differences were on a value for money basis between — —

Mr CAMPBELL — I suppose one thing you will not avoid is that even if you take a step back from what was done at Spencer Street, the private sector is still going to spend, on a project of that magnitude, millions of dollars on their bid. They may save some money, but overall they will still spend substantial sums on the bid.

The CHAIRMAN — I would put the view that you would not be striving to remove all of that anyway.

Mr CAMPBELL — No.

The CHAIRMAN — There is an element of bidder's risk attached to these things.

Mr CAMPBELL — Absolutely.

The CHAIRMAN — Which is legitimate. It is whether there is excessive — —

Mr CAMPBELL — Whether it is unnecessary to run two bidders through to commercial close, in which case they will incur additional costs, when the same could be achieved by maybe stopping the process, having a BAFO. It is a current issue. It is a big costs issue. It is a private sector issue.

Mr RICH-PHILLIPS — Can you quantify that from the private sector point of view? If you say that commercial close is 100 per cent of the cost for a bidder, what would stopping at BAFO represent?

Mr CAMPBELL — Again I would be guessing. I am not the right person to ask. My guess is they might spend 70 per cent of their costs. Whilst their design will be fully developed, they may not have done all the detailed drawings at that stage; whereas if you are a preferred bidder and you think you are going to start the project, you will be paying architects, engineers and all your design team. But that is a guess only.

Mr RICH-PHILLIPS — I wanted to follow up on your comment earlier when you said that recently there had been a lull in enthusiasm from the government in terms of — —

Mr CAMPBELL — This is my understanding from talking to clients and contacts. The feeling around town I suppose is with what has been in the press — and there has been some negative press out of the UK and also in Australia on PPPs — and the New South Wales government has launched its PFP policy, there is some concern that the substance is not behind it. The New South Wales schools project has stalled. There are no other PPPs in the market in New South Wales. There was a fanfare when that policy was launched, but there is not a lot happening in New South Wales. There has been a bit of fanfare with the launch of the policy in Queensland, but as yet we have

not seen projects coming into the market. In Victoria we have the Berwick hospital, the two prisons, and I think that is it.

Mr RICH-PHILLIPS — What about the fast rail?

Mr CAMPBELL — Fast rail is not a PV. I think the film and television studios at Docklands is supposed to be a PV, but I am not sure.

Mr RICH-PHILLIPS — Does that then have an impact on the private sector?

Mr CAMPBELL — There is just a bit of unease. People are gearing up. Clients of ours have appointed senior level executives to run PPP initiatives practices, and the projects have to be out there. The Bank of Scotland and Royal Bank of Scotland, which are two of the largest funders in the UK of PFI, have set up offices in Sydney in anticipation of the developing PPP market in Australia, but there is concern that the market is not developing perhaps the way it was anticipated to in the last year.

Mr RICH-PHILLIPS — Is that going to have an impact on future projects that do come to the market in that there will be less enthusiasm for the private sector to attend?

Mr CAMPBELL — In the short term I do not think so. I think everybody is looking for projects — contractors, banks, commercial advisers, lawyers. Everybody has geared up thinking our prediction was that PPPs will become a method of delivery that will be accepted by the public sector. You have government policies coming out. The concern would be that a lot of time and effort has been put into setting up, right across the industry. But for there to be a success policy there has to be some flow of deals coming through. One isolated project here and there is not going to keep up the market's interest.

The CHAIRMAN — It has been put to us that the number of tenderers can also affect the view of the private sector in these things, so if you have three tenderers, and a 1 in 3 chance of being successful, it is more likely to run than if there are six tenderers and a 1 in 6 chance of winning the ultimate contract, and that this can affect the way in which prospective tenderers might look at it and say, 'The risks are inherently higher'. What is your view on that?

Mr CAMPBELL — I think that is undoubtedly right. I was speaking to the commercial manager for AMEY, which was the successful consortium for the Glasgow schools project. I discussed this very issue with him. They went from four to two. There were four shortlisted bidders. AMEY was one of the two shortlisted for BAFO, and its view was that on any project — this project as well — they will put an effort in at the expression of interest stage and they will put their bid together, but they have got three other bidding consortia. You said six, which makes it even worse. But in that case it was four. He said it was not really until BAFO that 'We know we are a serious contender. We are only competing against one other bidder then'. They spent £10 million in their bid for the Glasgow schools project. Once they got to BAFO and they were appointed as one of the two preferred bidders at that stage, they put a huge effort in to win the project. But it was not until that point they were serious enough about the project. But that difference, reducing from four to two, made a difference to the way they thought about the project. I think that would be the case anywhere. Our clients want to minimise the competition during the bidding. They want to know who they are bidding against, what the strengths and weaknesses of the others are and how many there are.

The CHAIRMAN — Just broadly can I ask you finally, from the point at which a government says, 'Right, this is a project we are going to put out for expression of interest and PPP. We are designating this a potential PPP process', what in your view would be the optimal process from that point onwards?

Mr CAMPBELL — In what sense?

The CHAIRMAN — As we were just talking about. It is advertised obviously as PPP I guess at that stage. You may have a whole raft of people who say, 'We are potentially interested'. How do you get that then down to — —

Mr CAMPBELL — I think the way the process operates now is okay. It is similar to what happens in the UK. You go to expressions of interest. The view around the market is that there are probably about eight or nine bidders for the prisons project, although one has pulled out. That is about all you get because you need to have a major contractor. For a \$150 million project you have to look at a major contractor or major bank, or more than one major bank.

So probably in Australia you already have that number of players — may be 8, or 10 if you are lucky — then you shortlist to probably 4. The guidelines for procurement says it should be about 3 to 4. That is about right, because at that stage all you have is expressions of interest and you may not actually know what the bidding consortium has in mind in terms of design. Then if they are invited to put in a bid there is an opportunity to show what they have. But I am probably still persuaded that the United Kingdom's best and final offer (BAFO) system is better because you go from four to two. Then there is a further opportunity for those two to then refine their bids and put in their best and final offer. Then there is another period where there is only one preferred bidder that does the final work through to financial close. That is not a lot different from what we do.

In terms of a balanced view, in the state's interests the State should probably stick with three to four. Contractors would clearly prefer three. We are going through this process at the moment with the prisons bid; we would prefer three, but they realise it will probably be four.

The CHAIRMAN — But starting with a fairly general offer to express interest?

Mr CAMPBELL — Yes, and that is all it is. The expression of interest is really just demonstrating capability: what your team comprises of, what its capabilities are to do this sort of project, and where you it is going to get its funding from. It does not need a lot more than that.

The CHAIRMAN — One of the other criticisms is that if you do not have something of that nature you virtually cut out new players.

Mr CAMPBELL — Absolutely. I have not heard any criticism of that process; I think the expression of interest process is fine. Everybody understands they will have to bid for the project, but private sector bidders do not want to incur unnecessary costs. They realise they have to take on risks and costs, but they are just concerned to ensure they are not exposed to unnecessary costs.

The CHAIRMAN — I suppose the other general question is more philosophical. Is there any area of activity which should not be offered for PPPs?

Mr CAMPBELL — Nothing comes to mind. For me the drivers for PPPs is where you start. Is it something where a public-private partnership form of delivery can deliver the services? So it has to be some social or economic infrastructure that is amenable to this form of delivery. And can it give you better value for money than a traditional procurement? To me, you have to get over that. Part of that is building in your whole-of-life costing, and the efficiencies the private sector might bring to a project. It is really looking at it on a case-by-case basis. If I take local government libraries, for example, if I could get two or three libraries together with one contractor or one consortium funding the design, construction and operation and maintenance of those libraries over a 25-year concession, that could potentially offer significant value for money. It has to be tested against a reference project, but my view is that there is nothing much that would not be appropriate for PPP, so long as the drivers for PPP are satisfied.

The CHAIRMAN — Do you have a view about what the differential should be, or what the threshold benefit to the public should be on the public sector comparator?

Mr CAMPBELL — No.

The CHAIRMAN — Is it a matter of its being \$1 better, 5 per cent better, or something like that?

Mr CAMPBELL — That is a difficult question. I do not have an answer to it. I think that when projects are borderline — I think in the Portsmouth example that is what they are struggling with — and if there is a question about getting value for money consideration must be given to whether it will deliver a better service. There are other issues for Portsmouth as well. I do not know. If it is close to what it is going to cost the public sector there would have to be other drivers, such as the risk transfer; although you should have already built in the value of transferring significant risk. The private sector may be able to deliver infrastructure services more efficiently, so that is where you get your value for money. If you take all those things into account and it is still borderline, there is a problem.

The CHAIRMAN — The public sector comparator does value risk transfer, doesn't it?

Mr CAMPBELL — It does; value is put on those things, so you have to try to work that out. There is a factor for the risk transfer, there is a factor for the financing, and I think national competition policy is a factor as well.

Mr RICH-PHILLIPS — On the issue of tender costs, I am familiar with the United States defence industry where basically all hardware supplied by that industry is procured by the government to specifications. It has a practice where after it gets through shortlisting, typically down to two potential suppliers, much of the cost of tendering is actually borne by the US government. We are talking hundreds of millions of dollars — in some cases billions — rather than \$10 million. Do you know of any public–private infrastructure models anywhere in the world where the public sector takes on some of the tender costs once it reaches a certain stage of the process?

Mr CAMPBELL — It is an issue that has been discussed at length in the United Kingdom, and I think there are projects where there has been some component built into the tender process where the state pays unsuccessful bidding costs.

Mr RICH-PHILLIPS — That kicks in beyond those circumstances.

Mr CAMPBELL — It is a bit different. It pays the costs of unsuccessful bidders. The winning bidder would not get any refund of costs, but unsuccessful bidders get a proportion of their costs back.

Mr RICH-PHILLIPS — And is this in the United Kingdom?

Mr CAMPBELL — Yes.

The CHAIRMAN — That would be in particular circumstances.

Mr CAMPBELL — I have heard of it, but it is not used widely by any means.

Mr RICH-PHILLIPS — The US model seems to be that once you get down to two potential suppliers the government will pay the development or tender costs, if you like, for both potential contractors, and then obviously the successful one gets the contract, so they do not have to bear the development costs through that final stage.

Mr CAMPBELL — It is interesting. I do not think successful bidders have a problem with the costs. If you win the project, or even if you do not win the project, if there are other projects coming up where you are going to recoup some of your costs because you are going to be successful in one of them, I think it is less of a concern. The problem is in spending a lot of money on the costs and there is nothing coming around the corner.

Mr RICH-PHILLIPS — Do you know whether the example you have cited has encouraged more tenderers to participate?

Mr CAMPBELL — I do not know much about it. Someone said to me that this has been done on a particular project, but it is not at all common.

Mr RICH-PHILLIPS — Are you not familiar with where it is in the United Kingdom?

Mr CAMPBELL — No. I might be able to find out. The question of unsuccessful bidding costs is raised in major construction projects all the time, but really do you ever see anyone pay unsuccessful bidding costs?

The CHAIRMAN — The issue that has been raised with the subcommittee — I do not know whether it is the UK case — is where significant bidding costs have been incurred and then the government pulls out of the project, so the project does not actually go to completion for anyone.

Mr CAMPBELL — That may be the case. I am just trying to think where that has happened. With the projects that I am aware of, if the government decided once it got the bids in that it would not get value for money and it pulled out, bidders would bear their own costs. I cannot help you much further with that.

The CHAIRMAN — It has been put to the subcommittee as an example of where there should be a reimbursement.

Mr CAMPBELL — I think the policy makes this very clear: the government or procuring agency should not embark on a project unless it has satisfied itself that a Partnerships Victoria or public–private partnership approach is going to offer the benefits it expects, such as better value for money. In our process a significant amount of work has to be done, it has to get cabinet approval, and the projects has to go through a number of steps; so you hope that PV projects would not go to the market unless they had a very good chance of success.

Committee adjourned.