

# CORRECTED VERSION

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

#### Inquiry into private sector investment in public infrastructure

Sydney – 23 October 2002

#### Members

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#### Witness

Mr T. Harris, Journalist, *Australian Financial Review*, and former Auditor-General, New South Wales.

**The CHAIRMAN** — I declare open this subcommittee hearing on private sector investment in public infrastructure. I welcome Mr Tony Harris from the *Australian Financial Review*.

All evidence taken by this subcommittee is taken under the provisions of the Victorian Parliamentary Committees Act and is protected from judicial review. However, any comments made outside the precincts of the hearing are not protected by parliamentary privilege. All evidence given today is being recorded. Witnesses will be provided with a proof version of the transcript shortly after this hearing.

Mr Harris, before we go to questions would you like to make an opening statement to the committee?

**Mr HARRIS** — Just a short one if I may, Mr Chairman. New South Wales has had wide experience in outsourcing infrastructure to the private sector, not only in terms of roads, as has happened in Victoria, but in terms of private-for-profit public hospitals, water filtration plants and public housing, and that experience has not always shown that the public sector knows what it is doing or is undertaking those tasks in the best interests of the public. They are the two most important issues: that you know why you are seeking private participation in public infrastructure and that you do so competently; and if either of those legs fail then the government might be in grave difficulty. I am happy to explore those areas with you as you wish.

**The CHAIRMAN** — Going down that line, I note that in an article in January this year headed ‘Infrastructure’s hard road’ you say that New South Wales governments, Labor and conservative, have given a bad name to private participation in public infrastructure. Would you briefly elaborate on that statement?

**Mr HARRIS** — We can start with the first major example. I do not include the Eraring power station because that was just a tax minimisation scheme. I also do not include the Sydney Harbour Tunnel because the state government, at least on one occasion, has claimed ownership of the Sydney Harbour Tunnel, and I agree with that. It was a transaction that tried to get around loan council restraints that existed at the time.

If we start with the M4, which was the first major public infrastructure project in New South Wales, we find that the government allowed itself to provide a very significant subsidy to the owners of the M4. They started with a \$500 000 capital injection for that road and ended up with an asset worth upwards of \$70 million. They did that by actually taking out a franchise on collecting tolls rather than providing private roads, and the tollgate is not connected with the private road they provided — it is between Sydney and Parramatta whereas the road they provided is between Parramatta and Penrith. So about 20 per cent of road users pay the toll and do not use the private sector roads. That was a massive windfall to the private sector. Apart from the economic problems of toll roads, it was an ineptly undertaken task.

The M2, M5 and M1 were subsequent tollways, and we see again that giving chunks of a network to the private sector was inept — for example, the M5 owners were significantly benefited when the taxpayer paid most of the cost of the western extension of that tollway, thus adding to the value of the toll to the users. They added significant value again when they constructed the eastern part of the M5 tollway, which is not tolled and which further added something like 24 per cent of traffic to the toll owners of the tolled freeway. So giving bits of roads just allows either very high risk to the private sector because they cannot control the road use or it allows them significant windfalls. We are going to see some interesting issues. It is also a 45-year contract. Most people in Sydney were not here when trams were abolished, which was about 40 years ago. That is a very long time to lock in contracts dealing with something as mobile as public transport.

We have just finished the eastern distributor or the M1, and we are now negotiating with them about changing arrangements so we can put a cross-city tunnel in which will provide exits off that M1 tollway. The private sector is in a great position in those negotiations. It has its agreement, it has its road, if you want to disturb that agreement you will have to pay for it. Offering up chunks of the network is viewed by most economists as a very unsatisfactory and inefficient way of providing public infrastructure by the private sector. At least in Victoria you did it with some greater semblance because you did it in a unitised way.

**Ms DAVIES** — What you are saying about these freeways is really identical to the City Link project in that if the arrangement is long term it provides an incredibly good rate of return for the private investor. If there is any future change in government policy to improve public transport, for example, you have to give money to the private sector. Surely the sorts of things you are saying are identical.

**Mr HARRIS** — Yes. The one advantage you have is you do not have four or five owners of disparate unconnected tollways.

**Ms DAVIES** — So each of these is owned by a different owner?

**Mr HARRIS** — It used to be, and they used to have different electronic systems for collecting the tolls. It is now being gathered under the Macquarie Infrastructure Group, and we now have a single technology, but otherwise the problems are the same.

Your colleagues on the public accounts committee said that the public sector could not afford these projects, by which I think they meant that the public sector could not afford to charge for these projects because the private sector is as capital constrained as the public sector and can only afford these projects if it makes a charge. So it seemed to be saying that the government did not want to charge for roads but the private sector could. That seemed to be more a political issue than anything else, and it kind of overrode the fact that the government used to charge tolls on the now freeway to Newcastle, the now freeway to Wollongong, and still charges tolls on the Harbour Bridge. So the government has long been used to charging tolls and abdicating that responsibility on the grounds that the government cannot afford it seemed to be quite strange. It may be that it was saying the government did not wish to enter into debt.

From a macroeconomic view it really does not matter too much whether the private sector enters into the debt to build these roads or the public sector enters into the debt to build these roads. I am not talking about constructing them; I think the private sector should design, construct and maybe maintain and even administer the roads, but the ownership of the road is probably more cheaply undertaken by the public sector than by the private sector. Just saying that debt is bad — that is, ‘We do not want to enter into debt’ — is really an inefficient way of looking at debt. If debt is bad then so are savings, because savings are the reciprocal of debts.

**The CHAIRMAN** — But that was the political climate through the 1990s.

**Mr HARRIS** — Yes. There is an act here called the debt elimination act, which was one of the first acts introduced by the Carr government to eliminate public debt, in the same way that in Canberra there is a desire to eliminate public debt. I think both sentiments are wrong. Debt has its place, just as savings have their place.

**Ms DAVIES** — Are these roads BOOT roads? Do they eventually go back to — —

**Mr HARRIS** — Yes, they do.

**Ms DAVIES** — After 45 years?

**Mr HARRIS** — Yes, depending on the rate of return that the owner has enjoyed. If the rate of return is insufficient under the agreement then the life of the contract is extended.

**Ms DAVIES** — When you say that it would be better for the public sector to own the roads, you mean right from the start rather than waiting for the 45-year transfer?

**Mr HARRIS** — Yes.

**Ms DAVIES** — Do you agree that those types of arrangements would have been perfectly possible — and I am familiar with the Newcastle tollway and I know that New South Wales has a history of tolls — in having these roads built as public sector projects, obviously subcontracted out to the private sector to design, construct and even maintain, whatever, but they could have been built as efficiently as cheaply and in as timely a fashion by the public sector using tolls?

**Mr HARRIS** — Yes. The third runway, for example, was built by the private sector on behalf of the commonwealth and it was completed in record time and bonuses were paid to Baulderstone for that construction. There is no reason why roads also cannot be constructed as efficiently by the private sector under well-designed contracts.

**Ms DAVIES** — So that third runway was a commonwealth project?

**Mr HARRIS** — Yes, and is owned by the commonwealth but was constructed and designed by the private sector. There is a slight advantage in bringing finance, design, construction and maintenance together because the trade-offs that occur between quality of construction and cost of maintenance and financial costs can be worked out by the single entity. That slight advantage can be lost, however, because you are entering into a very sophisticated contract between the government and the private sector, and that contract might actually cost 5 per cent of the value of the project because it is so sophisticated.

The contract for the M2, for example, precludes government public transport facilities other than those in the contract, precludes any government from taking any action which reduces the flow of tolls, and compensation has to be provided. They are very sophisticated documents requiring very detailed analysis, and everybody works on them: the banks work on them, the investors work on them, the architects work on them, the engineers work on them, and the constructors — everybody is involved in that process. So the advantage of combining ownership with construction and maintenance I think is offset by the complexities of the contract and by the complexities of the life of the contract.

**The CHAIRMAN** — Continuing on those points, in that same article to which I previously referred you say that the New South Wales approach was initially on the silly basis that the private sector was better placed than government to borrow for infrastructure purposes. There seems to be a continuing argument over these things, over who can borrow better. We are often given an argument that the public sector can borrow better than the private sector, but then the private sector will come in and produce figures that it says indicate this not to be the case.

**Mr HARRIS** — There is an argument that says because the New South Wales and Victorian governments are AAA-rated that their borrowing rates have to be better than the rates of the private sector who are not AAA. I think there are one or two AAA private sector enterprises in Australia, and they are mostly AAA because of their relationship with the government. I do not accept that argument. I believe the risk lies in the project and that the risk of finance relates to the risk of the project. So are the risks of the project different if the government owns it than if the private sector owns it? 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 be an owner of the road, charges for that risk.

**The CHAIRMAN** — Or has clauses in the contract.

**Mr HARRIS** — To try to minimise the risk, yes, by saying that you cannot put in a railway that parallels my toll road.

**Ms DAVIES** — Again that parallels the City Link — they both get a higher return on their investment plus there are clauses in the contract.

**Mr HARRIS** — To try to reduce risk, yes. Those clauses cost the public as well because it limits the flexibility of government. That is a network argument. When we come to something like a water filtration plant I would argue that the finance risk is probably not much different between the private sector and the public sector or a public hospital for profit. I would argue that the risks are probably very similar.

**Ms DAVIES** — With something like water filtration units, could you not argue that again you have a similar network?

**Mr HARRIS** — Yes, it is unusual.

**Ms DAVIES** — And you have a sort of spread out public interest in that if there are elements of privatising in it then the broader public interest of, say, reducing consumption is not —

**Mr HARRIS** — I have actually argued that we own the water filtration plant because we take all the risks that a water supply authority takes with respect to that filtration plant. It is located on government land; the water filtration plant has one major input, which is untreated water, and it has one major output, which is treated water. It does not have any agreement with the government about the quantity of water it supplies so it has a two-part tariff. One part of the tariff says, 'If you do not use a litre of our water you have to pay all of the costs of this plant over its 40-year life. We then charge you for per-litre usage', so it is an availability charge and a usage charge. Whenever I refer to a usage charge and availability charge I tend to say that we have taken all the risk because we have a contract for the life of the equipment and we are paying it off as if it is a financing deal, and then we have a separate agreement about water. So I argue that in economic and accounting terms we own the filtration plant.

**Ms DAVIES** — Does it show up on the books?

**Mr HARRIS** — No, it shows up as an opinion which the Auditor-General provides in the audit opinion and which says that the government's accounting treatment is wrong, because it does for the Sydney Harbour Tunnel now. Nevertheless, it is a very strange creature. It is like Ford having a motor plant in the middle of a General Motors production line; General Motors owns everything except the engine plant in the middle which is

owned by somebody else. It has those strange characteristics. Nevertheless, it did provide some benefit because it linked together those three things of maintenance, construction costs and finance costs, and it provides some financial benefit to the state compared with the state constructing with its own design. The benefits are slight and there are problems with them.

I refer to the giardia and cryptosporidium problem — the Sydney drinking water problem. Under the agreement the government is able to occupy the filtration plant if there are problems with the filtrated water. It tried to occupy it and the owners said, ‘No, you have to go to court. We disagree that we are underperforming. We are not going to let you into the building. We control the filtration plant.’ So you do have problems like that.

**Ms DAVIES** — Would it not have been simpler to register it as a publicly owned utility that was designed, built and maintained by the private sector?

**Mr HARRIS** — Yes, probably.

**Ms DAVIES** — Would it have reduced the costs of developing a contract?

**Mr HARRIS** — If you do it that way, probably. Sorry, you would not reduce the cost but you would have eliminated some complexities in the contract and complexities in the control issue.

**Ms DAVIES** — It would have appeared on the books of the government?

**Mr HARRIS** — I still think it appears on the books. The Auditor-General still thinks it is owned by the government. Similarly, going from the water experience and quickly on to hospitals, the Port Macquarie for-profit public hospital is the only one of its kind in the state. We just stuffed up the negotiations with that. We constructed the hospital — we the state — on government land and entered into an agreement with Mayne Nickless. Mayne Nickless said it wanted to get paid for treating public patients — that’s fine. It said, ‘What formula will we use? We will use the Medibank Private rate. Why private? Because we provide a higher level of service to these public patients than other state hospitals provide to their public patients’. The government agreed. The government also agreed to pass over the ownership of the hospital and the land to Mayne Nickless if it provided satisfactory services.

So the government paid for the hospital and the land and provided it to Mayne Nickless free as part of the contract. But interestingly, the Medibank Private rate also includes a capital charge, as you would expect. So Mayne Nickless is charging the state twice for capital. It is charging the Medibank Private rate and it is getting it free as part of the contractual relationship. So the government paid for this hospital twice and gave it away once. That is as a result of inept negotiations, and there are other examples of inept negotiations. This is another issue. If you are going to enter into these things you must recognise that the private sector is extremely skilled at getting up from the table and leaving nothing on it. It will take the laminex with it. The government will find it very difficult to cope with that kind of negotiation because very often it does not have the same skills.

**The CHAIRMAN** — If I can come to that — that is a good point to come to — a couple of things come out of that. Again through the article you say — and obviously you have been saying there again — all of this New South Wales experience says we should be suspicious of PPP. Wouldn’t the argument that the government has put to that say, ‘But that experience has lead to the current PPP policy. That is what we are addressing in the policy’? How do you respond to that argument?

**Mr HARRIS** — PPP is certainly less problematic than most other examples of public infrastructure we have seen. In New South Wales they are approaching it quite interestingly. They are saying, ‘We have the money for these schools. It is a matter of do we finance them — we are not going to build them or design them, but do we finance them or does the private sector finance them?’. So this is not a matter about avoiding debt.

**The CHAIRMAN** — When you say they say, ‘We have the money’, do they show that on budget?

**Mr HARRIS** — They show that they have the capacity to spend the money, yes. So this is not a competition about debt. So you do get this slight benefit, although I would argue that we would own the school. The private sector builds the school, enters into a 40-year lease, that being the depreciation allowed by the commonwealth — 40-years depreciation at 2.5 per cent per annum. They lease it to the state for 40 years — that is the economic life of the school. I would argue that we own it, we paid for it in the lease. But they say, ‘Well, we maintain it and we have to maintain it to a certain standard and we can balance the maintenance cost with the construction cost with the financing’ — the same discussion we had before. That is a benefit.

On the other side you have this 40-year agreement and you are negotiating with someone who is the legal owner, not the economic owner but the legal owner, over 40 years. Can I extend it? May I extend it? May I extend it myself or must you extend it? And if you extend it, am I caught in the pincers because you have this monopoly position for the school and the district? Those issues subtract from the benefits of having the owner, the constructor and the maintenance person wrapped up as one entity.

**Ms DAVIES** — Do you reckon they cancel each other out?

**Mr HARRIS** — I do not know, but I would be very suspicious that the private sector would always win. It does not always win in fact. I mean, if you take the Olympic stadium and the multipurpose arena that was also built for the Olympics, the private sector lost their shirts — significant sums of money — in the provision of those two pieces of infrastructure. One of the reasons they lost is that we hired the negotiator from Transfield, who used to beat us to a pulp, and he changed stables.

**The CHAIRMAN** — So is it purely about that, about the relative skill of being able to negotiate the contract?

**Mr HARRIS** — He certainly was very successful on either side.

**Ms DAVIES** — And if you do have clever public service negotiators and they do extract blood from the private sector — and I presume the stadium has not gone under — one of the arguments that we have heard repeated several times is that in the end the risk for essential services is always going to stay with the public sector because if you do have a successful negotiation and you do pin the private sector down, in the end they will always go under rather than keep going with a loss for 40 years. They will not do that.

**Mr HARRIS** — Yes. When I first looked at your franchising of public transport in Victoria I thought that was brilliant, but the more I hear about it the more it looks like a financing lease, although it has never been portrayed as such, and that is that the government has to step in and provide whatever is necessary for the private sector to run this public service.

One accountant who has looked closely at all of the agreement — and I was able to look at only 90 per cent of the agreement because 10 percent was omitted from the public record — has said in public that it is a finance lease. In other words, the state takes all of the risks associated with the running of public transport in Victoria.

**Ms DAVIES** — Do we know who that accountant is?

**Mr RICH-PHILLIPS** — Is that a case of the state having to take the political risk?

**Mr HARRIS** — No, the financial risk.

**Mr RICH-PHILLIPS** — But as a result of having to take the political risk?

**Mr HARRIS** — No, it is in the agreement.

**Mr RICH-PHILLIPS** — Would the government take it?

**Mr HARRIS** — No. I understand your distinction that you cannot have something fail but it is in the agreement. It has already been predetermined what the state will pay when financial problems occur.

**Mr RICH-PHILLIPS** — But even in the absence of a clause like that the political reality is that the government could not allow public transport to fail?

**Mr HARRIS** — Yes, I think though the government could allow that owner or that franchise operator to fail, and if it is practical to substitute one franchise operator for another in a seamless way then you could allow —

**Mr RICH-PHILLIPS** — If that is possible, yes.

**Mr HARRIS** — And it is possible, yes.

**The CHAIRMAN** — But really part of the figure to be considered in that would be is it cheaper to pay the subsidy and keep the current owner or attempt to change the owner?

**Mr HARRIS** — Yes.

**The CHAIRMAN** — It will come down to that sort of equation?

**Mr HARRIS** — Yes, it could. Under this agreement it seems however that the government has committed itself to providing whatever is reasonably needed for the public transport to run.

**Ms DAVIES** — The original contract did that?

**Mr HARRIS** — Yes, according to this extremely skilled accountant.

**Ms DAVIES** — Who is it? Is it on public record?

**Mr HARRIS** — Yes, it is on the public record. I will have to think of the name. I will provide the name for you.

**The CHAIRMAN** — I was going to ask you about that because in the January article you made some comments about the privatisation which I thought, in light of later events, may well have affected that, because you later had those further subsidies being paid et cetera.

**Mr HARRIS** — Yes. It is quite strange.

**The CHAIRMAN** — But in spite of what you have been saying, again, just going through the article, you are not arguing that there should be no private involvement?

**Mr HARRIS** — No. I certainly argue that there ought to be private involvement in design, construction, and maybe the maintenance and administration. It is the financing that I have the particular issue with. Who is the legal owner, the economic owner and the accounting owner? It seems to me that if we take all the risks, including maybe the political risks, then we might as well be the financial owner, because it complicates matters quite considerably trying to draw up an agreement which reflects in a very complicated way that we take the risks.

**The CHAIRMAN** — Accepting what you are saying here, that the private sector should design, construct and maintain public buildings, what are the elements of a contract that you would see as being central to securing the public interest and protecting the public financial risk?

**Mr HARRIS** — If I am talking about an office block which is not specifically designed, as is the trade building in Canberra, which is specifically designed for ASIS people to work in the basement, and we sell it to the private sector, we are just putting ourselves in a hopeless position of course. But if we are talking about a normal office block then the private sector could own it and we could occupy it. But to get any advantages from that we would have to say to the private sector, 'We are not renting this for the life of the building. We are renting this as any other renter would do — five years at a time with options'. Now that might make sense for some agencies, but it does not make sense for the Premier's department or Treasury or the departments of education or health because they will always be with us and they are paying a premium to the private sector for flexibility that they will not actually use. So they may as well own the building and not pay the premium.

The Department of Foreign Affairs and Trade is paying premium in Canberra because it has a limited-life contract, and the private sector says, 'Oh, if you are not going to occupy this for the life of the building I suffer the risk that I might not have tenants so I will have to load up the rent to cover those periods when I have no tenants', the interesting thing being that Foreign Affairs and Trade cannot move out of the building because it is purpose built. That is just silly, which is what the Attorney-General in Canberra has basically said about that.

However, if you are talking about public structure like water pipes and the like, then I cannot see any benefit at all in the private sector owning them. I can see benefit in it designing and constructing them because that is part of the competitive market, but ownership? If you are going to carry the risks inherent in that pipeline you might as well own it as try to pretend through some agreement that the private sector is carrying the risk when it is not. Take a water filtration plant — the private sector does not care whether it is too big or too small, it does not care whether the technology changes and is now outmoded because the plant is already built and it has an agreement with us. Who cares? We care, we the public sector care, and we are the ones carrying that risk.

It is the same with a school. Once the school is built and occupied the private sector does not care whether the technology of teaching changes or whether the school is too big or too small because all of those risks have been passed back to the government. So if they have been passed back to the government, what is the benefit of the

government saying the private sector should own it? If the risks of ownership reside with the government, they reside with the government.

**Ms DAVIES** — One of the risks that everyone talks about is the great unknown, the science that ain't a science. Queensland has a long list which it believes covers all the different risks and which can be worked through so it can say, 'You deal with that risk and I will deal with this risk'. Victoria has a similar sort of process. Do you believe that is artificial and inevitably inadequate, or do you believe that risk allocation is sufficiently a science for it to be accurate?

**Mr HARRIS** — It is inevitably incomplete, but it is a process through which you have to go. If you are entering into a financial relationship with others you must try to itemise all of the risks that you face.

**Ms DAVIES** — But do you believe ultimately that the risk lies with the essential infrastructure or whatever, that the risk is always going to ultimately lie with the public sector?

**Mr HARRIS** — No, not all risks will lie with the public sector. The Yarra tunnel — —

**Ms DAVIES** — The construction risk does not.

**Mr HARRIS** — Yes, that did not rest with the Victorian public. So not all risks will reverberate back to the public, but fundamental failure probably will. Someone here said about the onus of the tunnel, 'What happens if, say, a ship sinks on the Sydney Harbour Tunnel and breaks the tunnel?'. The companies go bankrupt because they are only shell companies anyway. They are project companies; they have taken all their profit out of construction, they are just there for legal purposes, and if they go bankrupt they do not care and the public is left with trying to work out how to carry 30 000 vehicles between the north and south shores. So yes, some of these risks, political as they have been well described, will always come back to the government or public service facilities.

The risk of Telstra Stadium in Sydney going bankrupt would not worry the state; in fact, we have too many stadiums anyway. The risk of the multipurpose arena going bankrupt would not worry the state because we have other venues. But when you have a public sector facility that is necessary, whatever that means, then the state has to supply it, one way or the other.

**The CHAIRMAN** — So if, for example, you had a catastrophic failure at the Olympic stadium, would it result in financier takeover?

**Mr HARRIS** — Yes. They have already written off several hundred millions from the value of it, and the banks will have to wear the loss.

**The CHAIRMAN** — We keep talking about risk of catastrophic failure and where that ends, but how significant is that really? How often do we experience catastrophic failure of the sorts of things we are talking about? How often does a ship collapse on an underwater tunnel somewhere in the world?

**Mr HARRIS** — We had a fire in a filtration plant recently which affected water supply for 24 hours, but it was unnoticeable even though it was a very large supply of Sydney's filtrated water. No-one actually noticed any effects. So yes, catastrophic failure must be reasonably rare.

**The CHAIRMAN** — And many of these risks — the type of risks we are talking about — are already associated with government in a whole range of other areas, I would suggest. For example, if you get a massive problem with poisoned food or pharmaceuticals that have been tampered with, regardless of the fact that they are wholly private sector owned, the risk comes back to government?

**Mr HARRIS** — In a way. The regulatory risk certainly does, yes.

**The CHAIRMAN** — So I wonder sometimes whether we tend to distract ourselves when we talk about catastrophic risk?

**Mr HARRIS** — Yes. It is more the little risk, such as the school is too small and what do we do now because Lend Lease owns it?

**Ms DAVIES** — Changing needs and changing demand?

**Mr HARRIS** — Yes.

**The CHAIRMAN** — And there certainly have been examples of that type in Britain where departments have contracted public buildings on long leases only to find they do not serve their purposes after a small number of years.

**Mr HARRIS** — Yes. If they owned those buildings themselves they would face the same risk, but at least they could remedy it more easily than they can when the private sector owns it.

**Ms DAVIES** — Your paper argues that where there is a competitive structure the environment exists for private provision, and you talk about the electricity generation. I do not know whether you are talking just about generation or about distribution as well.

**Mr HARRIS** — Just generation.

**Ms DAVIES** — And you use it as an argument for why you could sell off New South Wales electricity generation as well. So this argument that it is competitive, can't you say that Victoria's example demonstrates where it is not necessarily in the private sector's interests to increase electricity generation because they get a market premium in times of high demand and shortage of capacity?

**Mr HARRIS** — Yes, so long as someone can enter the market. It is always true in economics that a person will not enter the market unless the person sees above-average returns; they see an opportunity to make more money in this pursuit than elsewhere so they invest in this pursuit. So long as there are above-market returns or the prospect of them and another person can come in and take advantage of that then I would not worry about the supply problems that you discuss. For example, in New South Wales the government is tendering an abandoned power station in Illawarra to be developed for gas and electricity generation. This will add to the competitive pressures in New South Wales, which is what the government should be doing, and there is a facility there — gas pipelines — so someone can come in, produce electricity and have it transmitted without any problems.

**The CHAIRMAN** — Is that as a base-load station or a peak load?

**Mr HARRIS** — It would be peak load, being gas, probably.

**Ms DAVIES** — Would there be a competitive benefit in having competition between some private sector and some public sector generation?

**Mr HARRIS** — To go back, it might also be base load in the sense that although the cost of gas is high, the cost of capital is low enough that it might be competitive for some base load.

**Ms DAVIES** — Would you not increase the competitive pressure on the private sector by having a mix of some publicly owned generation capacity and some privately owned generation capacity?

**Mr HARRIS** — If you needed to increase competitive pressure that way through a transition stage, you could do that. I suppose we have three or four major suppliers of food in Australia — Woolworths, Coles, Bi-Lo and what else — and the market is very competitive, and the government does not see the need to come in to provide a competitive pressure because the market is established. Now we do not have an established market in New South Wales for electricity generation and governments find it hard to compete — they prefer the dividends to providing the lower electricity cost — but there is an argument that says the government can facilitate in this transition stage.

**Ms DAVIES** — Would you argue that New South Wales should sell off its distribution and retail outlets?

**Mr HARRIS** — I did a report on this when I was presiding commissioner at what is now the Productivity Commission. I did it back in the 1990s and we were not game enough to argue that transmission or distribution should be privatised. The question of monopoly — privatising monopoly public sector infrastructures — is in my view a very uncertain argument.

**Mr RICH-PHILLIPS** — In your paper that you delivered to the Centre for Independent Economic Journalism in 1998 on this issue you spoke about taxation and the benefits that private sector agencies can gain through taxation that are not available to the public sector. Despite the New South Wales policy of not using that as a basis for private involvement, do you see that as a legitimate benefit when considering private sector involvement for state and local government?

**Mr HARRIS** — No, all it is is the transfer from one part of the economy to another part, from one taxpayer to another taxpayer.

**Mr RICH-PHILLIPS** — But as a state or local jurisdiction, is it legitimate for those entities to consider those benefits?

**Mr HARRIS** — It probably is legitimate for them to do so, but I would not agree 100 per cent; but probably the circumstances ought to be ruled out where they can take advantage of them because they are artificial advantages. I can understand why local government will consider them because to them it is a real advantage, but to the whole economy it is not an advantage — it is just a transfer — and the arrangements should not allow those issues to be taken into account. Quite interestingly, on the Sydney Harbour Tunnel, legally owned by the private sector, the government was advised to get a tax ruling before it entered into the agreement. It did not, but it provided a tax indemnity to the legal owners of the tunnel for depreciation for plant and equipment and the like. It requested a ruling from the tax office in 1989, and that ruling has not yet been provided because everyone is too embarrassed about it.

**The CHAIRMAN** — We are right at the end of our time. There were a couple of other matters that I would like to have gone further with, and perhaps some of the others too, including a question that is raised here about tolling as a specific use, and the government putting it into general revenue. I have to say I am not sure that it is not legitimate to do that as long as the revenue stream is clearly shown. Why should it be hypothecated?

**Mr HARRIS** — I do not mean hypothecated. It is a tax. The government has decided now that it is not good enough that tolls will cover the charges or costs. They will now use tolls as a taxing device to gather revenue, so it is whether it is a price or a tax.

**The CHAIRMAN** — It is the price setting?

**Mr HARRIS** — Yes.

**The CHAIRMAN** — Thank you very much, Mr Harris, for making your time available today.

**Witness withdrew.**

# CORRECTED VERSION

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

#### Inquiry into private sector investment in public infrastructure

Sydney – 23 October 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

#### Staff

Executive Officer: Ms M. Cornwell  
Research Officer: Ms C. Williams

#### Witnesses

Mr J. Miller, Executive Director; and  
Mr M. Lilley, Division Director, Macquarie Bank.

**The CHAIRMAN** — I welcome Mr Jim Miller, executive director, and Mr Mick Lilley, division director, from Macquarie Bank to this public hearing on private sector investment in public sector infrastructure.

All evidence taken by this subcommittee is taken under the provisions of the Victorian Parliamentary Committees Act and is protected from judicial review . However, any comments made outside the precincts of this hearing are not protected by parliamentary privilege.

All evidence given today is being recorded. As witnesses you will be provided with proof versions of the transcript some time shortly after this hearing. Mr Miller, would you care to make an opening statement to the committee before we go to questions?

**Mr MILLER** — Perhaps I will pass to my colleague Mr Lilley.

**Mr LILLEY** — Thank you, Chairman. I will be reasonably brief and maximise the time available for questions. We are obviously from Macquarie Bank, and in our opinion Victoria is the leader in policy and framework for this type of procurement in Australia. We think the leadership has been achieved through two main prongs. Wherever these sorts of arrangements have worked in the world there has always been political championing for this type of procurement, and that has certainly been in evidence in Victoria. Once that championing is there, though, you need a strong bureaucracy to implement the policy, and the senior bureaucrats in Victoria have shown that strong leadership, in our experience, particularly the specific areas set up within the Treasury to deal with these matters.

Those sorts of individuals have a very strong commercial focus, which is not always evident in government. They have been very accessible to the private sector. They have a willingness to listen and a very positive, proactive approach, if I can put it that way, to project delivery. All of this creates an atmosphere of certainty for the private sector, and I do not think you can underestimate the reaction. You will get the best response and the best performance out of the private sector if they have certainty in how something is going to happen. It is when there is doubt or when something is equivocal that the private sector is left in absolute darkness or mystery, or they fill in the blanks for themselves and often get it wrong if they do that. Again, as I said, Victoria does this very well. It is very much like a football match. You are only as good as your last deal, and while that is currently the case I think within Victoria they have to continue with that openness and transparency to keep that reputation intact.

The market also sees that Victoria is capable of meeting deadlines and time frames, which might sound a bit trite, but there are examples of similar projects around the country where the evaluation time frame ends up taking twice as long as the time given to the private sector to design, fund, bid and put up a fully committed bid to that particular project. Evaluation is not necessarily easy, but it does get difficult, particularly when you have a design element in there, to think that can take a multiple of the time given to the private sector.

Victoria is also very good at creating competitive tension. Obviously our belief is that getting that competitive tension — and I do not necessarily mean in numbers, because having 30 firms bid is not necessarily better than having 3 quality firms who can deliver — that gives you a result at the end of the day is very important.

I will mention very briefly, in terms of your terms of reference, future policy and practice — and I am sure we will touch on it today — we would see issues of deal flow, obtaining a national market, risk transfer and innovation, and the market existence and readiness as being some factors to take account of.

A couple of things requiring attention, which I think is the way it is worded there, include the way deals are evaluated, and I assume this committee's deliberations are part of that. We think individual deals can be pulled apart and with hindsight perhaps issues found with them, but as in all things in life, no-one is perfect and inevitably a bad deal gets done. But if that bad deal is part of, say, a portfolio of 20 good deals then we would think the analysis should be expanded. I realise that is a private sector view rather than the political reality, but perhaps I could put it another way. Yes, the political reality will be there, but do not necessarily kill something off because of an individual bad deal.

Deal size is an issue for the private sector. We think there are a number of reasons why the larger deals are better, and not just transaction costs, which I am sure have been raised with you. But if those deals are larger, you get a lot more attention from the best and the brightest, literally because the vested interest of the profit making over the concession periods means if this is a landmark deal, then yes, every company is going to put their A team on it, and they are going to spend night and day through that period working on it to come up with the best possible solution.

We would also like, if it is appropriate, to take up the issue of the public sector comparator (PSC), particularly whether it should be disclosed or not disclosed, because I think there is still quite a deal of debate on that.

**The CHAIRMAN** — Thank you. Can I go immediately to one of the issues that is always raised with us, particularly by critics of PPPs — that is, that government can always borrow cheaper than the private sector — and get a reaction to that?

**Mr LILLEY** — Yes, it is one of my favourite topics. Tell me to wind up if I go too long.

Government can borrow cheaper than the private sector, that is not debated. But when government says that, government is looking at the risk-free rate of borrowing, and to take that risk-free rate and attribute it to inherently risky projects — no matter what the project is, it has a project risk associated with it — to our mind would be naive. So you get the issues people would have been raising with you of the risk-adjusted cost of capital. This is probably a good point to hand to Jim who has some empirical evidence of why some of those risk adjustments are absolutely critical.

**Mr MILLER** — I think in simplest terms if the government is borrowing at a risk-free rate and using that money to invest in risky projects, there is a fundamental mismatch there, and any economic theory or just common business practice would say that if that was perpetuated for every transaction, that would be unsustainable because some of these projects will go bad. The government is not being compensated for that risk in terms of the return that it is getting on the projects. So what that would ultimately lead to is if the government kept borrowing for these deals and some of these deals went bad and it was not getting a sufficient return on that, that would lead in the first instance to increasing debt levels at the government level because it was not getting the return. Ultimately that would lead to a credit downgrade, for example, within — —

**Ms DAVIES** — Or they can raise taxes. That is why they have that — —

**Mr MILLER** — That is why they have the risk-free rate.

**Ms DAVIES** — That is right. They have just one option.

**Mr LILLEY** — Sure, but then we would say what is the equity in raising taxes in terms of trying to compensate for the transactions that have been entered into. They (the Government) obviously can raise taxes, but we have still seen government credit ratings downgraded, notwithstanding they have that ability. I would come back also, from a sustainability perspective, that that approach cannot be sustainable in the longer term, because you cannot keep raising taxes and stay in government, certainly, but arguably also from an economic perspective over the longer term. So it all comes back to risk should be priced into these deals. Whether the public sector does it or the private sector does it, the risk should be priced into this deal. I think that this is certainly a positive aspect of the public sector comparator because it is the first bona fide attempt across a lot of the states that have adopted this framework to value risk in these transactions. That then gives a framework to perhaps go against that traditional argument that government can always borrow cheaper.

**Ms DAVIES** — One of the arguments is that the risk adjustment that takes place somehow magically often takes the public sector comparator just over the limit, and yet risk adjustment and risk assessment is not an exact science — it is always going to be subjective — so if that is your critical factor that makes private sector involvement comparable or desirable, then that is very iffy, because it is so inexact and so subjective.

**Mr LILLEY** — I will take half a step backwards but get to that. Once that risk adjustment is in there, the critical analysis is the whole-of-life costing. You are talking about provision of service in these types of deals, not just the acquisition of an asset. So the cost of capital is one input, and there are multiple inputs. When you then look at the whole-of-life costing, I certainly would not say that the private sector will always come out cheaper. I think the empirical evidence in the UK has shown that the private sector can compete, and the UK is not good at risk transfer compared to Australia, and while the label PPP is very new, we have been doing these things for over a decade in Australia. We just did not call them PPPs, and we tended to concentrate on economic assets rather than social assets. In many ways the economic assets are harder because you are passing a fair box or revenue or patronage risk to the private sector, and it is a risk that it is very happy to take on.

Your issue about the inexact science is absolutely right. I mentioned do you disclose the PSC or do you not disclose it? I think the bureaucracy has probably argued — I say probably because I cannot attribute everything to them — that if you put out the PSC, then those very smart people in the private sector will bid just below the PSC. Well, no, they will not because they are not competing with the PSC per se; they are competing with one another. So you will

find instances where the PSC might have been set at, say, \$10 million, and your lowest bid is \$20 million. Let's say that the range of bids was \$20 million to \$25 million, I would question the calculation of the PSC. This is a personal view, but in those instances, based on this methodology, you would say, 'Well, let's go back and do it through traditional procurement'. That would be really interesting because it would take the iffy out of it. You would then be saying to the public sector, 'Now deliver that on a whole-of-life basis for \$10 million', and my bet would be, if the private sector was so far from it, that it could not deliver it for \$10 million, because it is an inexact science in putting that PSC together.

At the moment the PSC is very rarely disclosed, and I think for the reason, that they think people are going to somehow only just sneak in. But in Western Sydney Orbital that will probably be announced next week, our consortium is competing against another consortium, and nowhere did we stay up at night saying, 'Oh, my goodness, I wonder what the PSC is?'. The reason we were staying up at night was that we were saying, 'What is the other consortium's traffic forecast?'. In things like that we are talking about the cost of capital. The traffic throughput is the critical element. Do I believe I can get 50 cars on the road and you believe you can get 100. If you can get 100 you are going to be able to bid this deal a lot better than I can at 50. The cost of capital is marginal. It is only a marginal improvement. Even if it is 175 basis points, over a very large deal across 25 years, that is a very negligible advantage for ensuring government retains 100 per cent of the risk, both construction and operational.

**Mr RICH-PHILLIPS** — On the issue of cost of capital — —

**Mr LILLEY** — With your question, you talked about the government's ability to borrow and that being perhaps one of the arguments, but you also mentioned, like pricing risk in, is that the only justification for private sector involvement in these projects; is that correct?

**Ms DAVIES** — It has been argued that when people are working out the public sector comparator the only thing that makes the difference between whether something is a viable PPP or whether it should be a public sector project has been that sum that comes in, which is the risk adjustment, and since that is such a dubious figure I wonder if that is enough.

**Mr MILLER** — I would comment on that by saying that is an estimate of the value of risk, and even if the private sector does not meet that target, for example, and the government retains that project in house, the government has all of that risk. It has made an estimate as to what the expected value of that risk would be, and say that is \$10, but the magnitude of that risk could be \$100 to the extent that something were to go wrong.

I do not believe there is gaming on the PSC in that regard because the fact is you do have real risk transfer. I agree it is not an exact science, but there is real risk that is being transferred and people are trying to make an estimate of that. The best protection from the government's perspective in terms of making sure it is getting value for money, which is one of the fundamental tenets of the partnership's model, is through the competitive tender process. If the private sector can go through it and, as Mick said, come up with a number that is higher than the government's PSC, maybe the government could do it cheaper or maybe the government has got it wrong. By the same token, the private sector — —

**Ms DAVIES** — The private sector can get it wrong and make a bid that is too low, and then it needs to be bailed out because the risk ultimately stays with the government.

**Mr MILLER** — Sure, the private sector could well and truly get it wrong, and there are a number of examples where the private sector has had a set of looming issues and it has been bailed out. But there are also numerous examples where it has not been bailed out and the private sector has well and truly worn that risk.

**Mr LILLEY** — With Stadium Australia, for example, the people who have lost money on that are the equity holders who willingly took the risk. The risk has crystallised and they have done their money. I do not know the exact value, but the last time I looked Stadium Australia was down to about \$20 million on the stock exchange, and you are talking about a \$700 million asset. Sometimes that is put up as an example of a failed project; well, gee, it is not a failed project for the taxpayer!

The taxpayer did put in \$190 million, willingly, as the government's capital subsidy, and the private sector willingly put in the rest. They have lost their dough. It is a great deal for the taxpayer. What is the worst case if that organisation goes belly up? I do not know. The government would probably step in and buy it for \$20 million. I am not saying this should be a de facto way of government buying things cheaply when the so-called failure occurs and the bailout arises. It takes me back to another of my favourite things — that is, project initiation.

The only things that should be put to this procurement methodology are projects the government wants. It should never ever say, 'I am not sure if I want it. Gee, it would be nice, mate. It's on my wish list', because if you look at the things that really have gone belly up for everyone, it is those sorts of projects. If the government sits down and says, 'I am going to do my business case, I am going to look at why I need this, and I am going to make a decision that, yes, I want project A. Rule it off', it then moves to, 'How will I procure project A?', PPP being just one of the possible procurement methods, and it makes a decision on that. If that private sector provider fails, the government is left, through a series of step-in rights or buy-outs or whatever it happens to be, with a project it wants. Our view would be that because someone has already taken a hit, they should not have to pay for it twice.

Are there examples where government has bailed out at too high a price? I will say that is not important. If you look at the road projects in New South Wales over the last decade, every single project has been better than the one that went before it. So where does your contract start for today's project? It starts with all the things government has negotiated on the last contract. It never goes back to square one. So the market moves and it gets better and better. You can sit here today and say, 'Perhaps that Sydney Harbour Tunnel was a bad deal for the taxpayer', but often with hindsight you lose sight of the parameters that existed at the time. Can you imagine the traffic in Sydney if there were not a Sydney Harbour Tunnel, if that were the default?

Often with these projects if someone decides that going down the private sector route is not something we should do, they do not get built anyway because government has other factors sitting there. It is easy for a bureaucracy to say, 'Gee, Minister, this is a risky thing. You will keep that final risk', and again I would argue that PPPs are about risk allocation, so if there are 100 risks in the project, 95 go off to the private sector and government keeps 5. That is a PPP. People have allocated the risk that is best able to be managed by them.

**Ms DAVIES** — There are varying points of view on that one.

**Mr LILLEY** — Yes. If I can just finish that line of argument — if you say 'Well, because we are keeping 1 risk in 100 or 5 risks in 100, we should keep 100 risks in 100', that needs to be thought through very carefully.

**Mr RICH-PHILLIPS** — If we can go back to the risk of cost capital. We have moved on a bit.

**The CHAIRMAN** — Just a small way.

**Mr RICH-PHILLIPS** — Will the risk-adjusted cost of capital be the same for the private sector and the public sector on any given project, because the project risk is set whether it is funded by the private sector or the public sector, or will the risks be different for the public sector and the private sector and therefore the risk-adjusted rate will be different for those two?

**Mr MILLER** — 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 theory there should not be a difference, but in practice there inevitably will be a difference. I do not think you could say with statistical accuracy whether one would be biased lower or one would be biased higher in terms of the estimation. At the end of the day the best way to properly quantify the risk is through data and experience. On certain projects the private sector will have more data and experience to be able to come up with a more accurate view of that risk, and hence would arguably then price that more efficiently than the government; conversely, in other circumstances the government may be in that position.

**Mr RICH-PHILLIPS** — Just on that point, is the underlying private sector experience placing the private sector in a better position to make that assessment, given its history of pricing versus the government's comparatively short history?

**Mr MILLER** — I would argue yes, because fundamentally the private sector's business is managing that risk and pricing that risk. The government has the job of managing risk as well, but basically in everything the private sector does, in every tender — be it with government or with other private sector proponents — it has to form a view on that risk, price for that, and, within the constraints of its contract, be held accountable to that. That is the sort of mentality it lives and breathes.

**Mr LILLEY** — Your investors also go through the same process, so as a consortium if we were tendering for a project, as Jim said, our firm would go through that exercise, but then our senior bankers would also go through that exercise and our equity would go through that exercise. So there are additional levels of calculation, and then that is inevitably followed by different levels of supervision. People talk about the extra level of supervision that comes to these projects from this type of procurement, because once people put their money into

these deals, even though there are several examples of failed deals, people do not just walk away and say, 'Let me know how it turns out'. You will get all of that engineering, actuarial and economic supervision — the whole gamut.

**Mr RICH-PHILLIPS** — And presumably your bankers, your equity partners and yourselves are better at that assessment, given your experience, than, say, New South Wales Treasury.

**Mr MILLER** — That is the business we are in. There are obviously a lot of very good people within Treasury who can form that assessment, but, as I said, fundamentally that is what we do every day.

**The CHAIRMAN** — Is there within those contract negotiations an imbalance between the relative negotiating skills?

**Mr LILLEY** — Governments hire their advisory teams, and we do not exclusively sit on the buy side, we do work on the sell side as well, and we think we provide a very good quality of service. It probably raises some issues about governments generally still hiring the lowest tenderer, because that then raises the question, 'Well, it is good you have got a low price, but again on the whole-of-deal costing maybe the guy who has tendered a little bit more can keep that deal closer to what you wanted'. There are always multiple evaluation factors, and governments should hire themselves an A team every time.

**Mr RICH-PHILLIPS** — You spoke in your introductory comments about the Victorian experience and the relative strength of Victoria, and you also mentioned the need for Victoria to continue its record in that area. Was that a reference to recent issues, and one in particular, the Eastern Freeway development, which has been through a number of stages of requests for tender, a change in the specification et cetera, which have created some concern among the private sector?

**Mr LILLEY** — No, it wasn't a reference to that at all. I think it was just a reference to the fact that you cannot live in the past. You have been by far the best to date, but unless you keep on working at it you may not be the best in the future. That was not predatory in any way. In fact, sitting right here right now, if two identical deals turned up, one in Victoria and one somewhere else, the Victorian deal would be given the most serious consideration because people would have the feeling that that deal was a doable deal.

The private sector always hates to lose, but what it hates even more is when no-one wins. If someone wins, then life goes on — we have learnt our lessons or we have been victorious, and the wheels have kept turning — but if there is a series of deals where no-one wins then we have lost real money. Part of my background is that I have worked in government for many years, and government definitely underestimates the number of dollars required to tender a large deal — and I mean seriously underestimates it.

**The CHAIRMAN** — I want to pick up on some of the other issues you raised at the start because we are running towards the end of our time. One was big costs and deal sizes, and this has been a recurring theme in our hearings when we have talked to the private sector. Perhaps I can roll into that issue, because I think it will be related, the creation of a national market which you talked about. Could you give us a bit of an idea of your view on the minimum deal size you would consider a useful deal size, how big costs can be dealt with, should we have a best and final offer (BAFO) process or something of that nature, and the national market?

**Mr LILLEY** — We will share that. It is very difficult to say the minimum deal size is X, because it depends on the complexity of the deal, how hard it is to put together and how hard it is to keep it running. It depends on the amount of risk that will be transferred. If you have a large deal you can transfer more risk. If you think about a \$10 million deal, how much risk can be transferred and how much profit is there to absorb that level of risk? How can it be priced so that it still ends up as a value-for-money deal? The lower you come down, the harder that is to do.

I also mentioned the issue that you want the best and the brightest working on it, and again if there were two deals and one was a larger deal it would attract more attention. I am saying that the small deal gets tossed out and that it is always looked at badly because there are other issues. The private sector will chase a deal of a smaller size than they would like for other reasons — they might like to be the first company to have a PPP in South Australia, for example, and they might do a deal they would otherwise not do. It is a very hard question. We would say the bigger the better.

**Mr MILLER** — Extending on one of Mick's points about not only getting the best and the brightest but in any bid situation you want to maximise the number of bidders you get, and the larger the deal — up to caps,

which are within the billions of dollars — the more competitive tension you will get in that process, because you will have more bidders to choose from.

**Ms DAVIES** — Surely the larger the deal sometimes the fewer bodies there will be that are capable of dealing with that size?

**Mr LILLEY** — That is very true, but remember we are talking about transactions that are generally going to have long concessions on them, so you have to have companies with the capability to get through that concession period. We were talking earlier about what happens if there is failure, so you want a field that will minimise that risk of failure. You want operators who will be able to deliver.

**Ms DAVIES** — If it is going to last for 45 years, or 30 years.

**Mr LILLEY** — Do we have any 45-year deals in Australia?

**Mr MILLER** — In Sydney we do, but in Melbourne, City Link is a 34-year deal. Once the deal gets past a certain size, having two bidders, for example, is not an undesirable outcome. Using City Link as the example, that was a \$1.8 billion deal and there were only two bidders in that transaction, and they crawled over broken glass to do that deal.

**Ms DAVIES** — They have a very high rate of return.

**Mr MILLER** — Sure, and there were a number of risks that were accommodated in that.

**Mr RICH-PHILLIPS** — But with the smaller bids, you will not be talking to a Macquarie Bank, you will be talking to a western Pacific bank, and that is where you should be focusing.

**Mr LILLEY** — As the deals get smaller, we would make a very conscious decision as to whether we would or would not bid. I could almost say that if it was a \$10 million PPP, you would not see us there.

**Mr RICH-PHILLIPS** — But there are other operators in the market who would be interested in those?

**Mr LILLEY** — They would be interested, but again you would start to think that perhaps a few of those \$10 million deals could have been put together to end up with a \$50 million or \$100 million deal, and somewhere between that \$50 million and \$100 million is probably at our very lower end. A \$50 million deal would be pretty hard.

**Mr MILLER** — Yes. The \$100 million number would give you critical mass. If you had a discretion to do 10 deals of \$10 million or one deal grouping them all together, on balance, looking at all the factors in terms of competitive tension, economies of scale for the bidders, level of risk transfer and fundamental desire within an organisation to push the boundaries on a deal, you would get a better outcome at the bigger deal size.

**Mr LILLEY** — We think having a national market is critical to have deal flow across Australia, because this is a very small marketplace. Having listened to the previous speaker, I put that with the issue of taxation. There is a fundamental flaw in this. The sorts of organisations that are bidding for these deals are bidding for these deals around the world, so the choice is not, ‘Do I do project A in Sydney or do I do project B in Melbourne?’, or inevitably, ‘Will I do projects C and D in either of those cities?’. The choice is, ‘If there are no deals happening here, we still have to put bread on the sideboard, so where will we go?’. We will go to a marketplace — as will everyone else — where deals are actually happening and where governments are putting these things out to the marketplace on a regular basis. We cannot do one deal in 1996 and another deal in 2004. The gap is just too great. If we are going to pursue this as a procurement methodology, we have to create a national market.

**The CHAIRMAN** — Who would run the national market?

**Mr LILLEY** — I do not know. I am just saying the national market exists. Victoria retains its sovereignty and New South Wales retains its sovereignty, but at least there is a meeting of minds, and there are plenty of organisations that exist to allow that to occur.

**The CHAIRMAN** — It is more a conceptual national market you are talking about?

**Mr LILLEY** — Yes, and a willingness to put the deals to the marketplace.

**The CHAIRMAN** — Coming back to the other part of the question I asked, which was about the best and final offer process rather than the full bid process, do you have a view on that?

**Mr MILLER** — Yes. For a one-off it would work fine, but as we are seeing in the UK and the like, that methodology has become enshrined. People's reactions and processes have changed to accommodate that, so you do not get the best deal the first time around. They always leave a little bit on the table and then they go into a BAFO and then maybe look at other opportunities to finetune it, but you will not get the highest level of innovation in that first phase. It is not economical for people to do that, because they know they will be asked to rebid as part of the process.

The most successful public sector partnership deals have been where, as we said at the outset, the process was certain, the time frames were set and the time frames were adhered to, because that gives the bidders the maximum certainty. They like nothing more than basically saying, 'Put us in a situation where we obviously have to come up with the deal, but where we know that from a policy perspective the issues are being thought through. If we come up with an acceptable deal, that will be accepted and moved on'.

**The CHAIRMAN** — And you prefer that process, even though it means everybody's bid costs will be higher?

**Mr MILLER** — Perhaps I will draw a distinction there, as I may have overestimated what you meant. There are certainly no issues about having a short-listing process, so having an expression of interest and then a short-listing process down to final bids. In the United Kingdom they have been getting fully financed bids and then doing a BAFO after that as well. If the game is to get fully financed bids and then essentially do another bid, I do not think that is in the long-term interest, because that will cost more.

**The CHAIRMAN** — It has been indicated to us by previous evidence that there is a belief that the UK BAFO process may have reduced costs. You are saying you believe it actually increases them?

**Mr MILLER** — People just adjust to the methodology. As I said, the more successful ones have been one stop bids.

**Ms DAVIES** — You were talking about a national market, and one of the obvious bodies for dealing with that kind of national perspective would be the federal government. In the middle of the year Nick Minchin said that the federal government, which has been rather badly burnt by a few projects it is involved in, was wary of PPPs, and there is an item saying that the ANZ bank has been a bit concerned about PPPs, which have delivered less returns to the operators than was projected. I have a quote from Richard Gates saying that from the banks' perspective and the private operators' perspective the projects themselves have been successful in terms of quality of services but the financial returns for operators have been lower than expected, and that the bank has never been at risk but the operators are the ones who have had difficulties. Do you have a list of the ones you believe have had problems and why they have had problems?

**Mr MILLER** — We can certainly go through the transactions. There have been successful transactions that have had problems and they have been able to be solved, and there have been unsuccessful transactions that have had problems and that have caused difficulties. There is a whole range of things. Perhaps I will use Transurban as an example, because we mentioned that earlier. In one sense it has been a successful transaction in terms of your comment about high returns.

**Ms DAVIES** — So you are talking always — from the private sector's point of view it has been successful?

**Mr MILLER** — How do you judge success on a project? I guess you have to wear your different hats. In the private sector if you are an investor on day one and you are an investor today, the shares have appreciated considerably, so that is a positive. However, within that transaction we all remember the problems that were had with the Burnley Tunnel, and even prior to that, with the western link, the Bolte Bridge, where there was a problem with the head contractor and the subcontractor. The subcontractor was going to walk off the job, which would have slowed down production and not delivered from a financial perspective or from a policy perspective for the project.

One thing that Transurban was able to do specifically on the Bolte Bridge issue was to put a financial contribution down on the table — \$30 million. It was not its risk to manage; it was technically the head contractor's risk, but Transurban saw that it was commercially in its interest to deal with that. Obviously when the problems arose with the Burnley Tunnel there were all kinds of talks about having to fill in the tunnel, perhaps build another tunnel, and

so on. Once again Transurban was able to sensibly or effectively manage that risk and ultimately mitigate it. I use that as an example of a project that is perceived to be successful but has had a number of risks, some of which could have been fatal to the project, but which they have been able to manage. But yes, there will always be examples of where people have got returns below what they expected.

**Ms DAVIES** — Like in public transport?

**Mr MILLER** — Yes, the public transport system in Victoria. Certainly from our perspective it is important not to prejudge where that will end up in terms of what the ultimate resolution for that will be. The reason why I say that is that there may be some sentiment that there is a bailout on those transactions. It is probably important, if that line of argument is to be used, to look at it and say, ‘Well, if the government had done it itself from day one and the private sector had never been involved, what would the outcome have been?’. The private sector has been involved and, depending on how the situation ends up there will be an outcome there.

I think it is important to look at all of those things together rather than just focus on the end game. Obviously there has already been, through the Department of Transport, a financial contribution to the franchisees. I still believe that if you look at the whole context of that project, the government has arguably achieved a significantly better outcome than if it had not undertaken the franchising in the first place, in terms of service standards, quality of service, reliability and, arguably, financially as well because of the subsidies that have been reduced from where they expected the subsidies to be if they had kept running the franchises.

**Ms DAVIES** — The previous speaker said that while there were competitive pressures he could see benefits to private sector involvement, but that where there were natural monopolies, such as distribution networks like railway lines — the actual track — or electricity transmission lines, that was not appropriate. Would you have that same view — that there are some things that should or should not be?

**Mr MILLER** — I would say the government — and I use small-g government — does not have to have ownership to have control. So when you look at something like an electricity transmission line, that is recognised by the Australian Competition and Consumer Commission (ACCC) because it comes under its jurisdiction as a monopoly, and that has a regulated rate of return. Arguably once again, from a control perspective, you can go through the arguments as to whether the ACCC is a good or a bad thing, but it is not like you are handing a monopoly over to the private sector and saying, ‘Do what you like’. There are very strict controls, there is a number of acts, and the financial returns are regulated on that.

You can look at a project even like City Link; it is actually a regulated asset in the sense that the government has said that the price per car will not exceed a certain level. That is set down in the concession deed and that will run for the life of that concession. The private sector cannot do more than that, so it is regulated. Whether the private sector wins or loses is whether traffic volume is greater or less than what is expected, but the government still has control over that in terms of the key elements of the concession. The private sector cannot extract monopoly rents on that, on the basis of arbitrarily increasing its prices at a later time because it has a monopoly position.

**The CHAIRMAN** — Thank you. We must conclude there. That has been a very interesting session for the committee. I thank both Mr Miller and Mr Lilley for their attendance today.

**Witnesses withdrew.**

# CORRECTED VERSION

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

#### Inquiry into private sector investment in public infrastructure

Sydney – 23 October 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

#### Staff

Executive Officer: Ms M. Cornwell  
Research Officer: Ms C. Williams

#### Witnesses

Mr J. Tripodi, Chair;  
Ms K. Hodgkinson, MP; and  
Mr I. Glachan, Public Accounts Committee, New South Wales Parliament.

**The CHAIRMAN** — I welcome Mr Joseph Tripodi, MP, chair of the New South Wales Public Accounts Committee, Ms Katrina Hodgkinson, MP, and Mr Ian Glachan, MP, to this hearing. I also welcome as observers a delegation from the northern province of South Africa. All evidence taken by this subcommittee is taken under the provisions of the Victorian Parliamentary Committees Act and is protected from judicial review. However, comments made outside the precincts of the hearing are not protected by parliamentary privilege. All evidence given today is being recorded and as witnesses you will be provided with proof versions of the transcript some time shortly after today. Mr Tripodi, before moving to questions would you like to make an opening statement to the committee about what the New South Wales Public Accounts Committee has been doing in the area of public–private partnerships (PPPs)?

**Mr TRIPODI** — First of all, thank you very much for the opportunity to have this dialogue. I have to say that I do not think any of our committee members are used to being witnesses, but I think it is a good idea and a smart way of exchanging each other's experiences and knowledge.

The Public Accounts Committee has an ongoing brief and is pretty vigilant in watching what happens in terms of PPPs. The last report in which we touched on the matter quite comprehensively was a report referred to as the Parramatta rail link report. There was a proposal by the government to build the railway line between Parramatta and Epping and up to Chatswood. We were concerned about the fact that the government may not necessarily have considered or allowed in its processes the opportunity to maximise value for money in the way it was going to finance and construct the whole project. We had a look at the matter and tabled a report examining the processes — that is, the government allowed the opportunity for the private sector to offer its innovation and experience so the government would, for its dollar, get the maximum return. That included the possibility of allowing it to be a PPP. At the end of the day the government chose that, for a whole range of reasons, primarily because it was part of a broader rail network, the best way to go was to have it entirely financed and owned by the government and constructed by the private sector. That was the best combination of public–private relationship that would get the best value for government.

We were satisfied that the processes of procurement were sufficiently flexible to allow the private sector to have its say in terms of why and how that procurement should occur. The process allowed the private sector to suggest the possibility of its ownership and control and that proposal was considered. At the end of the day the executive decided that the best way to achieve this particular procurement was to have public ownership and to have it built by the private sector and operated by the public sector. We were convinced also as a committee that first the process was sufficiently flexible to allow the private sector to have its input and allow it to offer its innovation, and second, that the decision made was the most optimal for New South Wales taxpayers.

**The CHAIRMAN** — Has your committee formed general views about PPPs and what should be constituted within them on issues like the private sector comparator and whether it should be disclosed or not disclosed, those sort of more general issues? Has your committee looked at those issues and formed any views?

**Mr TRIPODI** — We debate it all the time. I think we could say that on 80 per cent of matters we would agree and probably on 20 per cent there is some room for ideological differences; that is perfectly acceptable, they are legitimate and well-put arguments. I would say that there is a general consensus that in some sectors of the public service and public service delivery there is room for the private sector to participate and in other sectors private sector participation may not be optimal in terms of value for money.

**Ms DAVIES** — Do you have specific sectors in mind?

**Ms HODGKINSON** — I suppose a good example has been in roads. It has worked well in getting roads developed, tolls seem to work well. However, personally I am not sure how well it is going to work with educational facilities such as schools. Those proposals are out in the New South Wales government policy arena at the moment. Personally I have reservations about whether PPPs are going to work well in that area but from experience we have seen some failures and we have seen some successes when it comes to tunnels and roads. It was trial and error at first and the government is certainly getting better and learning from its mistakes. I suppose governments around the world have been doing that with PPPs. It works well in some areas and in other areas I would have some reservations.

**Mr GLACHAN** — My view is that government does not have to, of itself, provide every service that the community needs but simply see that that service is available. Other people can deliver that service on behalf of the government. That is my view. There is a view that using private money is a way of getting a project earlier than the government would otherwise get it. There is also a view that government should not get involved in these things

anyway because governments can borrow money more cheaply than the private sector can and the private sector will only be involved in the project if it can make a profit and why should the government allow that to happen; why should the government use public money to provide the project? There are all these sorts of arguments that we have looked at and considered.

**The CHAIRMAN** — As a committee have you formed views on those particular things?

**Mr TRIPODI** — There is a general consensus that with some of the transport infrastructure and some of the water treatment services — those that identifiably can be connected to a competent transfer of patronage risk to the private sector — the committee probably supports. Those where the cash flow essentially is coming from government — for example, with schools and other projects where essentially a lot of the risk still remains with government; social infrastructure is a good example — we are of the view that it would be more difficult to justify government entering partnerships with the private sector.

**Mr GLACHAN** — There were some projects where the private sector had technical expertise that no-one else had, they had intellectual property and without that intellectual property the project would not have been a success. One was a water treatment plant where a French company had this intellectual property that no-one else had so it was valuable to have it involved in that. In the case of the harbour tunnel there was a company that had the intellectual property that made that construction possible. It was able to solve the problems with the construction of the tunnel when no-one else could and so it won that project. There are cases like that when for the benefit of the community private involvement is not only desirable but necessary because you could not have the project without it.

**Mr RICH-PHILLIPS** — Couldn't that access to intellectual property be achieved simply by having those parties as contractors to a government project rather than — —

**Mr GLACHAN** — What you could do is purchase the intellectual property — you call for tenders to solve the problem and you purchase the answers and then you put out to contract the construction phase.

**Ms DAVIES** — You could get over that technical expertise or intellectual property by doing what has been done for a very long time. The actual design, construction and possibly maintenance are contracted to the private sector but not necessarily the financing and the actual ownership — —

**Mr GLACHAN** — There is no limit to the mixes you can have.

**Ms DAVIES** — Do you as a committee have a consensus view? We heard from your previous Auditor-General about this disputation on where the actual ownership of some of these facilities lies. Does the committee have a view on whether some of them that are theoretically not owned by the public sector are for all intents and purposes owned by it?

**Mr TRIPODI** — The issue there is one of the accounting standard and that ownership lies with risk: whoever owns the risk owns the asset. Therefore, applying that accounting standard would dispute whether the private sector does own the asset because in its view a lot of the risk lies with the public sector. That is a point of view from an accounting principle and an accounting perspective, but in terms of a legal ownership perspective the ownership is pretty clearly defined in the contract. The accounting treatment of that contractual relation is where issues arise. I think the Auditor-General's input on these issues is valuable generally because it increases the level of discussion about the risks involved and the issues involved, but in terms of the strict legal ownership, usually that is well defined. The issue then becomes one of the accounting treatment of that contract or relationship. That is where there is no accounting standard at the moment. The Public Accounts Committee made a submission to a draft accounting standard on this issue and expressed a point of view on that. That is why the Auditor-General would view it from the accounting perspective and auditing perspective in terms of who owns the asset. That primarily relates to our M4, our western Sydney motorway.

**Mr RICH-PHILLIPS** — I note the comment on the accounting standards because I do not think anything will happen there terribly quickly. As a Public Accounts Committee do you have difficulty with accountability of public money when it is for private projects? Are there issues in New South Wales in that off balance sheet area?

**Ms HODGKINSON** — I am sure Joseph will answer that question, but one of the concerns we have had as a committee is the government's expertise in making good deals with the private sector — does it have the management ability to get the best deal possible for the public because at the end of the day it is the taxpayers'

money. Also, keeping staff and having staff with experience with PPPs going from one project to another is a big issue within the government.

**Mr RICH-PHILLIPS** — Tony Harris said this morning in his statement that — —

**Mr TRIPODI** — Tony Harris or Bob Sendt?

**Mr RICH-PHILLIPS** — Tony Harris, the former Auditor-General. He said that was a significant issue and went to the point of saying that the private sector always wins because it has the expertise over the public sector.

**Ms HODGKINSON** — The private sector has definitely had some wins and I guess it is one of those lessons that the government needs to learn as it goes into this arena.

**The CHAIRMAN** — He did say that the Olympic stadium was a case where the government probably won on the contract, but that was a particular instance where it brought in a negotiator who had previously been working on the other side.

**Mr GLACHAN** — There really should not be any winners or losers; it should be done to the mutual benefit of both parties. We all recognise that the private sector is there for one reason only and that is profit. The government is also there for one reason only and that is to get a service for the community. That should work for the mutual benefit of both.

**The CHAIRMAN** — I think the issue we were picking up on here was the event that everybody likes to talk about with PPPs — the catastrophic failure, and who ends up holding it.

**Mr TRIPODI** — The government.

**The CHAIRMAN** — The argument Tony Harris put forward was that in the case of the Olympic stadium the government did not end up holding it.

**Mr TRIPODI** — There is one problem with the former Auditor-General's argument — that is, there are major private sector enterprises which when they fail end up in government ownership too. HIH is the very best example. To logically extend Tony Harris's argument is to conclude that we should nationalise everything in the economy. It is a pretty interesting perspective for someone from the right of the political spectrum. It is easy in hindsight to make comment about these things; the issue is ex ante, what are you going to do? What is the most optimal combination of private and public sector that you anticipate? It is easy to come back later on and say, 'Look at this, the government lost again'. That is easy in hindsight, but the government has lost in a whole lot of private sector ventures too. The fact is because it is the government's role to be the welfare net for Australian society you can often have what is entirely a private sector enterprise and also end up with a liability.

**Mr RICH-PHILLIPS** — I want to follow up on that issue. In your Parramatta rail link report you recommended the establishment of a unit within the government with that expertise. Has the government taken that up?

**Mr TRIPODI** — No.

**Mr RICH-PHILLIPS** — Has it responded to it? Is the government required to respond to your reports?

**Mr TRIPODI** — Yes, it is. I am not sure we have received a written response — we have but it has chosen not to take it up.

**Mr GLACHAN** — The reason we recommended that was we thought the Department of Public Works and Services was entering into contracts all the time with private enterprise and they had the expertise within that department to do that well — they had proved that they could. We felt in the earlier days many of the people in the public sector were not quite as smart as far as these contracts were concerned as were the people in the private sector because they were used to doing it and used to making sure that they got a good deal. The government representatives were looking at getting a good result to suit the people of New South Wales while the private people were looking at a good result in getting a profit and not having too much risk involved: get the profit without the risk.

**Mr TRIPODI** — Just extending on that theme because I think this is the crucial part of this debate, in the private sector negotiators are for risk: they take risk and when they get it right they are rewarded financially. Public servants are not rewarded for risk, they are actually rewarded for being conservative. If they do not make any mistakes they progress; if they make a mistake they are in trouble. However, when they get it right, when they undertake a risk and get it right, there is no financial reward for them. All the incentives under which a public servant operates push them to be conservative because if they get it wrong they lose their job and if they get it right they get no financial reward or recognition — normally the minister will take the credit for it, not the public servant who negotiated it — —

**Ms DAVIES** — Except the knowledge that they have done what they are required to do, which is serve the public interest.

**Mr TRIPODI** — The point is that on their \$50 000, \$60 000, \$70 000 salary they are not rewarded for taking the massive risks of what might be the optimal outcome for government and for the taxpayers but may not be the optimal outcome for them if they get it wrong. If they were set up in a structure where they were rewarded by some means, it does not have to be financial, but they were rewarded for the risks they take and for getting it right they might perform just as well as the private sector negotiators. You could actually have people on both sides of the table of equal ability but operating under completely different incentive structures and so the pressure on the public servants is to be conservative while the pressure on the private sector is to take risks and get rewarded for it.

**Mr RICH-PHILLIPS** — There is a predisposition within the public sector to transfer as much risk as possible.

**Mr TRIPODI** — No, there is a predisposition in the public sector to do nothing.

**Ms HODGKINSON** — Once they have had a successful negotiation, of course, they become a lot more attractive to go to work in the private sector. They have a bit of experience and once it has been seen that they can do a good job they are given heavy incentives and rewards.

**Ms DAVIES** — In New South Wales how does the government measure the value for money and do you think the measures it is using are adequate and precise enough? Does it have a precise formula for determining the value for money?

**Mr TRIPODI** — The government has had Pricewaterhousecoopers draw up a public sector comparator. We have not had a chance to see that calculation or formula. The value-for-money argument, or the way we ensure that we get value for money, is primarily through the tender process and expressions of interest (EOI) documents that are wide enough but at the same time prescriptive enough to make sure that there is an identifiable and measurable difference between the tenderers, and from that process you identify those that are offering the most for the least reward. That is the way the government is trying to ensure that it gets value for money.

**Ms DAVIES** — Does it have an allocation against the public sector comparator?

**Mr TRIPODI** — They will do that before it goes to tender or EOI; Treasury would make that assessment.

**Ms DAVIES** — Is that transparent? Will it be released?

**Mr TRIPODI** — I am sure it is transparent within Treasury. I do not know if it is transparent to the rest of us.

**Ms DAVIES** — There is no discussion of part of that comparator being given to the bidders?

**Mr TRIPODI** — There has not been to date. I do not think to date there has been a comprehensive public sector comparator drawn up, primarily because it is not a transferable formula. Every project is extremely different and therefore the same issues are not involved in those comparators. Theoretically you can have a comparator that you can apply, but generally in reality it is not the case.

**The CHAIRMAN** — It is different on each project.

**Mr TRIPODI** — It is very different.

**The CHAIRMAN** — Has New South Wales done many projects to date using a PSC?

**Mr TRIPODI** — Not that we are aware of.

**The CHAIRMAN** — You are still talking theoretically as are most other places?

**Mr TRIPODI** — I think it is a theoretical concept, yes.

**The CHAIRMAN** — In the inquiries you have conducted and reports you have released have you formed a view about the appropriate accountability regimes around PPPs: what the Parliament should know; what the public should know: what should be reported: what should show on balance sheets; and what should show on budget?

**Mr GLACHAN** — In one of the earlier reports we set out clearly what should be known of the contract and what the public needed to know about the contract.

**Mr TRIPODI** — A summary of the contract.

**Mr GLACHAN** — Some things are commercially in confidence and there is intellectual property involved. There are certain aspects of it all that the public should know about.

**The CHAIRMAN** — Following that through, did you have a view as to a process for the way the summary contract is made?

**Mr GLACHAN** — I think we did in one of our reports.

**Mr TRIPODI** — Just to finish that, the committee has discussed — and in effect it has been agreed — that there is an issue about how much the private sector does benefit from these deals. If you are looking at the financial statements of Macquarie Bank, for example, and you cannot work out how much it is making from its ownership of the M2, one of our motorways, that means that the public does not know at the end of the day whether the deal that was struck was in the interests of the public or whether it was in the interests of Macquarie Bank. We have not written a report on this, but we think increasingly if this is going to be a partnership then that partnership requires it to separately disclose the returns it makes with the deals that it enters into with the government, and that that is available for the public to make that assessment because it is able effectively to hide within its financial statements the internal rates of return on these projects with the public sector.

**The CHAIRMAN** — Do you have a view as to whether all documents that it may use to do those assessments, et cetera, should be made available to the Auditor-General?

**Mr TRIPODI** — I think the Auditor-General does have those documents. The only documents it has not been able to get into have been some Olympic documents. Apart from that it has not complained about it.

**The CHAIRMAN** — It has been raised in a couple of places and it may be that auditors have the power, but it may also not be clear that they have the power. They can access any document held within the public sector, but it may not be clear whether a document held in the private sector that relates to that project can be accessed by the auditor.

**Mr GLACHAN** — I do not know whether that is right.

**Mr TRIPODI** — You could demand it as part of the contract.

**Mr GLACHAN** — You could if you wrote it into the contract, yes.

**Ms DAVIES** — Is the government likely to do that?

**The CHAIRMAN** — I am talking about whether more generally there is a view about that.

**Mr GLACHAN** — I do not think the private sector would agree to anything like that.

**The CHAIRMAN** — It probably would not, but what would the Parliament say? That is what I am asking.

**Mr GLACHAN** — They might not want to enter into the contract then. They would say, 'We do not want your contract; we can invest our money somewhere else'.

**The CHAIRMAN** — But would not the Parliament say that this is the price of doing business?

**Mr GLACHAN** — They might say they are not prepared to pay that price. You have to be careful. It is one thing to say it, but you might not get anybody bidding.

**Mr TRIPODI** — I believe there should be disclosure, there is no doubt about it, because it allows the public to assess not only the quality of the deal the private sector has procured, but the quality of the deal the public sector has procured. If the private sector is making enormous rates of return on its investments and people do not know about that, what pressure is there on the public sector to get the contract right the next time? What pressure is there on the public sector to have claw-back provisions?

**The CHAIRMAN** — Ultimately the government of the day will be held responsible for that deal regardless of what those arrangements were.

**Mr GLACHAN** — That is an important point, because in the end, whatever happens with the deal, the government has the final responsibility, because if you build a toll road — —

**Ms HODGKINSON** — Like the airport tunnel.

**Mr GLACHAN** — Yes, if you build some project and it does not work and the private sector says, ‘We are losing money on this, we will abandon it’, then the government has to keep it going because once the public has started to use it they expect to go on using it. You cannot just say, ‘That expressway is closed now because nobody can make any money out of it’. You could lose government over that, so governments have to keep it running. In the end, whatever the contract says, the government takes the final responsibility.

**The CHAIRMAN** — Which brings us to a point that has been put to this committee a few times now — that is, the only things you go into PPPs with are things that the government actually wants to do; not things that it may like as a project, but things that it actually wants done. What is your reaction to that? The government is always in control of the priority. It is about the provision of things that the government wants done.

**Mr TRIPODI** — That is what happens in effect. Ideally what would be better is that the private sector is able to contest all activities of government, that it is able to apply a process of transparency and say, ‘Look, at the moment you are providing these particular services in the hospital system; we believe we could do it cheaper and better’, and that there is a process by which they can contest parts of government. There will obviously be resistance from all sectors and from many stakeholders, including the union movement, and that is a legitimate objection that they could express. But in theory and as a matter of principle they should be able to contest and put to government proposals about the delivery of services in a more competitive fashion.

The committee has been of the view that there has not been a streamlining of the processes by which they can put propositions to government. At the moment the director-general and the Premier’s department considers them, but if you had a flood of applications you would wonder whether they could be properly assessed. It also goes through Treasury, so there is a partnership working there. Theoretically we could argue that the private sector should be able to express views about the delivery of any kind of service.

**Ms DAVIES** — Do you think in the system you are operating at the moment in New South Wales that there is enough disclosure of government public subsidy to private projects and public input into those projects, or are further disclosure requirements needed?

**Mr TRIPODI** — I think the level of disclosure increases annually. It increases every year so that disclosure of government is always increasing. The value of reports are also increasing and improving. New South Wales was the first jurisdiction to adopt accrual accounting. Obviously if from the financial reports you cannot identify what assets you are using to deliver a service, then how will you evaluate whether you are getting value for money? That has all been possible as a consequence of those reforms and those reforms have been adopted in all parts of the world.

Increasingly there is more and more transparency in government. The issue is whether there is a process that allows the private sector to contest that public provision of services.

**The CHAIRMAN** — Rather than the government determining which it will allow to do.

**Mr TRIPODI** — There is nothing wrong with that. There is nothing wrong with the government deciding it would like to build a railway line from Parramatta to Chatswood, and asking how it will do that.

**The CHAIRMAN** — I understand that, but I thought you were taking that further.

**Mr TRIPODI** — The document is out there — I have forgotten what it is called, but the New South Wales government put out a document a year and a half ago that said, ‘We will have unsolicited propositions and we will look at them’.

**Mr GLACHAN** — Committee members should read one of our earlier reports on this issue about what the transport department did in California. It asked the private sector to suggest projects that would be of benefit to the people of California but would not cost the government any money. A number of projects were suggested. One that was adopted, and which was very successful, did not cost the taxpayers anything and everybody benefited from it. The people who proposed this said they wanted to make a profit, so the department said, ‘Okay, you can make up to a certain percentage of profit; after that if you make more than that you have to share it with the government, and to implement this project you must achieve certain goals that we set’. It was a road project and they had to reduce the accident rate, pollution, congestion. They were told they must do all that for the project. There is a benefit for the community.

**The CHAIRMAN** — It is really an issue of good contract management.

**Mr TRIPODI** — No, it is an issue of contestability in public dominance in the service area.

**The CHAIRMAN** — But then there is the outcome from government and the way in which the contract was managed after the idea was proposed.

**Ms DAVIES** — You mentioned before that you put a submission in about accounting standards. Would we be able to get a copy of that?

**Mr TRIPODI** — Yes. It is pretty complex. We employed Pricewaterhousecoopers to help us with that.

**The CHAIRMAN** — We have also been doing an inquiry that relates to an accounting standard so we understand what you are saying. They are technical matters. Our inquiries have been into the valuation of heritage, cultural and other infrastructure assets for accrual accounting.

**Mr TRIPODI** — We are in the middle of an inquiry into valuing the assets of our museum.

**The CHAIRMAN** — Which is exactly what we have just concluded. We have adopted a report which will be tabled next week. That report also goes to those issues. I note that the committee looked at overseas jurisdictions. In general what were your key findings in regard to that?

**Mr TRIPODI** — Every jurisdiction is different and a lot of the issues are driven by tax considerations in respect of jurisdictions. We think, for example, France is probably the world leader in PPP.

**Ms HODGKINSON** — It has been doing it for 100 years.

**Mr TRIPODI** — Yes, it has been there for a long time. At the same time it does not have accrual accounting, so you do not know who is bearing the burden of risk in the deals. Maybe the public sector is bearing an enormous amount of risk that no-one is aware of because the financial reports do not allow an opportunity for that risk to be expressed and identified. The French are obviously considered to be leaders in these deals, but we had some reservations about whether they were optimal in terms of value for money for the French taxpayers.

The United Kingdom obviously has received enormous media attention about its drive for PPPs, but we think also the issues there are sometimes quite different — for example, the rehabilitation of old schools, or existing assets like the London Underground, and these are different to the procurement of new assets. There is a whole range. Also there are tax issues there which are very different to those in Australia.

Likewise in the United States we found there were not that many PPPs, but there was a very different tax treatment there. With a lot of the issues in the US there is competition between the states to procure investment for the respective states, and they heavily subsidise private sector involvement in their particular state jurisdiction which leads to a partnership in ways such as they would provide the land and the developer would build the social housing, for example, and different kinds of configurations of relationships between the private and public sector. But generally speaking it was our view that they were not that good at striking up these deals.

**The CHAIRMAN** — And not of the type that we would now commonly refer to as PPPs.

**Mr TRIPODI** — That is right, yes.

**The CHAIRMAN** — If I could quickly go back — I started this question earlier and wandered away from it — to the summary contracts question. Did the committee have a view about the summary contract, that the summary contract would be released while it was a live project? Did it look at, once the project was concluded, whether the full detail could be released?

**Mr TRIPODI** — I think our conclusion was that a summary is released at the conclusion.

**The CHAIRMAN** — At the conclusion, so in the event, just following that through, say you have a 20-year project — —

**Mr GLACHAN** — It would be revealed before then.

**The CHAIRMAN** — You have a summary project at the conclusion of the tender process. Did you look at a subsequent date when there was no longer a live contract and whether the full contract would be released? Did you have a view on that?

**Mr TRIPODI** — I do not think there has been a PPP that has expired yet.

**The CHAIRMAN** — I suspect that is right.

**Mr GLACHAN** — If you think about it, if we look in 25 years at a road we build now, even if the private people have made what we think now is a hidden profit, in 25 years we may think we have a great road, so who cares?

**The CHAIRMAN** — It may only be for historic purposes at that time, but it is an issue about public accountability and what the public ultimately has a right to know about projects, even at the concluded stage.

**Mr GLACHAN** — You have to remember all the time that these are projects that the government would normally have to build anyway, with its own money. You are just using someone else's money. Even if someone else makes a profit out of it, I think you are getting something you would not otherwise get, and you can use it.

**The CHAIRMAN** — Does that not actually strengthen the argument for disclosure because if it was done fully in the public's eye it would be disclosed?

**Mr GLACHAN** — The point I am making is that the government can use its scarce money capital resource on other projects in which private enterprise would not be involved.

**Ms DAVIES** — Surely it is not free money. If you are not paying it up front but paying it as you go, the public is always paying. It does not matter whose who is funding it, the public is paying.

**Mr GLACHAN** — Yes, the public pays for everything.

**Ms DAVIES** — That does not work as an argument. You are not saying that one of the apparent disadvantages of the United Kingdom's PPPs was that the figures were all skewed because the public sector was told, 'Make this look good or the project will not happen'? Don't you get the proper determination of the public interest if you say, 'We want this project; this is how much it would cost if the public sector did it; this is the sort of project you would get if the public sector could do it; we will only go to the private sector if the private sector can do it better'. Is that not what are you saying in New South Wales?

**Mr GLACHAN** — But how do you measure the value?

**Ms DAVIES** — Is that not one of the issues that has to be discussed? Why do it unless you can say there is a value for more money.

**Mr TRIPODI** — That is the specific issue we looked at in the Parramatta rail report: was the government process of procurement sufficiently flexible to allow the private sector to contest the public sector's provision of that service? And we found it was in that particular project.

**Ms DAVIES** — Did you analyse whether it was better value for money for the private sector to do it rather than have it as a straight public sector project?

**Mr TRIPODI** — We did not express a point of view about the government's decision itself because it really is not just a value-for-money decision; it can be an ideological and political decision also.

**Ms DAVIES** — In New South Wales is it a value-for-money decision or an ideological decision?

**Mr GLACHAN** — It can be either.

**Mr TRIPODI** — It is a combination; there is no point pretending that it is not. The issue is one of, is the documentation for the Parramatta link process sufficiently flexible to allow the private sector to say, 'We can do this cheaper than you guys in the public sector'?

We found that that documentation was sufficiently flexible for them to contest the ownership, the control and the operation that the public sector ended up having. So we gave the private sector an opportunity to contest that and put up all their proposals in terms of their BOOT projects in providing for a BOOT scheme, and at the end of the day the government chose for a whole range of reasons, some of which are captured in a process and some of which are not, that it was best that it was built by the private sector but owned and operated by the public sector, primarily because it is part of a network and it would be very difficult to set up part of your network as a private operation and the rest of it as public. You know, what do you do when the train comes off the public sector into the private sector and then goes off to the public sector again?

**Ms DAVIES** — That is one of the problems Queensland has had, and initially Victoria as well.

**Mr TRIPODI** — That is right. For example, it works well on roads. It is quite different on roads; you can have private roads linking in with public roads quite reasonably, so you need to assess on each case.

**The CHAIRMAN** — I might say my questions about the contract were not to do with that but purely with the disclosure regime, what an appropriate disclosure regime should be around those sorts of things and whether ultimately at some point you can have full disclosure.

**Mr TRIPODI** — We covered those issues comprehensively in the Parramatta rail link report.

**The CHAIRMAN** — Good. Thanks for that. Can I thank Mr Tripodi and other members of the committee for making themselves available today.

**Witnesses withdrew.**

# CORRECTED VERSION

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

#### Inquiry into private sector investment in public infrastructure

Sydney – 23 October 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

#### Staff

Executive Officer: Ms M. Cornwell  
Research Officer: Ms C. Williams

#### Witness

Dr C. Sheil, Visiting Fellow, School of History, University of New South Wales.

**The CHAIRMAN** — I welcome Dr Christopher Sheil, visiting fellow from the University of New South Wales. All evidence taken by this subcommittee is taken under the provisions of the Victorian Parliamentary Committees Act and is protected from judicial review. However, any comments made outside the precincts of this hearing are not protected by parliamentary privilege.

All evidence given today is being recorded. Witnesses will be provided with proof versions of the transcript shortly after the hearings. Dr Sheil, before going to questions from the committee is there anything you would like to make in the way of an opening statement?

**Dr SHEIL** — Not really. I am just responding to the invitation today.

**The CHAIRMAN** — Perhaps I could ask about some of the general parameters around public–private partnerships. In the broad, have you made any observations about the way in which public–private partnerships can operate, whether there are sectors of government activity that should or should not be subjected to public–private partnerships, those sorts of issues?

**Dr SHEIL** — Before we get to that one — I have made some observations on that — there really is a threshold question about the idea that these policies should be called partnerships. At one level it is superficial. It is badging things. Bureaucrats rebadge policies according to fashion and buzz words and so forth, so we could treat it as fairly trivial. But I think we should have more weight on that. It goes to the definition of what we are talking about. The concept of partnership belongs within particular ideologies. We have derived it from different countries and used it in different ways. My response to you from that question would be, ‘What do you mean by partnership?’. Once we have that straightened out then I think we could perhaps start talking about in which areas so-called partnerships or what we might not call partnerships may apply. That is where it may be useful.

**The CHAIRMAN** — I understand precisely what you are saying, and I tend to concur that there is a real definitional issue around many of these things. We tend to talk about them having happened in Victoria, for example, for about the last 15 years, and yet I think many people would say that a lot of those things were not PPPs as they would like to talk about them, and you get lumped into discussions about whether they are privatisations, franchises or partnerships. That definitional aspect is one of the issues that this committee is probably dealing with. I certainly cannot offer you a concluded view on what precisely that partnership is at the moment. That is in fact part of what we are looking at — what is it?

**Dr SHEIL** — Indeed!

**Ms DAVIES** — Can you give some examples in New South Wales? You have been quite scathing about some of the things we call PPPs, but can you give specific examples of projects in New South Wales that the government calls PPPs that have been successful in terms of the public interest or not, and what is the difference between the arrangements that have made them successful or not?

**Dr SHEIL** — Again we get to this question of what is PPP. The public sector is dealing with private firms at the boundaries all the time, and a great many of those are very successful. Wherever there is a pre-existing private investment in a particular area and the public sector has not already got the pre-existing investment and there are things that are proximate to what we conventionally understand as real markets you can have — and we do, every day — the private sector successfully interacting with private firms.

**Ms DAVIES** — So where there is a real market, where there is competition — —

**Dr SHEIL** — And it does approximate the neo-classical definition of the market that no individual player can by their own actions affect the competitive equilibrium, then you have a real discipline to the extent that the market theory approximates that very real discipline out there and the public sector can and does interact with it all the time quite successfully.

**Ms DAVIES** — So you say you have the public sector contracting out for the building or the construction, design and maintenance of the building?

**Dr SHEIL** — That is right; that is one particular example. There is a commonsensical element to this. If the public sector wanted to stage a celebration to mark a particular event, and it wanted to have some music playing, the public sector is not going to go out and buy a music training firm and start training up a whole lot of public servants on how to play instruments because there is a real existing industry out there that you can contract

or hire and you can test the prices and so on, so wherever the pre-existing investment lies would be my first presumption, or where I would start to analyse it.

You are probably not familiar with some of my work, but in a book I wrote on water, which is infrastructure, my conclusion was that it is very difficult to make universal claims in this area about things that are highly specific, such as water, that have characteristics that cannot be extrapolated to apply to other areas of infrastructure let alone other areas of industry. So my starting position is to be very careful and to talk about which particular interactions rather than the general rules. But, for the most general rules, to the extent that the activity does approximate the vision of a genuine competitive market and the investment is in the private sector rather than the public sector, I would start from a position that that is where the public sector would interact, would buy it from the private sector.

**Ms DAVIES** — So would you say that those items that had very specialised or very specific characteristics that would perhaps be more like a natural monopoly do not lend themselves to — —

**Dr SHEIL** — Yes. As soon as one sees a natural monopoly one starts to think, ‘This is not approaching what you would say is a neo-classical interpretation of a market’.

**Ms DAVIES** — So you would see more risks involved in having public–private sector involvement in areas where there is a natural monopoly?

**Dr SHEIL** — Where there is a natural monopoly, if you go to duplicate it you are going to have waste, and if it is going to be private you are going to have to regulate it to stop monopoly profits. They are the conventional wisdoms on natural monopolies.

Seeing we are on water, I will bring this one on early. There is a particular issue on the relationship involved in dividing up a piece of infrastructure such as water, which is a whole unit. Effectively if you put in something called a PPP — but what you are doing is privatising the distribution of water or the filtration of water or some aspect of it — and the two parts remain absolutely dependent upon each other, then the relationship is naturally not a competitive one but a cooperative one where different interests are inserted. The economic literature suggests that there is no way in which you can use economics to set a price on how one party should sell to the other party and where the dividing line is. You can create a surrogate and so on but that ends up being basically a game between the two different interests. They are both dependent monopolies and there is no economic way, principle or doctrine by which you can set a price between them, so the consequence of that is that the price is set by who has the strongest bargaining power.

**Ms DAVIES** — So is that roads where you might have one private bit but you have a network, so are you talking about networks like that?

**Dr SHEIL** — In that particular instance I was just talking about, say, if you had water or sewerage privatised and your water catchment and distribution was public, where the dividing line is — the price I mean, the flusher where it goes from the water supply to the sewerage department — there is no economic theory to tell you how you set a price where one sells to the other one.

**The CHAIRMAN** — Yes, or in the case of distribution, where the pipe relies on the water and the water relies on the pipe.

**Dr SHEIL** — Two absolutely dependent monopolies to produce the final product. If one decides to, for example, lower its price it cannot expect to pick up more in the market. It runs the risk that the other one will simply absorb that benefit and the final price will remain the same, (or if its costs rise) — the interaction of what you have done is that a naturally integrated unit has been divided and you are dealing with two monopolies.

**The CHAIRMAN** — Your argument is you may as well leave it as a single monopoly and operate it publicly?

**Dr SHEIL** — Well, you have no way of setting a price. Take, for example, a big firm like Vivendi, which is a water player and has maybe four or five times the budget of the South Australian government.

Then you have a very big global player negotiating with a very small provincial government. The odds are that the government would get screwed in that relationship. You could turn it around the other way and say that if you had a small non-government organisation (NGO) that provided one specific thing and only provided it to the government, and it was virtually the monopsony provider, one would expect the small NGO to be the weakest. Because there is

no economic guidance as to how you set the price between dependent monopolies, the theory says that the strongest bargainer will set the price.

**The CHAIRMAN** — That one with water, or whatever, is an example?

**Dr SHEIL** — Yes.

**The CHAIRMAN** — Do you extend that then to other things — for example, let's go to the health system? In a hospital would you differentiate between the provision of the buildings and the building maintenance, maybe even administration, from the provision of clinical services, or would you argue that those are dependent as well?

**Dr SHEIL** — I would actually. What I would say would be operating there is you have a situation which I think technically might be described from the point of view of, say, the government in that circumstance: It would be dealing with a monopolist after the initial contract. That is, basically whatever savings come out of that are theoretical really. They are relevant for that particular year or the next year. But once you are talking about things like 30 years, everybody is dead, are they not? They have to go and find the contract, and you will never ever figure it out anyway. There is some point where the initial negotiation and whatever savings might have gone into the budget disappear into never-never land, and you are on a contract, and no-one can ever figure out what they meant.

But once you pass that first round, from a government's perspective what it is dealing with is a monopoly provider, and technically what the provider is dealing with is the monopsony customer. It only has one customer, so it depends on where you sit. They are absolutely dependent on each other, and yes, you do have all of those problems with incentives. Why would a government, particularly the provider of a hospital, have any incentive whatsoever in minimising the costs of the person who provided the building? They would not have any. And if the person who provided the building could find lots and lots of ways where they could save costs on behalf of the government, why would they bother? There is no incentive to do that. They just draw the residual income down from the place. So you have that problem where there is not any theoretic guidance as to how to set prices between these two parties once the initial competitive situation has gone.

**The CHAIRMAN** — What then would be the response if the government said, 'Yes, we accept that they are dependent monopolies, so what we will do is put out the whole of that — —

**Dr SHEIL** — Including the provision of — —

**The CHAIRMAN** — Yes. They say, 'We need a new hospital at Wollongong. We will do the whole lot by putting it out'.

**Dr SHEIL** — Just make it a private hospital?

**The CHAIRMAN** — Essentially.

**Dr SHEIL** — I guess it gets back to — —

**The CHAIRMAN** — The government argument would be in that way you have the public benefit in Wollongong of a new hospital. They have had it built in this way, and the government may shift it off balance sheet or off budget.

**Dr SHEIL** — Then you get into the more general arguments about privatisation, rather than like this part privatisation or bits and pieces privatisation, and there is a whole raft of arguments there about that.

**The CHAIRMAN** — This comes back to your definitional argument at the start, and that is where I was heading. If that was done with government providing the land and the private sector providing the building and all services for 30 years, at which time, under the agreement, it then becomes a publicly owned institution.

**Dr SHEIL** — One of the interesting things is why do they think these things revert back after 35 years? If it is valid for 35 years that it be run by the private sector, what conceivable argument could there be that after 35 years the validity of that runs out?

**Ms DAVIES** — Because the argument that is used in funding these is that government cannot afford to fund them up front. Effectively by these arrangements what they are doing is funding it over the whole life of the project.

**Dr SHEIL** — Yes.

**Ms DAVIES** — It is like a hire purchase; it was described to us yesterday that in fact the effect of the arrangement is that the government or the public sector has paid for it over 30 years, and after 30 years it is theirs.

**Dr SHEIL** — Right. So it is just a financing deal?

**Ms DAVIES** — I am just going to ask you that. Do you see that part of the real problem you were talking about — that everybody is dead after 30 years and nobody understands what the original intention of the contract was, and all the rest of it — one of the significant problems with this kind of arrangement is that very fact of the long-term contract? Do you see that as a fairly critical issue?

**Dr SHEIL** — Yes and no. From an economist's point of view, if the case was there for the private sector to do it, that case could not possibly exhaust after 35 years. That is absurd. It either was valid for them to do it on economic grounds, but once you get into finance and contracts, I guess it is — —

**Ms DAVIES** — Who owns the project then, if you are saying that? You are saying that the private sector should maintain that it is the owner of the infrastructure?

**Dr SHEIL** — I have lost the question a little bit there — what were you trying to get at?

**Ms DAVIES** — The original question was you had mentioned before about the 25 years or 35 years being too long for there to be any real memory of what the original intention of the thing was in the first place. Is that one of the main problems you see with these kinds of things which are being called by governments public-private partnerships, which tend to have as a part of them a long-term contract? Is that one of the core problems?

**Dr SHEIL** — I have not thought about it very much other than, as I said, from an economist's point of view. If it is valid for 35 years, it should be valid for 70. When we are talking about just the finance and the management of the contract, I guess it is a problem. One of the problems is that once you have the initial competition over, you have a 35-year monopoly, so you have to negotiate any changes in standards with the monopolist, and, as I said, because there are actually two monopolists there is no actual theoretic advice — you have to build surrogates, and its involvement with gaming — so that is an ongoing problem. That problem presumably becomes more difficult the further away you get from the original parties who often negotiate the deal and have a lot of implicit understandings between each other, so I guess once that memory is passed — I am just thinking it through as you are asking me — it becomes more and more problematical. One of the big problems with the Organisation for Economic Cooperation and Development stuff on this is that the British ones have not gone for very long and there is no firm evidence on what the medium and long-term costs of these things are going to be because it is so new.

**Ms DAVIES** — So it is very new, and basically everybody is operating on an assumption of faith that they have learnt all the lessons from the previous ethics, and these ones are going to be better?

**Dr SHEIL** — We make up our own minds on what they are operating on, do we not? I suspect they are just operating in the same way that we have seen from time to time. My guess — are we allowed to say this here? — is that the financial interests that derive a benefit from putting together these packages have lobbied one or two of the premiers, who have then introduced it in the major states, and it has just flown around to the others, and it is a way of moving the costs and the structure off balance sheet to keep the look of this ridiculous zero debt policy that we have and deliver the infrastructure, move the costs of it off balance sheet and appease the financial interests that are pressing governments to introduce these things. That is my starting assumption.

**Mr RICH-PHILLIPS** — I was going to pick up on the transfer aspects of these projects. Thinking about it, I guess that is a risk management tool or mechanism of government in the sense that at the expiration of a 35-year contract, a government which did not assume ownership of the asset would be in a very, very poor position to negotiate the ongoing operation of that asset. Take the City Link example in Melbourne. If at the expiration of its 50-year lease, I think it is, you had Transurban owning the central road network of Melbourne, but the government having no claim over that, in terms of negotiating an ongoing agreement, the government would be in a very poor position if it did not assume the ownership of that asset.

**Dr SHEIL** — Why could it not just regulate to protect whatever it defined as the public interest?

**Mr RICH-PHILLIPS** — Sovereign risk?

**Dr SHEIL** — Sovereign risk.

**Mr RICH-PHILLIPS** — If suddenly you have the government, through regulation, legislation, whatever, imposing some sort of framework on the private sector, assuming ownership, or whatever mechanism you choose to — —

**Dr SHEIL** — I am just wondering what advantage you get from actual ownership if you have a 50-year lease where you can regulate what — —

**Mr RICH-PHILLIPS** — You mean regulate at the commencement of that lease?

**Dr SHEIL** — You can regulate at the commencement, or regulate it whenever you regulate it, surely. What advantage does ownership give you? In fact, ownership might even leave you a little bit more exposed to risk, particularly in the last period seeing the thing is going to transfer back to government. The residual value in that asset does not belong to the firm that is running it, so what interest would it have in maintaining it? So ownership might increase the risk, whereas if you have had a regulatory framework, you might reduce it, instead of resting on ownership. It might be a risk mismanagement tool, particularly in the last period.

**Mr RICH-PHILLIPS** — I can see that point, and that would be something that would have to be managed presumably in the ongoing contract, for the continued maintenance of that asset up to the point in time at which it is transferred back to government.

**Dr SHEIL** — Yes, but even that does not work in the last period, does it, because unless the penalties outweigh the benefits — —

**Mr RICH-PHILLIPS** — True, but in terms of management of the project from handover, or resumption of government ownership, at that point in time — and you can argue whether it would be legitimate to legislate the ongoing management of that asset, assuming you did not have a contract where it transferred back to government — when you reach the end of a contract the asset is owned by the private sector. It is then up to the private sector to negotiate a new contract with government or do whatever it chose with the asset — sell it to another operator, or whatever — to then legislate at that point in time — —

**Dr SHEIL** — You legislate at the start, and they can own it. You legislate at the start and you just keep the legislation there.

**Mr RICH-PHILLIPS** — Certainly you could do that, but given — —

**Dr SHEIL** — Amending it as necessary.

**Mr RICH-PHILLIPS** — But given that has not been done — —

**Ms DAVIES** — Without giving a contract.

**Dr SHEIL** — Yes, although they extract rent every time you amend it, of course, and at commercial rates.

**Mr RICH-PHILLIPS** — That is why I would see you would have that transfer mechanism, so that the government does have some — —

**Dr SHEIL** — I do not see you would have anything additional other than what you have in legislation anyway. In fact, it might expose you to a bit more risk.

**Ms DAVIES** — So you are a bit cynical about the New South Wales government policy at the moment then?

**Dr SHEIL** — I am very cynical about it. I write a column for the *Australian Financial Review* as a sideline of a sideline, and I have been trying to write very polemical columns to provoke some serious criticism and some focus on the issues.

The history of these partnerships is, it seems to me, that partnership was a concept that was invented by Blair when he got into government, because he had to manage that very active, very difficult body to manage, called the City of London, and he invented the concept of partnership to sort of say, 'I am friendly. Even though you have lost Thatcher'. Partnership, if you go to UK Treasury sites, describes a whole interaction between the UK government

and the private sector. It incorporates full privatisations, joint public–private sector ventures, and what they call the private financing initiative, which is the one that is comparable to what is now being called partnerships over here.

But Blair himself, with respect to the origin of this term, does not call them partnerships. The concept partnership I believe comes from the sort of communitarian philosophy that Blair has tried to take to the government over there in dealing with that — which is used to getting contracts from the government — part of the world called the City of London, and we have just cynically grabbed that and stuck it on to what is called the partial privatisation, or the privatisation of a whole lot of social infrastructure here, and called it partnership because partnership implies values of equality and striving for a joint goal, which these policies do not do, by the way. That tends to disarm the whole opposition to privatisation, which in this country I think in every opinion poll that has ever been taken, with the exception of one in South Australia in relation to ports, has shown that 60 per cent to 70 per cent of the population does not like privatisation. So partnership is a spin doctor's abomination being wrenched from its original context, where it was not stuck on deals like this, brought across to the other side of the world and stuck on deals — it was purely that objective.

**Ms DAVIES** — So you dispute that UK research which says it is 17 per cent cheaper to do PPP projects than traditional public sector delivery? We have had that figure quoted at us quite a bit.

**Dr SHEIL** — I want to come back to the concept of why these things are not partnerships shortly, if you do not mind, but it seems to me — and the bundle of literature on this is so large that every time you come round to it you have another go at it and see how far you get — from what I can establish, the UK quotes include the construction phase, which we already get here. So you can take that one out. Are you familiar with the work that has been done by Allison Pollock over there? She had a close look at six of the hospitals in the UK. We cannot see the way in which the Blair government uses its comparator. We cannot see how it prices and allocates risk. As it turns out in the studies, the private option was always much more expensive until the risk allocation was gone through, which brought three of the six hospitals in at 0.1 per cent, and the other ones were around 1 per cent or 2 per cent, so it just got across the line to justify it. So it seems that unless this can be made transparent, in addition to the principles and also the case in relation to each particular project, the public is entitled prima facie to be suspicious of the way in which this comparator and the concept of risk allocation have been used in these.

Again, if you were to think — like I tend to think as an initial hypothesis: that this is about keeping the facade of low debt by expensing these things on the one hand, and keeping the financial interests in the city happy on the other — then it would be logical that the comparator would be the area, and the concept of risk evaluation would be the one that you would go to, to try to get them across the line.

**Ms DAVIES** — Is there a broader public interest in keeping the financial interests happy?

**Dr SHEIL** — I do not think there is any public interest in keeping them happy at all. Should we keep the financial interests happy? Well, perhaps — perhaps if they were in such dire straits. It looks like the government bonds are now under pressure, and the commonwealth is attempting to perhaps even pay out all debt. If there were no PPPs around, they would not have a lot of business. Maybe we do have to keep an amount of expertise in the financial industry in this area. So perhaps there is, if you want to think about it.

**Ms DAVIES** — Because otherwise it might all just disappear overseas.

**Dr SHEIL** — And then we might have trouble with start-up if we want to do it again, which would be more costly, so yes, there may be, if you want to think about it. You might be able to find some public interest in ensuring that we have requisite financial expertise in these areas in Australia.

**The CHAIRMAN** — If the government does not borrow and does not issue bonds and does not go to one of these mechanisms, it is going to have a very small public works program.

**Ms DAVIES** — Unless it taxes highly.

**Dr SHEIL** — If it does not issue bonds and if — —

**The CHAIRMAN** — If it does not borrow, does not issue bonds and does not use some form of PPP, it has a very small capital works program.

**Dr SHEIL** — We are in serious trouble. It has to do one or the other.

**The CHAIRMAN** — That is right. So it comes down to choices of the way in which you finance the deal, really.

**Dr SHEIL** — Yes.

**The CHAIRMAN** — I guess whether you take a Keynesian view of that or a Chicago view — —

**Dr SHEIL** — That is a good thought here. Just talking about the partnerships, because it is an important one, if you go to the actual documentation I take it that for anything to be described as a partnership — we have lots of partnerships in lots of contexts — there have to be some connotations of equality and/or striving for joint goals. If you do not have that you do not have something that can be described as a partnership, I would think. You are just using the word falsely.

Now if you go to the documentation, all the policy documents are very explicit about this. The government remains fully responsible for all of the policy outcomes, and the private firms are only responsible for specified and measurable outputs. Now that is a very starkly asymmetric set of relationships, and in any definition that is just a conventional principal-agent relationship. That is not anything that could go anywhere near being described remotely as something that could be called a partnership.

The only areas where they could be described honestly as partnerships, or approaching honesty as partnerships, is in the provisions where it says that the governments can share in some unanticipated or windfall gains that the private firms have. That does tend to approximate something that might be reasonably described as a partnership.

Importantly, however, it opens up a range of new accountability issues. That idea of sharing in windfall gains and unanticipated profits is very close to the idea that drove a lot of the activities that are now described under the heading of —WA Inc—. You do have some serious auditing problems. The Auditor-General will have to be able to audit the private firm as well, because once the government has a vested interest, if we put the rate here — bugged the community — this firm will get a great gain, and we are going to get part of it. This idea of using the private sector to generate profits that the government would share in was the underlying logic of WA Inc. and it is at the margins in this policy. So I think there is a very important auditing issue there, particularly in enabling the auditor to get into the private firm and to be able to have a look at the books in the private firm.

**The CHAIRMAN** — Can I quickly go to the accountability issue, and we must finish, obviously. If we set the other issues we have been talking about aside for the moment and just say, ‘Well, these things exist because the governments are into them’, have you a view on appropriate accountability regimes?

**Dr SHEIL** — I have had a look at them, and I go along with the Australian Auditor-General. They have looked at commercial in confidence and how it has been used at a commonwealth level over the last couple of years, and they have found it is almost always misused. I would say firstly I think it is repugnant to the very idea of accountability and democracy that the Auditor-General only gets contract summaries. These contracts are seen by ministers, advisers, public servants, junior public servants, accountants advising governments, lawyers advising governments, accountants advising private firms, lawyers advising private firms. If it is a float, all the shareholders can look at it. Why can’t the Auditor-General look at it, and why can’t a parliamentary committee look at it?

I think this is just another one of those things that makes you highly suspicious. With the Auditor-General and the relevant parliamentary committee, I think a reverse onus of proof should operate in relation to commercial-in-confidence provisions, and they should be strictly time limited. There are some public interests in some areas of commercial in confidence. A lot of these firms would like to share a lot of this information, but the ACCC might not like them to do that. There are some legitimate commercial in confidence, public interest — —

**The CHAIRMAN** — Is there any issue that is still there after the contract has concluded?

**Dr SHEIL** — I cannot see. Again, you have to keep an open mind.

**The CHAIRMAN** — Just separating those two issues.

**Dr SHEIL** — It is impossible for me to imagine that there could be, but you have to keep an open mind ultimately.

**The CHAIRMAN** — Dr Sheil, I thank you for your time with us this morning. I again apologise for our late start, but thank you very much for your attendance.

**Ms DAVIES** — It was very interesting. Thank you.

**Witness withdrew.**

# CORRECT VERSION

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

#### Inquiry into private sector investment in public infrastructure

Sydney – 23 October 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

#### Staff

Executive Officer: Ms M. Cornwell  
Research Officer: Ms C. Williams

#### Witnesses

Mr R. Sendt, Auditor-General; and  
Mr A. Whitfield, Deputy Auditor-General, New South Wales.

**The CHAIRMAN** — I welcome Mr Bob Sendt, Auditor-General, and Mr Tony Whitfield, Deputy Auditor-General, New South Wales, to this public hearing on private sector investment in public infrastructure. All evidence taken by this subcommittee is taken under the provisions of the Victorian Parliamentary Committees Act and is protected from judicial review. However, any comments made outside the precincts of this hearing are not protected by parliamentary privilege.

All evidence given today is being recorded. As witnesses you will be provided with proof versions of the transcript some time shortly after today.

Mr Sendt, before we go to questions from the committee, is there anything you would like to say in the way of an opening statement?

**Mr SENDT** — Only very briefly, thank you, Mr Chairman. We are probably at somewhat of a disadvantage in New South Wales in being able to provide many insights into this topic, because the extent to which there have been private sector–public sector ventures has probably been less than in your state. Certainly in the last five, six or seven years, while there have been some examples, many of those examples were projects completed following decisions taken a number of years earlier.

Currently — I am sure we will address this in answers to your more detailed questions — there are a few arrangements in the pipeline: there is some public school provision, where tenders are being evaluated at the moment, and there are also three significant roads projects that are at a similar stage. Projects that have come to fruition in the last three, four or five years are probably fairly thin on the ground.

**The CHAIRMAN** — Obviously I do not want to take you into policy comment on these issues, so I will try to go to other areas. Perhaps you could begin by describing for us what role the Audit Office of New South Wales has in relation to public–private partnerships?

**Mr SENDT** — There would be a couple of roles. One is the general role that most auditors-general would have in being able to comment on agency operations — either as part of the financial audit, where there are implications for agencies of a financial nature, or by way of performance audits if one of those is chosen — that encompass an area where these public–private arrangements are in place. We have another role in New South Wales which involves a request by the Treasurer — that is, in reviewing summaries of contracts entered into after they are entered into and prior to them being tabled in Parliament.

**The CHAIRMAN** — For what purpose are you asked to do that?

**Mr SENDT** — To provide some assurance to members of Parliament and other readers that the contract summaries being provided are a fair summary of the contracts. As you would appreciate, contracts for these major projects can run into hundreds, if not thousands, of pages. The summaries that are presented are reviewed by us.

**The CHAIRMAN** — Do you receive the full contract as well as the summary so you can satisfy yourselves about them?

**Mr WHITFIELD** — If I can step in, there is a requirement within New South Wales for agencies that enter into such private sector participation in public infrastructure arrangements to provide to the audit office within the period after the contract is signed a summary of that contract. On receipt of that, the audit office has 90 days to audit that summary to ensure that the disclosures within that summary accord with the contracts that have been signed in relation to that particular venture and to put a certification on that. The summary plus the audit certification are then required to be tabled by the relevant minister in Parliament.

**The CHAIRMAN** — And if you have a reservation?

**Mr WHITFIELD** — We would qualify that.

**The CHAIRMAN** — Before you go on, just so I can get that clear, your statement to the Parliament would have a qualification?

**Mr WHITFIELD** — Yes. The form of statement we put on it is more a negative assurance statement saying that nothing has come to our attention in reviewing the contracts and the summary that would indicate that there has been any material nondisclosure or misstatement in that summary. For example, when we reviewed the contract summary for the airport rail link, which is the railway line from Central out to the airport, there were some 16 different contracts that formed part of that arrangement, plus there were other documents referred to in the

contract summary — be they from consultants espousing an opinion on levels of patronage to economic justification or whatever — that we had cause to look at to make sure that whatever was in the summary was an accurate reflection of the documents referred to.

**Ms DAVIES** — Do you believe that is a better way of disclosing to the public the nature of the contract than actually releasing the whole voluminous contract? Do you think that getting a summary that has been vetted by people who know — i.e. yourselves — is a better level of public disclosure than requiring that the entire contract be released?

**Mr SENDT** — I do not think it is necessarily better than it, but I think it would add to it. I do not think having an Auditor-General review of the summary of the contract precludes the contract itself being released, and I would not suggest that the contract should not be released simply because we are certifying the summary. But the summary, which is probably what most people would only be interested in or would have the resources to examine, gives that extra assurance.

**The CHAIRMAN** — That is what I was coming back to with my earlier question about your role in this summary. Is it about saying that, in your view, every part of the contract that could reasonably be released has been released, or is it about just saying that this is a reasonable summary of the contract details?

**Mr SENDT** — The summary could not exclude or omit any issues or clauses or parts of the contract that we felt materially affected the user's ability to understand what the contract was about. I do not think in my three years as Auditor-General I have actually completed one of those summaries.

**The CHAIRMAN** — We understand those sorts of things.

**Mr SENDT** — From my knowledge of what happened before, I do not think we were ever in the position of qualifying our statement, but it may be, of course, that we went back to an agency and suggested it should change the summary to add in further information.

**The CHAIRMAN** — If I can take a step backwards: prior to this regime — the summary contract regime — what was the position of disclosure of contracts on projects that may have been carried out in the past in relation to what are broadly being termed as similar to PPPs — some of the road projects and things like that?

**Mr WHITFIELD** — There was no requirement within New South Wales at that point in time to make any disclosures.

**The CHAIRMAN** — There was no requirement, but was there any disclosure?

**Mr WHITFIELD** — That would be before my time. I took office in 1994, so I am not aware of it.

**The CHAIRMAN** — Obviously you are not aware of any in those contracts?

**Mr SENDT** — I would suggest there was probably no single policy that said they should or should not be disclosed.

**The CHAIRMAN** — I will not put the words in your mouth, but I might posit the suggestion that where there is no requirement to disclose, it probably does not occur.

**Mr RICH-PHILLIPS** — The summaries that you sign off on as being an accurate reflection, are their contents prescribed in the statute that requires the tabling? Is it a statute or is it a ministerial direction?

**Mr WHITFIELD** — It is within the guidelines.

**Mr SENDT** — Yes. The government's guidelines require agencies to submit the summaries to us for examination, and our mandate to carry that out is part of the act that allows the Treasurer to request any audit or audit-related services.

**Mr RICH-PHILLIPS** — Do the guidelines require certain disclosures?

**Mr WHITFIELD** — Yes, they do. They require certain disclosures to be made in terms of whether a cost-benefit analysis has been done and whether a risk assessment has been done, outlining what the risks are that have been transferred from public sector to private sector and any pertinent or material information within the contract.

**Mr RICH-PHILLIPS** — Is it your view that the requirements in the guidelines, having seen the full contract and the summaries, are adequate in terms of disclosure? Do they require sufficient information?

**Mr WHITFIELD** — I think I am in a better position to answer that than Bob because Bob has not done any of this; I did the contract summary for the airport rail link, and in my opinion the disclosures and the requirements in relation to that contract were such that all the material information was required to be disclosed.

**Mr RICH-PHILLIPS** — So those guidelines are a good basis on which to work?

**Mr WHITFIELD** — Yes, I believe so.

**Ms DAVIES** — Everybody talks about the complexity of some of these arrangements and these negotiations between the public sector and the private sector; when you are evaluating these summaries, if you come across things in these contracts which you regard as being mislabelled risk or something else that is a contradiction within the contract, do you have any capacity to comment on the substance of the contract or are you only there to say, 'This is an adequate summary of this contract'?

**Mr SENDT** — If there were something in the contract that was contradictory or in any way gave rise to a risk that was not disclosed in the summary, we could certainly either ensure the agency disclosed it or resort to a qualification. We also have the capacity, of course, in commenting on our general audit of the entity, to raise any issues. Our mandate in that was certainly clarified late last year along the lines of the legislation that was in the Victorian Parliament earlier this year, although I am not sure if it is still in the Victorian Parliament.

**Ms DAVIES** — Do you feel you need extra resourcing to deal with these kinds of arrangements? Do you have the expertise within the Auditor-General's office in New South Wales to properly evaluate some of these incredibly complex arrangements?

**Mr SENDT** — If we felt we did not have the expertise in-house we would buy it in, and we probably have done that in the past.

**Mr WHITFIELD** — I would like to differentiate there, because in doing the audit of the contract summary, it is purely a matter of reading the contracts and making sure that all the relevant matters have been carried across to the summary. There was not a need for an expert engineer or any other requirement to make sure that someone has summarised a large amount of documentation or a small amount. We would bring in experts if we chose to do a performance audit, for example, on a particular project where we may need to have someone with engineering expertise or whatever expertise that was relevant to that particular project. The third area where we look at these projects is in the accounting treatment.

The first element is just attesting that it has been summarised correctly; the second is looking at the performance of the contract; and the third element is how the accounting treatment has been effected in the agency that is responsible for that particular project. One of the issues that arises there is that currently there is no particular accounting standard that deals with these particular sorts of transactions, although the heads of Treasury have just put out a paper.

**The CHAIRMAN** — That is the question I was going to ask: is anyone working on it?

**Mr WHITFIELD** — Yes. We are looking at that paper at the moment, and having just read it, I can say that it has basically taken the same stance that the New South Wales audit office has taken in relation to how those transactions should be accounted for.

For a number of years, particularly in the earlier transactions such as the Sydney Harbour Tunnel and a number of the water filtration projects that were done with Sydney Water, we had advocated that the transaction, where it was capable of being unbundled and where there were separate revenue or payment streams, should be accounted for separately. We have based our assessments of the accounting treatment principally on the leasing standard, which is the closest accounting standard you can apply to that type of transaction. In the main, they tend to be in the nature of finance leases and therefore should be recorded in the books the agency would keep.

**The CHAIRMAN** — As required.

**Mr WHITFIELD** — As is required, yes.

**The CHAIRMAN** — Just going a little bit back there, on performance audit, are you satisfied that you have all the necessary powers to obtain any document that you require in relation to a contract under a PPP, particularly those that might be held in the private sector?

**Mr SENDT** — We don't have powers to obtain documents from the private sector, but principally we are looking at it from the point of view of the parties that are in the government sector, and there may be contractual arrangements between other parties related to the project, but clearly in the private sector we would not have the ability to obtain those.

**The CHAIRMAN** — If I can just follow that through, if you have a project — let's say a rail project, into which X hundreds of millions of dollars of public money are going, and a similar amount of whatever private money to enhance the project — when you come to audit that as a performance audit we can make the assumption that all relevant documents or duplicates are held within the public sector, but if that is not the case, do you look at things and say, 'There seems to be a gap here'? We are talking about the use of public money, et cetera; do you have the ability to get every document you need?

**Mr SENDT** — No, we do not have the ability to call for documents outside the public sector.

**Ms DAVIES** — One of the issues that was raised with us in Queensland was that while it may be rational to expect that the public sector would hold all the copies of written documents, what they might not hold is some of the internal knowledge, expectations or understandings that are held by the private sector. If it is a contract that is utilising public funds, then there should be an opportunity for an Auditor-General to question or have access to information from the private sector.

Another suggestion was made that the public sector would be entitled to have an idea of the actual return that the private sector is getting — in other words, how much profit the private sector is making from the deal, if that is relevant information. Can you see any way in which you would be able to encourage access to that sort of information?

**Mr SENDT** — Well, not under our present legislation. That would require changes to our mandate to allow us to either call for documents held outside the public sector or call for people to appear before us for questioning. We have neither of those powers in New South Wales.

**Ms DAVIES** — Do you have an opinion on whether you should have those powers when there is such a close relationship between the use of public money and the private sector?

**Mr SENDT** — We have certainly expressed the view in the past — in a slightly different context, looking at government grants particularly to the not-for-profit sector — that the ability to properly audit whether the money involved has been spent efficiently and effectively really necessitates being able to go beyond the public sector donor and examine what is happening with the private sector, including the not-for-profit user of the grant.

**The CHAIRMAN** — How would you react to the argument that is often put that if you set up a regime like that, no private company would become involved?

**Mr SENDT** — Private sector companies have to understand and are coming to understand that dealing with government can be different from dealing with other businesses, particularly in relation to confidentiality provisions. Businesses are now understanding that while they may sign a contract with a minister or an agency, there is another party standing above those — i.e. Parliament and its various organs — which can call for those documents. As long as businesses understand that, they can accommodate it.

**The CHAIRMAN** — As long as the ground rules are clear.

**Mr RICH-PHILLIPS** — One of the issues that Ms Davies raised was that the private sector does not have to deal with government, and indeed this morning we heard that Australia is a small marketplace and that a lot of the big players in the provision of infrastructure do not have to operate in the Australian market if they find there are too many impediments.

Are you aware of models in foreign jurisdictions whereby auditors-general have access to private sector agencies? Are there any models in existence where that type of information in the partnership model has been made available to auditors?

**Mr SENDT** — I am not sure what the situation is in the UK. I understand that in relation to chasing the dollar as far as grants are concerned, there was a proposal — and I am not sure if it has been enacted — in the UK that an auditor-general had the powers to go beyond the public sector. I am not aware of any jurisdictions where the role has been extended into commercial arrangements. In saying that, I am not suggesting it does not exist. I simply do not know.

**Mr RICH-PHILLIPS** — Could that be achieved through contractual means rather than legislation? Would that be an acceptable way of doing it, rather than legislating power for you to require that as a term of a contract?

**Mr SENDT** — It could be, but there would have to be some direction by central agencies to each of the line agencies that all contracts have those provisions built in.

**The CHAIRMAN** — If every contract was happening, I cannot see the difference between doing that and legislating.

**Mr SENDT** — That is right.

**The CHAIRMAN** — Otherwise you will leave yourself to the vagaries of the individual contract and possible amendment and modification.

**Mr SENDT** — Yes. The advantage of the legislative provision is that it gives a sort of parliamentary imprimatur to the framework.

**The CHAIRMAN** — I guess the difference is whether you want to say that this is an as-of-right power or an agreed power on the basis of the individual contract.

**Mr RICH-PHILLIPS** — Counter to the legislative argument is the one that the private sector involvement in each contract is different, and it may not be appropriate for the Auditor-General to have the same degree of access to the private sector agency. It would depend upon exactly what that private sector involvement is in a partnership, given that there are so many different models and levels of involvement.

**Mr SENDT** — I guess that begs the question, though, of who makes the decision.

**The CHAIRMAN** — I would say the answer to that is that the public interest is the same, and the audit would be on behalf of the public interest, not on behalf of the private sector. In the broader gain do you have a view on the appropriate governance and accountability regimes that should pertain, on a blank sheet of paper if you like, to these things, starting from the contract process and things like probity auditing of the process, through to the ultimate disclosure to the Parliament and the people? Do you have a view about the elements of a good governance and accountability regime?

**Mr SENDT** — I guess some of the elements would be openness, both of the process and of the ultimate contracts, so the use of commercial-in-confidence provisions would be the exception rather than the norm.

**The CHAIRMAN** — Can I stop you on that?

**Mr SENDT** — Sure.

**The CHAIRMAN** — Going to the specifics there, who should decide what is commercial in confidence in these things?

**Mr SENDT** — I think that perhaps the initial decision should be made by the public sector organisation or minister concerned, but it, he or she should be in a position of having to justify that. But I guess some right of overturn, and I am not sure what that process should be —

**The CHAIRMAN** — You would be aware of the report we tabled a couple of years ago?

**Mr SENDT** — Yes.

**The CHAIRMAN** — That worries me, given that part of that report said there was a greater propensity within the public sector to seek commercial confidentiality clauses than existed in the private sector.

**Mr SENDT** — And I think quite often that is done almost without thinking.

**The CHAIRMAN** — Yes.

**Ms DAVIES** — When in doubt, cut it out.

**The CHAIRMAN** — Sorry, I stopped you on the way through. I think you got to the second or third.

**Mr SENDT** — I guess it is openness of the process and the use of probity auditors or equivalent for all arrangements, perhaps over some threshold which may not simply be a dollar threshold but also may be by the type of contract; and the capacity for some sort of independent review, whether by auditors-general or otherwise, of the outcomes of the contractual arrangement, not of the contract itself.

**The CHAIRMAN** — No, where the outcomes were actually delivered?

**Mr SENDT** — Yes.

**The CHAIRMAN** — Or are being delivered, because they could be long term?

**Mr SENDT** — Yes, continuous or at the end. I guess they would be the main elements.

**Mr WHITFIELD** — The other thing we have seen start to emerge that was not around in the early contracts was the use of a public sector comparator, where someone has actually sat down and worked out what it would cost the public sector to provide that infrastructure, given a set of circumstances, so you then have something to assess the various tenderers on. In the past one tenderer has been assessed against the other, as opposed to — ‘Well okay, we might end up with the cheapest project or the best value for money, but it may well be something different from what it would cost the public sector to do it’.

**The CHAIRMAN** — On that my understanding is that the national audit office has done some work on the public sector comparator, et cetera. I am not sure whether it does it as part of a formal obligation or part of a post audit.

**Mr SENDT** — Sorry, the Australian National Audit Office or the UK National Audit Office?

**The CHAIRMAN** — No, the UK one. Again what is your view on whether there should be some audit undertaken of the PSC, at least about the assumptions that are used to construct the PSC?

**Mr WHITFIELD** — My view would be that yes, there should be some form of review to make sure that the underlying basis has reasonableness to it and some validity to it. Otherwise it is a bit the same way as where agencies are reporting key performance indicators in their annual reports, we are auditing the financial statements by the KPIs — which, in the case of a lot of the departments, are probably more relevant than the financial statements because the departments are service providers and we know they have received money and spent money, and the bottom line really does not mean a great deal. It is how efficient and effective the views are that have been given to them, and therefore it is the relevance and the appropriateness of the KPIs, as they are reporting the accuracy of them. They are more evidence as to how they have performed than the financial statements are.

So in my view, if we are having a public sector comparator there is a need to, first, make sure that it is a valid comparator and is reasonably accurate; and second, that there is some validity in the assumptions that have been made in putting that comparator together, otherwise you are not getting the benefit out of it.

**Ms DAVIES** — Under the current rules have you been able to do that? Have you ever done that?

**Mr SENDT** — No, I was just going to say that there has been a fair bit of work done in Treasury in New South Wales in recent years in developing and refining a public sector comparator model. I guess it is awaiting testing in a real-life situation.

**The CHAIRMAN** — We are talking a little bit in the academic here.

**Ms DAVIES** — To the extent to which you are aware of the public sector comparator in New South Wales, how important is the weighting that is put on the risk analysis?

**Mr SENDT** — As the Chairman alluded to, it is a bit academic at this stage because there have not really been many applications, if any, over the past couple of years. We are really awaiting the first round of them, with the three major roads projects that are lined up: the Cross City Tunnel, the Lane Cove Tunnel, and the Western Sydney Orbital.

**The CHAIRMAN** — I go back to Mr Whitfield on the point about auditing the PSC. Do you have a view about where in the process that should take place? Should it be audited pre-tenders so that you know the comparator is valid, or is this something that you would do post tender completion, more as a test, or just as part of the overall performance audit at a later stage?

**Mr WHITFIELD** — Personally I think to get the value out of it, it should be done before the tenderer is determined. In my view it is a bit late to audit the public sector comparator and come to a view that it was not accurate, but you have already made a decision based on that process. So it is a bit hard to unscramble the egg after you have broken it. In my view it would be better to get some view on the public sector comparator prior to its use in the evaluation process.

**Ms DAVIES** — What do you see as being the key risks associated with the private sector involvement in the provision of public infrastructure?

**Mr SENDT** — 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. There are a couple of reasons for that. One has been the amount of resources that private sector proponents can throw into the contracted negotiations. The second factor is the limited skills or limited experience people in the public sector in New South Wales have had in dealing with those sorts of issues. There is not or has not been a sufficient body of projects to build up and maintain a skill base within the public sector.

Now you can argue that you can buy in those skills at contract time. If you are dealing with a large project where two, three or four consortia may be bidding, it is quite possible that they are tying up all the skills available in the private sector that the public sector might want to try to glean.

**The CHAIRMAN** — Which takes me to a point that is removed but not necessarily not relevant to that. Earlier you said that in your view every project should have a probity auditor on the way through. Perhaps I should not prejudge what you are going to say. From where would you draw the probity auditor? Where would the probity auditor come from?

**Mr SENDT** — To date probity auditors have come from anywhere, from one of the big four or five firms down to former auditors-general and deputy auditors-general.

**The CHAIRMAN** — That was essentially the answer I expected, but I did not want to prejudge that answer before going to the next step.

Given what you were just saying that, particularly on a big project, the top couple of bidders may actually tie up the whole field, how do you handle potential conflict of interest issues if your probity auditors are being drawn from the same field as the people advising on the project?

**Mr SENDT** — That is a risk. Of course in the big four firms — and I presume they all have people skilled in probity auditing — you probably would not find all four of them tied up, but it does limit your choice somewhat. There are perhaps some boutique firms that may have specialist probity auditing personnel within them. There are others who by way of background, whether in the big four or otherwise, who are now out of those firms and who would have experience.

**The CHAIRMAN** — Is probity auditing of these sorts of projects a task that the audit office could or should take on?

**Mr SENDT** — I am not sure what Mr Whitfield thinks. I would probably be a bit wary of getting involved in the project, even as probity auditor, given that we may then want to come along subsequently and do some other form of audit on the project. I might feel constrained, having been involved during the project, reviewing or evaluating it later.

**Mr WHITFIELD** — If I could add to that, I think there is a need to differentiate between what I would call a probity adviser and a probity auditor. We tend to see that line being blurred. People say they are probity auditors, but they are really in there providing advice to the agency on how they should do it, as opposed to auditing that a proper process, a due process, with systems and controls has been put in place. That line tends to get blurred on occasions.

I echo what the Auditor-General said, that if we were involved in probity auditing the risk is that if we were to come along later and do an audit, it could be perceived that we were in effect auditing our own work when in reality we were not. I think it is more the perception than the reality that you need to be careful of.

**Ms DAVIES** — Can I just switch the focus a little bit here. You can say that New South Wales does not have a lot of experience with PPPs, but the reality is that it has had a very significant private sector involvement in the public sector in the provision of public works. One of the figures that gets quoted is in the Arthur Anderson study which says that the private sector can provide infrastructure at possibly a 17 per cent cost saving. Has your office done work which would enable some kind of a judgment to be made about projects that have been done in New South Wales with private sector involvement and some sort of comparison about whether there were any savings made by choosing to go with the private sector financing or management arrangement?

**Mr SENDT** — I do not think we have done anything in a major sense. A few hours ago we had a performance audit report come out which talked about outsourcing of IT. It indicated that in the five agencies we reviewed, the majority, if not all of them, indicated some savings from having outsourced IT. I think that is a bit different to running a railway line yourself and entering into some arrangement with the private sector to build, own, operate and transfer 30 or 40 years down the track.

**Ms DAVIES** — Likewise, the federal government did audits of their outsourcing of IT and found that it was humungously more expensive. Is there a particular reason why the New South Wales outsourcing was more successful than the federal outsourcing of IT?

**Mr SENDT** — Again we only looked at five agencies, and we perhaps did not have the projects the size of the federal projects. They were probably not driven in the same way that the federal outsourcing program was driven.

**Ms DAVIES** — What do you mean by driven?

**Mr SENDT** — I guess what I am saying is that perhaps in New South Wales it was more something that agencies themselves chose to go down rather than having a policy imperative to go down the outsourcing route.

**Ms DAVIES** — So it was a more rationally based, department-by-department decision of, 'We think it is more efficient for us to outsource'?

**Mr SENDT** — Well, it was certainly a department-by-department decision. I am not sure whether I can say whether or not it was rational.

**Mr WHITFIELD** — The other thing one needs to be careful of when talking about outsourcing is that it is not necessarily the whole IT that is outsourced; it can be sections of the IT that are outsourced. Yes, one of the problems inherent in outsourcing the total is that if you change your mind and want to bring it back in, it can become rather expensive trying to reassemble the whole lot, because you have lost a whole lot of corporate knowledge that you have passed over to someone else. If it is one segment of the process it is a lot easier to move it out and bring it back in with less disruption and loss of corporate knowledge.

**Mr RICH-PHILLIPS** — On the issue of risk management, obviously one of the reasons advanced for the involvement of the private sector in public projects is the appropriate management of risk between the two sectors. With the issue of core infrastructure or key infrastructure — and by 'key' I am referring to infrastructure which, for whatever reason, political or otherwise, cannot be allowed to fail or fall over — is it possible to transfer the risk from the public sector to the private sector? At the end of the day is it not the public sector which would train that risk, even if it had seen it only as political risk? For example, if CBD public transport were operated by the private sector, there is no way a state government could allow that to fall over if something happened to the private sector operator, and therefore the government would retain that risk and could indeed even hold increased risk by having it at arm's length of the private sector rather than retaining the operation itself?

**Mr SENDT** — I could probably almost read verbatim my answer to a question asked when the New South Wales Public Accounts Committee did a review of the Parramatta-Chatswood rail link. I will not read it verbatim, but effectively the answer was along the lines you suggested, that there are projects which, because of their very nature, are perceived to be a public or a government responsibility, and if the private sector party falls over in any sense the public expectation is that the government will take over the project. We have our rail link project, where the private sector operator is in receivership. The stations and trains are still being operated under arrangements with the receiver.

However, at the end of the day I do not think the government will be able to walk away and say, ‘The private sector operator fell over, we will close down that service’. There have been almost whole suburbs built up along the stations along that route taking advantage of the transport links to the city and it is not feasible for the government to walk away.

**Mr RICH-PHILLIPS** — Nor would they be able to find an alternative operator smoothly; it is just not possible to have one substitute straight in, in reality?

**Mr SENDT** — Possibly. There are some terms in the contract that require in circumstances yet to be tested by the courts that the State Rail Authority will take over operations of that service.

**Ms DAVIES** — If the ultimate perception is that the government will stand in, in what sense has it been shown that it is advantageous to not have it as a public sector project in the first place?

**Mr SENDT** — At the time I think it was seen as being, because of the nature of the project, a major engineering feat and that perhaps the private sector could handle the risks better in terms of construction and operating the stations; they could also perhaps bring more flexible arrangements to managing the operations in the public sector mind. I am not sure what was in the decision-makers’ minds 6 or 7 or 8 years ago.

**Mr WHITFIELD** — It actually goes back to 1993 when the project was first mooted. It moved through some iterations and changes of consortia until it finally took off and it was opened 18 months to 2 years ago.

**Mr SENDT** — There would certainly be other projects where the risk can be transferred and if the private sector operator does go out of business the government could walk away from — —

**The CHAIRMAN** — That is actually what I was going to ask you: isn’t the political risk like other risk in that it is not of the same dimension on every project?

**Mr SENDT** — I could imagine that if you had a series of arrangements with the private sector for the provision of public housing with each of them being fairly small contracts, if one operator fell over you could walk away from it. However, when it is, as these projects often are by their very nature, a very large, stand-alone project that cannot sensibly be duplicated, the possibility of the government walking away from it is minimal.

**The CHAIRMAN** — It has been put to us that there have been catastrophic projects done purely within the public sector as well.

**Mr SENDT** — Yes, and quite often the costs of those are hidden.

**The CHAIRMAN** — Thank you very much for your time. It has been a very useful session for us. No doubt we will hear more about these issues over time.

**Witnesses withdrew.**

# CORRECTED VERSION

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

#### Inquiry into private sector investment in public infrastructure

Sydney – 23 October 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

#### Staff

Executive Officer: Ms M. Cornwell  
Research Officer: Ms C. Williams

#### Witnesses

Mr R. Opiat, Director, Business Development: and  
Ms D. Gattelari, Corporate Communications Manager, Boulderstone Hornibrook.

**The CHAIRMAN** — I welcome Mr Robert Opiat, director, business development, and Ms Diana Gattelari, corporate communications manager, from Baulderstone Hornibrook to this public hearing on private sector investment in public infrastructure. All evidence taken by this subcommittee is taken under the provisions of the Victorian Parliamentary Committees Act and is protected from judicial review. However, any comments made outside the precincts of this hearing are not protected by parliamentary privilege. All evidence given today is being recorded and witnesses will be provided with proof versions of the transcript shortly after these sessions. Before going to questions, would you care to make an opening statement to the committee?

**Mr OPIAT** — Perhaps just very briefly, Baulderstone, with the full support of our German parent, Bilfinger Berger AG, has made an absolute commitment to this business sector. In the United Kingdom we have three schools completed, we are building two hospitals, we are building a tunnel in Germany, 18 months ago we completed the British embassy in Berlin and roughly 12 months ago the Lufthansa Beijing centre in Beijing. As a result of that track record and platform, when this market developed in Australia, roughly a year ago when the guidelines were first released by Victoria, Baulderstone made a clear and unequivocal commitment to it.

Our parent is prepared to be the equity investor in PPPs. I will use PPPs as the general acronym. For us that includes not only social infrastructure such as schools, hospitals and police stations but also economic infrastructure — toll roads, bridges, tunnels, things of that nature. Our parent is a very keen equity investor. Baulderstone with its design and construction and developing facility management and operating expertise in Australia is a keen partner. We are active in this market at the moment — for example, in New South Wales we are in the last two for the nine schools project, and two weeks ago we were short-listed with two others for the two prisons project in Victoria.

**The CHAIRMAN** — Can I firstly ask you a question that we have been discussing with auditors and others — that is, appropriate transparency, accountability and disclosure regimes? A view has been put to us that if there were significant disclosure regimes involved with public–private partnerships no-one from the private sector would ever tender. Do you have a view about that?

**Mr OPIAT** — That is a rather extreme position. In New South Wales I believe the contract is eventually tabled in Parliament; it is a matter of public record.

**Ms DAVIES** — A summary of the contract.

**Mr OPIAT** — That may be correct. I believe the same is true in Victoria and in Queensland.

**The CHAIRMAN** — There will be summary contracts, yes.

**Mr OPIAT** — Yes, this is a competitive industry, a competitive market sector and to the extent that it is possible we would prefer to retain on a confidential basis the detailed terms and conditions of our bid. We accept the fact that if your counter party is the public sector, disclosure and transparency is essential.

**The CHAIRMAN** — It is part of that process.

**Mr OPIAT** — Yes, and we accept that.

**Ms DAVIES** — As part of the requirement for transparency of projects when there has been very significant public sector financing or financial input, would you as a private sector representative be happy and willing to cooperate with an Auditor-General's audit of a PPP to the extent of appearing before him or her, of disclosing the level of your return on that particular project and making available documents to an Auditor-General for a probity audit or a performance audit?

**The CHAIRMAN** — It is not necessary that everything disclosed would be absolutely reported, but it would be used as the basis of the Auditor-General's report.

**Mr OPIAT** — If I can just clarify the question, the preface was in cases where there was significant public sector investment — —

**Ms DAVIES** — The theory with these PPPs is there is a partnership. There is a financial and an expertise contribution from the private sector and there is usually a significant public sector component to the funding and payments over a long period of time.

**Mr OPIAT** — When I think of investment I think of front-end investment. The public sector's financial participation is analogous to a lease or rent over 30 years and our terminology would not define that as an investment.

**Ms DAVIES** — But it is.

**Mr OPIAT** — I accept that.

**Ms DAVIES** — From the public point of view they are paying one way or another.

**Mr OPIAT** — It is a commitment of cash or time.

**Ms DAVIES** — Yes. Because that is public sector investment. I am trying to get an idea whether the private sector would be prepared to participate and make known information at the very minimum in confidence to the Auditor-General's office.

**Mr OPIAT** — I think you should consider two things. First, it is a highly competitive sector. For the schools, for example, there were 18 registrations of interest. Quite frankly I was surprised by that number. Four were chosen for the short list and two for the BAFO — best and final offer. It is highly competitive. The bid is down to the pennies. As a result of that, the market has established some levels and those levels of equity return or earnings before interest and tax return to a facility manager, for example, are under extreme pressure in order to be competitive and successful and they are not dissimilar to the returns that the same private sector providers would achieve outside of the public sector. I can tell you that an equity IRR for a PPP project in Australia — —

**Ms DAVIES** — Sorry, you will have to translate that into words.

**Mr OPIAT** — Pardon me?

**Ms DAVIES** — I know the PPP bit; what is IRR?

**The CHAIRMAN** — Internal rate of return.

**Mr OPIAT** — The investors' return in a PPP in Australia will be around about 11 per cent, 12 per cent, perhaps 13 per cent. That is the same as in the United Kingdom. That is probably down from 14 per cent or 15 per cent when PPPs were first introduced in the United Kingdom but Australia has benefited from the fact that it is a six or seven-year old market in the United Kingdom and many of the same players there are here and some of the same benchmark returns have been translated to here. A facility manager's margin on revenue will be somewhere between 7 per cent and 10 per cent. That is a fairly narrow band and, as I said earlier, it is under competitive pressure. There are enough players in the industry that in my opinion that will continue. To answer your question, yes, we would be prepared to discuss that with the auditor.

**Ms DAVIES** — On particular projects. You can say that that is your assessment of the average rate of return but every project is negotiated differently. There have been some projects in Victoria, for example, where the contract has fallen over because the estimated rate of return that the private sector had when it became involved has been vastly overestimated and it has subsequently said it is not making its return. Every project has different rates of return in reality. The City Link project in Victoria has a very generous rate of return. When I ask the question do you believe the private sector would be willing to disclose its actual rate of return on particular projects, do you think that you would?

**Mr OPIAT** — We need to draw a distinction here for clarity. I am referring to public–private partnerships in perhaps the strict terminology, meaning social infrastructure where the private sector is earning a return based on availability and performance. Quite separate from that we frequently talk about so-called build, own, operate and transfer (BOOT) projects such as City Link, the Cross City Tunnel, Western Sydney Orbital, perhaps the Scoresby–Eastern freeway, which are a function of demand — user pay. We call that economic infrastructure as opposed to social infrastructure. Where there is both an availability risk — is the road open — and a demand risk — will automobiles and trucks use it — the equity return is obviously higher because of that incremental risk. In contrast — and I will use the New South Wales schools project as an example — we earn a return based on availability. If there is one student and one teacher or 100 students and 100 teachers, it is not relevant to our return; we are merely being paid to make the facility available and the public sector provides the students and the teachers.

**Ms DAVIES** — So in fact the public sector wears all the risk.

**Mr OPIAT** — No, I did not say that at all.

**Ms DAVIES** — They wear a considerable risk if they have miscalculated how many students there will be or whatever.

**Mr OPIAT** — If I could still use the New South Wales schools as an example, the Department of Education and Training has provided a forecast as to student numbers for 30 years. It has cautioned us that that is an estimate because these are all so-called greenfield sites in the west where they are assuming subdivisions will arise and families will move in and provide students. If their projections are low, we are obligated to add additional facilities. If their projections are too high, in our contract we are offering them a mothball price for taking a school or a portion of the school out of service. The Department of Education and Training has some risk in that if the subdivisions are not built and the families do not arrive, it does not have students but that risk is mitigated by the fact that it can either increase it if the projection is low — it can ask us to increase the capacity of the school if the projection is too low — or mothball it if it is not. Given that New South Wales has 2600 schools in the state, its systems and procedures for estimated demand are relatively sophisticated and highly accurate. You are correct that there is an element of risk for the department but it has been significantly mitigated.

**Ms DAVIES** — So if the school needs change in other ways like we have a revolution in teaching styles over the life of the contract, what happens then? Or if departmental policy changes and decides that the best way to deliver a good education is by a different structure of classrooms and schooling, who pays?

**Mr OPIAT** — They would issue a change notice and we would respond to that with an estimate of the cost and the service fee over time and the department would have the ability to accept or reject that. It is no different from any of the other 2600 schools that it owns and operates today.

**Ms DAVIES** — So what is the advantage to the state in having this kind of long-term contract rather than its just contracting you to build a school and then having no long-term commitments?

**Mr OPIAT** — There are numerous advantages and the first advantage is becoming quite paramount. Again using New South Wales schools as an example, they need the first five of the nine schools in January 2004. As a result of delays, we are now faced with a 9 to 10-month construction period; that is from submission of the DA to opening of the school. We have said to the department that we will mobilise the resources necessary to deliver the first five on time. The other four are required one year later. The first advantage is the mobilisation of resources and the acceleration of the availability.

Secondly, we are obligated to maintain schools in as-new condition for 30 years and in 30 years hand them back to the state in as-good-as-new condition. One of the major advantages of this type of delivery, quite frankly, is the maintenance of social infrastructure. I think you probably know as politicians that the first thing that gets cut in a budget is maintenance. In your own budget at home you probably do the same thing. The Secretary of State for Education and Skills from the United Kingdom was out here two months ago. As you know, they are building hundreds of schools in the United Kingdom and she was asked, ‘What is the main advantage from your perspective as the Secretary of State for Education and Skills of PPP delivery of schools?’. She said quite simply and without hesitation, ‘Once I have signed that contract, a school is delivered to my specs and it is maintained for 30 years. I never have to worry about maintenance for 30 years and neither do my staff have to be concerned with maintenance. The budget is assured. The quality standards are assured and my staff can focus on their core responsibility which is teaching’.

**Ms DAVIES** — What if the private sector has miscalculated how much it is going to cost it and its rate of return towards the end of the project is not adequate to its commercial needs.

**Mr OPIAT** — The private sector loses and earns less than its forecasted rate of return.

**Ms DAVIES** — That has not happened in other examples. There have been additional subsidies put in by government. What makes you think that these new projects are going to be different from that.

**Mr OPIAT** — If we are referring specifically to social infrastructure PPP, I am not aware of that example.

**Ms DAVIES** — There has been not much social infrastructure. I do not see the difference. It is the same, it is an essential service that has previously been provided by the state — for example, railway services. The estimated rate of return in Victoria was vastly overestimated, the companies were having difficulty and what has

happened is the government has stepped in with considerable extra public subsidies. Why will these projects be any different from that?

**Mr OPIAT** — I cannot comment on the Melbourne transport situation because we are not involved in that sector and I do not have any knowledge. However, I can comment on our experience from the PPPs we do in the United Kingdom and Germany and I can comment on our expectations here — that is, if we have miscalculated the cost of providing the service we will wear that risk.

**Ms DAVIES** — When has a commercial enterprise ever worn a loss for an extended period of time? Surely in the end there is no possibility of a company being prepared to accept a long-term loss like that. It will go broke, it will renegotiate the contract, you cannot survive.

**Mr OPIAT** — The private sector is filled with swings and roundabouts. You have good luck and you have bad luck. The better companies are diligent, hardworking and disciplined, and they earn at or approximately their forecast IRR. I can assure you that there is no guarantee. We were describing advantages; risk transfer is probably the third advantage. In PPP the public sector transfers significantly the risk to the private sector and earning an equity return or an investor's return lower than forecast is one of those.

Two weeks ago I was in London visiting our schools and hospitals. In the case of one of the hospitals a design fault was discovered part way through the construction project. We corrected it and our equity IRR will now be less than forecast.

**Ms DAVIES** — But, again, people have been familiar with construction risk for a long time.

**Mr OPIAT** — And it happens.

**Ms DAVIES** — Yes, it happens, but the concern that has been expressed is that over a long period you will not wear that ongoing loss. Based on something you said before, is it a function of size? If you are large enough, if the project is large enough, then are you in a better position to wear any losses?

**Mr OPIAT** — I would recommend that the public sector contract with credible creditworthy private sector suppliers, and I would put us up as one of those.

**Ms DAVIES** — Naturally. You are talking about larger organisations.

**Mr OPIAT** — Size counts, but size is just one characteristic of a credit review or a credibility review.

**The CHAIRMAN** — I refer to some of the parameters of what you are doing. You were talking about maintenance provision, et cetera. Are you providing services?

**Mr OPIAT** — The model in New South Wales is similar to Victoria, which is largely following the precedent in the United Kingdom, which is that the public sector continues to retain responsibility.

**The CHAIRMAN** — Staff, et cetera.

**Mr OPIAT** — Correct.

**The CHAIRMAN** — What about things like technology? Is that yours, or is that still in the public sector?

**Mr OPIAT** — The education department found it difficult to specify its technology requirements for a 30-year contract.

**The CHAIRMAN** — Yes, one can understand that. It would be hard to do that for a three-year contract.

**Mr OPIAT** — Precisely. No-one was surprised by that; that is quite logical. As a result our specifications call for us to provide a technology backbone — plugs in the wall — and the department is responsible for the technology that attaches to that.

**The CHAIRMAN** — We were talking before about the end of the contract when you hand over a building which is as of the day, if you like, so the technology for the plug in the wall at the moment might be that it is broadbanded, whatever. Is that also required to be kept at a level which is appropriate to the time? Obviously the hardware will be provided by the public sector, but the delivery, if you like, that the technology operates on, is that part of the contract?

**Mr OPIAT** — It is not. We provide the backbone, the infrastructure; the education department is responsible for technology from that point forward. I believe there is a UK school example where the private sector supplier has taken an amount of technology risk — that is, it has gone from the plug in the wall to the laptop on the desk. I apologise that I cannot remember which education council that is, but there are examples of that. If the department was prepared to give us that risk and that opportunity, we would accept it.

**The CHAIRMAN** — I think you will find the Victorian County Court project is similar.

**Mr OPIAT** — Yes.

**The CHAIRMAN** — You talked about size and so on, and we talked a bit about accountability, those sorts of things before, and from your point of view. I refer to the other side and to your perceptions of how the process is being handled and managed at the moment. Do you perceive that there are any significant weaknesses, or gaps between policy and practice in the way things are being pursued at the moment?

**Mr OPIAT** — I would make two observations. May I say that both of these are immature observations because here in Australia, and I think we have to talk about Australia — —

**The CHAIRMAN** — That is right, and I was specifically asking about the experience.

**Mr OPIAT** — There has not been much experience. We only represent a small subset of that experience. On the basis that this is immature comment, there are two areas: no. 1, the process that is currently being used short-listing three or four, and then going to a shorter list of say two and requesting those two final bidders to produce fully documented offers, is exceptionally expensive. Once we are short-listed, say to three or four, and we submit a bid, we will spend on a PPP project — as opposed to a BOOT project — such as a school, hospital or prison, somewhere between \$500 000 and \$1 million. If it is a BOOT project you can multiply that by a number — a big number.

I believe that the public sector should have enough information at that point to select a preferred proponent, and to complete documentation with that preferred proponent. What has occurred in Australia to date is that two are then selected for a best and final offer — we call it BAFO — and are required to produce a fully documented offer. We will spend somewhere between \$1 million and \$1.5 million for a PPP project, and again a multiple of that for a BOOT project such as a road or a tunnel. You only have to begin to add those numbers up, recognising that they eventually get embedded in costs to the government. We will begin to increase our required rate of return to compensate us for the expenditure of those we lost. The industry will do that across the board, and it will become a higher risk because of those front-end costs. Similarly, the sponsoring department is wearing those same expenses. They tend to be technical, design and legal. I believe that a government department, with all its advisers — both public service advisers and private contractors — would have the ability to select a preferred proponent and complete with that one single preferred proponent.

**The CHAIRMAN** — Is that the situation in England?

**Mr OPIAT** — Yes. You have a short list, a preferred proponent is selected, and you then — —

**The CHAIRMAN** — It is a single proponent after the BAFO stage?

**Mr OPIAT** — There is no BAFO. I apologise for the terminology. You have expressions of interest publicly advertised and anyone can submit. From the expressions of interest you select three or four to be short-listed. You then exchange more information with them and they develop a more detailed proposal. Then here is where I have my complaint: from those three or four, two then make a BAFO, a best-and-final offer, and you ask them to have fully underwritten and documented equity, fully underwritten and documented debt and fully drawn designs.

Last night we made an estimate in our schools project. Next week we will deliver somewhere between 3600 and 4000 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.

**Ms DAVIES** — If there is that much complexity and that much money, tell me there is still an economic value for the state and the public interest in not just having you build a school and then — —

**Mr OPIAT** — Absolutely. Experience in the UK — —

**Ms DAVIES** — I would like that demonstrated. I have heard the quote from the UK over and over again; that is the only one anyone ever talks about. Nobody has ever given us any documentation that does not refer to those particular studies which are disputed from the UK.

**Mr OPIAT** — If you and I agree to meet here in 33 years — I am serious — we will examine the science.

**Ms DAVIES** — The only way to do it is to wait. It is an item of faith, isn't it? If we will not know for 33 years, that is a very long time.

**Mr OPIAT** — You will actually know at about 10 or 15 years, because we will then be going through the first life cycle change. If you can accept the fact that the public sector sponsor is knowledgeable about its infrastructure and has the ability to judge offers, and that the private sector is also clever and must ultimately deliver value for money below the public sector comparator, then on a forecasting basis which is highly rigorous and contested we have the prospects of value for money.

**Ms DAVIES** — I do not suggest it is as scientific as you suggest.

**Mr OPIAT** — I make my life out of it, and I am confident.

**Ms DAVIES** — It is very good for the private sector. In the old days accountability for schools was very clear: if you have a school and the facilities are not up to scratch or something goes wrong and it needs to be fixed, and it is not being fixed, first you whinge to the region, then you whinge to the department, and if you do not get any action you go public and you whinge to the minister and the Parliament, and ultimately there is a clear line of accountability. If it is not fixed somebody gets into trouble.

**Mr OPIAT** — That is not the case.

**Ms DAVIES** — That is what happens.

**Mr OPIAT** — I disagree with that; go to any hospital or school in New South Wales.

**Ms DAVIES** — Sometimes facilities are fixed, sometimes they are not; sometimes new ones are built and sometimes they are not. People on the ground — parents, teachers, communities — know where the blame lies or where the credit lies, and that is very directly with government. If you have your company which is a multinational company involved in a vast number of projects building and responsible for maintaining the school, where does the line of responsibility go if a parent or a community says, 'This school is not up to scratch, it is not meeting our needs'? Who is responsible? Who do they whinge to? And who will take any notice of them?

**Mr OPIAT** — I make two comments. No. 1, I must disagree with your observation that the public sector maintains its assets. Look at any road with its potholes, at any school that is dirty and not up to standard, at crowded conditions in public sector hospitals.

**Ms DAVIES** — You have a very negative view of the public sector at the moment.

**Mr OPIAT** — In terms of maintenance, yes.

**Ms DAVIES** — But that is a coloured view. There are some very well-maintained schools and some not. Again, I make the point that because it is a public facility — publicly owned and publicly maintained — you know where the theoretical line of responsibility is. If you go ahead with these schools, what will school communities do if the facility, for whatever reason, is not meeting the needs that they believe they have? Where is the line of responsibility going, and how will they know where to complain to?

**Mr OPIAT** — I apologise, but we must disagree. In New South Wales, where I have more familiarity, the departments of education and health have documented their maintenance backlog. It is a huge number.

**Ms DAVIES** — I accept that but the question remains. You cannot assume that will all be perfect; you might claim that it will be better. It might be better; it does not mean it will be perfect. If there are problems seen at the ground, where will people go to complain? Where will the responsibility lie?

**Mr OPIAT** — Are you familiar with the Partnerships Victoria guidelines, the New South Wales Working with Government guidelines and the Queensland partnership guidelines?

**Ms DAVIES** — Vaguely. I do not know them all off pat.

**Mr OPIAT** — We would be happy to provide that documentation to you.

**Ms DAVIES** — I have them.

**Mr OPIAT** — It is very clear in the guidelines, which are embedded in the contracts, that if the facility does not meet highly specified performance standards and availability standards, deductions from the service fee are made. Those deductions accelerate and can aggregate to 100 per cent of the scheduled service fee. So the public sector has the ability to withhold payments contractually if the facility does not meet the specified standards.

**Ms DAVIES** — What if the specified standards are different from what the community expects? You are still not answering the question. Does it mean that in order for there to be any successful complaint there has to be a legal dispute between the government and the company? Again, where do any complaints go?

**Mr OPIAT** — The community's standards, in my opinion, are expressed through the departments of education and health specifications. I cannot speak to the community, but I can speak to the community's representative, which is the department concerned. It has specified performance standards based on its other facilities and its expectations, and we will meet the department's specifications. We will exceed the department's specifications. If the community feels that their schools should be of higher spec than does the department, then I suggest that is an issue between the community, the education minister, the New South Wales government, and the education department.

**The CHAIRMAN** — We have run out of time. Thank you, Mr Opiat and Ms Gattelari, for your attendance today and for making yourselves available for the committee.

**Ms DAVIES** — We had better make a pledge to meet in 30 years!

**Mr OPIAT** — We have done a little note which I am happy to tidy up which we entitled 'Popular beliefs', and then 'Partnership advantages', and I would be happy on the basis of this discussion to tidy it up. Sadly, because this is a relatively new concept in Australia there is a fair amount of misunderstanding and concern. I agree with you, we are making promises to provide facilities for 30 years into the future and you are quite right to ask, 'Will you keep your promise?'. I am here to say absolutely we will. The sponsoring department has specified what those promises will be. We will exceed those. We will welcome the opportunity to do that.

**Witnesses withdrew.**

# CORRECTED VERSION

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

#### Inquiry into private sector investment in public infrastructure

Sydney – 23 October 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

#### Staff

Executive Officer: Ms M. Cornwell  
Research Officer: Ms C. Williams

#### Witnesses

Mr D. Graham, Acting Director; and  
Ms B. Archer, Principal Financial Analyst, Private Projects Branch, New South Wales Treasury.

**The CHAIRMAN** — I welcome Mr Daniel Graham, acting director of the private projects branch, New South Wales Treasury, and Ms Belinda Archer, the principal financial analyst, to this public hearing on private sector investment in public infrastructure. All evidence taken by this subcommittee is taken under the provisions of the Victorian Parliamentary Committees Act and is protected from judicial review. However, any comments made outside the precincts of the hearing are not protected by parliamentary privilege. All evidence given today is being recorded. As witnesses you will be provided with proof versions of the transcript some time shortly after these hearings. Mr Graham, before we go to questions from the committee is there anything you would like to say as an opening statement on PPPs?

**Mr GRAHAM** — Not really. I came to respond to questions from the committee and I assume they will be questions on the New South Wales government policy and framework.

**The CHAIRMAN** — Essentially, or aspects that may be in common with various jurisdictions, yes.

**Mr GRAHAM** — I may open by saying that I and other Treasury officers have worked closely with our Victorian counterparts through what we call the heads of Treasury working group which was formulated over 12 months ago now to try to coordinate and get a consistent policy framework across states and territories within Australia. Because New South Wales and Victoria have been leading the group in the development of guidelines and policy and procedures I suppose we have had a degree of influence over the types of arrangements for guidelines that other states and territories start putting together.

I therefore think it would be accepted that there has been a high level of consultation and a degree of interaction that has probably not been evidenced in other areas of interstate cooperation. If this particular sector is to grow there is a recognition that it is an east coast Australian type of market, if there is anything there, and it cannot be driven by one state being the leader, if you like, of the whole program. We recognise that as well and that is why trying to achieve, at least from an approvals or risk transfer point of view, a common approach to it gives the industry some understanding of moving from one state to the other in terms of the types of contracts and arrangements they would be entering into.

**The CHAIRMAN** — What does the practicality of having a single east coast market for PPPs mean in practical terms? Does it require identical policy guidelines in each of the states? Does it require some sort of single repository? Are you talking about having similar deadlines and time lines — things like that.

**Mr GRAHAM** — I think the practicalities of having identical policy guidelines across each state probably make it not achievable, given that each state has particular organisational arrangements that affect this, and each state has its own unique policy objectives in terms of what it is trying to achieve out of that.

What we have come up with is a common arrangement on some of the technical elements. I will reference here that we did not see the need to do a great deal of work in some of the technical risk areas because Victoria had produced a guideline a couple of months before us outlining how it was going to do the more detailed risk allocation arrangements. We talked with our counterparts and got agreement and support on our copyright arrangements, so we have just cross-referenced the Victorian technical information and highlighted areas where we might have a slightly different approach to it.

As a result we have achieved a degree of understanding that some of the technical elements of these transactions are consistent across states. When we look at the approval regime, both Victoria and New South Wales have a cabinet committee approving at different steps in the transaction. We require similar types of reporting at those transactions, so the private sector understands that a cabinet committee approval regime is required at different steps in both states, the other states are adopting a similar approach, and consequently the time line for that is reasonably well known.

In addition, we have also approached it from the point of view of having an expression of interest phase, which is getting the capability statement of the organisations before going to the detailed stage, so we are trying to minimise the number of operators asked to do a lot of detailed work in the transaction. There is some commonality flowing through there.

We have similar thoughts on commonwealth tax arrangements. We have taken similar approaches where that is a major risk; so to the degree we can achieve commonality, we do. We have been sharing information — for instance, we encountered, probably before Victoria, the issue of related companies and how to handle them in a tender arrangement, and we have produced a related companies arrangement. Indeed, the private sector may say it is overly complicated from a probity point of view, but our concerns are running a fair and honest transaction. The

Victorians have had access to that documentation and have been using a similar framework for some of their transactions. We have also been doing a lot of work together on the application of discount rates in terms of public sector comparators and analysis of bids.

I suppose Victoria and New South Wales have been influencing the policy debate which has been taken up by the other states as they have worked on it. The practicality of having coordinated programs is obvious and would be ideal. Given the different budgetary and service requirements of the different states that is probably not achievable in the short term.

**Ms DAVIES** — If you are talking about an eastern states sort of market why has there not been equivalent cooperation with the federal government?

**Mr GRAHAM** — There has been. The commonwealth is on the HOTS working group. It has a different service supply requirement from those of the states. It is looking at defence procurement, it has been looking at procurement of the immigration accommodation and so forth. So the commonwealth has been part of the working group and has funded the major research work into discount rates and so forth for the working group.

**Ms DAVIES** — My understanding was that the federal government had backed off a bit from PPP arrangements.

**Mr GRAHAM** — In terms of the transactions they are doing?

**Ms DAVIES** — It is expressing some doubt about whether it was appropriate, whether the rate of return was adequate for the private sector.

**Mr GRAHAM** — I personally have not received that kind of information. There may be internal policy issues. There is more delegation of responsibility in the federal government to the agencies than in the states where there has been a centralisation of resources and decision making on PPP projects in Victoria, New South Wales and Queensland. In the commonwealth there has been a delegation down to the Department of Defence and other agencies that are responsible for delivering their own programs. To the extent that one agency has decided not to pursue it or another agency has, I am not aware of what their grassroots program is doing at that level. But at the policy level the commonwealth is working with us on a cooperative basis, discussing the major issues that are confronting us in the delivery of PPPs.

**The CHAIRMAN** — Your Public Accounts Committee has previously reported its belief that the public sector here does not have the necessary skills to evaluate value for money and risk. What is your response to that?

**Mr GRAHAM** — From our perspective I do not agree with that, and I was asked about these views at the committee. We take a team approach to formulating bid teams from a public sector side. It is not just the use of public servants; we employ experts in the area of finance, legals, accounting and even into the technical area. This is a new field for both the private sector and the government so it is hard to say that the other side, the private sector if you like, necessarily has superior skills to the public sector. It is a balancing of skills and capabilities. I would be of the view that on the public sector side — and it may be obvious in my position — we hold as good a quality of qualifications, experience and skills as the private sector side. It is bringing the team together and balancing out the public sector component with private sector expertise to actually negotiate the best deal for government, so it is not purely a public servant team that ends up working on the project from the government side.

**Ms DAVIES** — Isn't it one of the arguments, though, that because of the complexity of the arrangements, there is only a comparatively small pool of people who are experienced or capable at these kinds of arrangements and that the public sector is disadvantaged because you do not pay to the same level and you are going to lose the really experienced ones off to the private sector and have what is referred to as a brain drain?

**Mr GRAHAM** — I have not necessarily experienced that in New South Wales. I have assembled a core team of people. We have been running projects in New South Wales since the 1980s. I know PFP in a social area is a new area, but we have been doing deals in New South Wales since 1986. We have a core of expertise in New South Wales and we bring those people onto the team when required, so we have senior people who are quite experienced in this field, and it is not like we necessarily reinvent the team each time we come through. That has been one reason why we have concentrated our resource expertise in a Treasury group. We know who is in the agency, so we can call upon them when required to formulate the best possible team to address the project and program we are looking at.

**The CHAIRMAN** — And you also go outside the public sector?

**Mr GRAHAM** — Yes.

**The CHAIRMAN** — Can I ask you whether in going outside the public sector you have encountered any problem, particularly on the bigger projects, of conflict of interest, because essentially the big companies are involved in advising or as part of the bidders to the budget?

**Mr GRAHAM** — Can I example our toll road program, which is probably big biggest procurement program in Australia at the moment. We have deliberately held the same team together, apart from a change in financial adviser, for all three bids basically because we are of the view that, firstly, moving across to the other side for another transaction may involve disclosing positions that the government may or may not take. Secondly, because those people were familiar with our procedures, how we were doing the development, the work program, that meant they fitted in quite neatly, we did not have to make some of the people relearn the transaction. The fact that the legal team was familiar with the contract documents meant there was no major change in that area so we have kept basically the same team of roads and traffic people, legal, financial and technical advisers for the whole three projects.

**The CHAIRMAN** — If I can paraphrase you or summarise the issue, you say that you recognise there may have been a potential for conflict of interest but you managed it?

**Mr GRAHAM** — Yes. To the extent that the agent or an organisation wants to be part of the team there is an exclusivity arrangement with it that it will be with us for the duration of the bid and it will not move out of the government side and go across to the private side some way through the bid, so an exclusivity arrangement is tied up there.

**The CHAIRMAN** — Does that arrangement extend beyond that bid, taking it outside?

**Mr GRAHAM** — No.

**The CHAIRMAN** — Can I ask you again in relation to your processes, how is your probity advice or probity auditing done through the project?

**Mr GRAHAM** — Normally we have an independent, and it is normally a private sector probity adviser. They are appointed at the time that we initiate the project before we go to expressions of interest. The probity auditor's responsibility is to review from our point of view the documentation we put together, and then to be available to both the private sector side and the government side if there are concerns about the information flow or the transaction and so forth. The probity auditor is normally in attendance at meetings with private sector parties and at major review points in the project.

**The CHAIRMAN** — And reports on the project process?

**Mr GRAHAM** — And reports on the process.

**The CHAIRMAN** — As a public report or an internal report?

**Mr GRAHAM** — Internally, but then it would become public after the contract. There is a period when you are dealing with confidential information until you have determined the contract and signed and finalised it, and then there is disclosure of procedure and the arrangements that we have put in place.

**The CHAIRMAN** — Again on accountability arrangements, you have a system of summary contracts, as I understand it?

**Mr GRAHAM** — Yes.

**The CHAIRMAN** — Which are attested to by the Auditor-General before they are tabled?

**Mr GRAHAM** — Correct.

**The CHAIRMAN** — Firstly, the auditor sees both the summary and the full contracts?

**Mr GRAHAM** — The audit office is a party to all documents that were part of the transaction. It may not just be the contracts but all documents. Normally the audit office in its certification lists every one of the documents

that it has actually viewed, and if it requires other documents during the audit process it will request them of the agency. All the office is asked to do is not to say whether it was a good or a bad idea but to say just that the contract summary is a true and fair reflection of the major contracts.

**The CHAIRMAN** — If the auditor — this is again very much hypothetical — said to you, ‘I believe the prepared summary omits items which could fairly be disclosed’, how is that resolved?

**Mr GRAHAM** — Normally through negotiations with the audit office, so the representation would go back to the agency saying that I feel that this piece of information should be included. I must say that I cannot recall having one of those situations.

**The CHAIRMAN** — I do preface that by saying it is a hypothetical.

**Mr GRAHAM** — But normally it would be accommodated through a negotiated arrangement. If the piece of information was considered to be commercial in confidence and not part of our disclosure rule from that point of view then it may not be disclosed, but normally we have not been as tight on the commercial in confidence. We find that companies have to disclose to the stock exchange and so we are taking that as a rule of thumb. If all this information is available for reporting to the stock exchange then surely it should be available on the contract.

**The CHAIRMAN** — There should certainly be no less disclosure to the public than is required of the exchange?

**Mr GRAHAM** — Yes.

**The CHAIRMAN** — To follow that a bit further, if in fact it is an overseas company, is that standard to the ASX or what it is required to disclose in its own jurisdiction, because they can be different?

**Mr GRAHAM** — We regard this as a New South Wales transaction and that is not written down as the basis for a legal definition of disclosure. It is a guideline to say we would be expecting this kind of disclosure if you were a public company in Australia. We would expect no less from a government-signed contract that was spending public money. If that is not commercial in confidence from the stock exchange point of view it is not commercial in confidence from our point of view.

There may be some areas there of the micro-level of disaggregation that the company may argue against, that it gives the competitors extra information they may not have had, in which case the aggregation factor could be put looked at and we could say that if you put those three together in one number, you do not disclose that particular item which is of importance to you.

**The CHAIRMAN** — Can I go then to the accounting treatment of the project?

**Mr GRAHAM** — Yes.

**The CHAIRMAN** — There have been various views put to us about the accounting treatment — some people talk about the inadequacy of the accounting treatment or that it needs a new standard development — and we understand that some work is going on towards developing a new accounting standard to accommodate PPPs.

Firstly, can you tell us currently what the accounting treatment would be in New South Wales and whether you have a view about new standards? That is in the public sector. Secondly, is there also a need for a different accounting treatment in the private sector so that the company reports more clearly identify what has occurred as a result of their PPP so the revenue streams or whatever are actually disclosed over there can be seen?

**Mr GRAHAM** — Can I address the first one. Public sector accounting standards will basically be treating privately financed transactions as leasing arrangements. Under the currently agreed standard there are two frameworks. It can be designated as either an operating lease or a finance lease. The technical analysis of that is not straightforward. You can do a number of tests — there is a qualitative test and a quantitative test. The big issue facing the analysis of the accounting treatment is basically whether it is off or on balance sheet.

From a New South Wales government policy perspective we have not taken a position that we are trying to drive these transactions off balance sheet. We have a strong balance sheet, as does the Victorian government; we are AAA rated. We are looking for efficiency savings, productivity improvements, better delivery of service, quality of service and value for money in the transaction. We are treating services at the moment in our preliminary stages

where we are the purchaser of the service — such as schools or hospitals and so forth — as potentially finance leases, so that component would be regarded as the asset.

We are looking closely at the risk transfer associated with that and the degree to which we achieve a major shift in risk. We would argue the balance of the ownership being with the government or with the private sector as being the argument you put forward at the time. It is still those two criteria.

With regard to a new standard, we have been working with the other states through the heads of Treasury accounting framework to try and come up with a standard. The issue we have is long-term leases. These transactions go 20, 25 or 30 years, and even in the private sector these are unique contracts. So we have been looking at an approach that recognises more the risk transfer of the transaction and the underlying principles we are trying to achieve to come up with a better framework to address that part that would be regarded as on the balance sheet and that part that would be regarded as an operating transaction. To the extent that the UK system, FRS5, which is the only international standard available at the moment, sets a framework for looking at that, we have used that as a template to start looking at ways of using that methodology to potentially come up with a standard we could adopt Australia wide.

**The CHAIRMAN** — Where you are purchasing services as part of that deal, say, with yourselves, the provision of maintenance could be defined as the purchase of a service?

**Mr GRAHAM** — Yes.

**The CHAIRMAN** — Will that be shown on budget as the yearly — —

**Mr GRAHAM** — It will be. Our arrangement would be that these contracts require periodic payments, and normally the contract would probably have a total payment that covered the cost of creating an asset and the cost of the recurrent services. We will be allocating to the agencies the full annual recurrent amount once the contract becomes effective. We would be offsetting that against an equivalent budget for the capital amount that would have been pre-programmed in the early years.

**The CHAIRMAN** — We were talking before about the Auditor-General's role in summary contract, and you mentioned in passing to effectively performance audit, that he also has that function, those contracts.

**Mr GRAHAM** — Yes.

**The CHAIRMAN** — With performance audit, is the Auditor-General here able or under the arrangements will he be able to access all documents and others related to that project even though they may be held in the private sector rather than the public sector?

**Mr GRAHAM** — I would have to take it on notice with regard to the private sector. You are talking about his core legislative arrangements. I know that Parliament can request all of the government's documents, and — —

**The CHAIRMAN** — There is clearly no limitation of his power in relation to public documents or public servants appearing as witnesses, or whatever.

**Mr GRAHAM** — I am unsure of the extent to which he can achieve access to private sector documents that go beyond what would normally be available in the transaction.

**The CHAIRMAN** — It may well be argued that every document should be held within the public sector anyway, either as a duplicate or whatever.

**Mr GRAHAM** — The same as we have background working papers, discussion papers, strategies and options, I could see the private sector probably having similar arrangements. Post-event some of those documents are not valid any more because they did not take particular actions that were discussed in the strategy papers. The same on the government side. We may have been organising and negotiating arrangements, so there is a lot of information that people could say, 'You could have done A, B and C'. At the time, yes, maybe they were canvassed. I could see in the private sector similar documents where they would probably not have wanted them disclosed because that would have revealed to their competitors potential strategies that they were able to adopt, or potentially thinking about as well.

**The CHAIRMAN** — That may be relevant up to the time of the bid. It may not necessarily be relevant at a later date.

**Mr GRAHAM** — Correct. I can come back on the legal basis.

**The CHAIRMAN** — It would be good if you could, thank you. The other question I was going to ask you in relation to that was that summary contracts after the contract is signed — —

**Mr GRAHAM** — After the contract is effective.

**The CHAIRMAN** — Effective, thank you. Has your government formed a view on the later release or disclosure of the full contract, say, upon completion of the entire project? So 15 years down the track, when everything is completed, is there a view then about full disclosure?

**Mr GRAHAM** — We have full disclosure. The full documentation is available under a Premier's memorandum. We have taken the view that in terms of transparency and information, sometimes 45 fairly thick volumes are not very transparent to the general public or other people that want to understand the transaction. Our contract summary normally runs to 20, 25 pages and clearly articulates the rights and obligations of both parties. It is an easy document to read. It is written in plain English. It clearly sets out what the financial transaction is, and I find that is a far more transparent and accountable arrangement than saying, 'Well, if you want them, you can go to our web site and download so many volumes of the contracts, and then try and understand how all the clauses come together'.

**The CHAIRMAN** — You actually have both available?

**Mr GRAHAM** — We have both.

**The CHAIRMAN** — That clarifies that for us, thank you.

**Mr GRAHAM** — We have a particular procedure for tabling in Parliament of the summary, but the full documents for those who consider that they really need them, as I say, I think there is a balance between copying a lot of paper as opposed to producing a document that may be this size.

**Ms DAVIES** — The issue of the New South Wales schools intended to be built as PPPs was discussed with the last speaker. One of the issues that I raised was that at the moment with schools being a very grassroots sort of infrastructure a community has a fairly close attachment to its school. If there has been a problem with a school facility there has been a very clear line of responsibility and a process that you go through if the community or individuals within the community have a problem with their school facilities. You go and whinge to the school, you whinge to the region, you whinge to the department, and then ultimately you can whinge to the minister and the government.

Ultimately it is the minister and the government that will be held accountable if the school facilities seem to be inadequate or not meeting the needs. I asked Robert: if it is the complicated financial arrangement between the state and the private sector that has built these schools and is supposedly maintaining them and there is a problem, who do people go and whinge to? His approach was that there will not be those problems. I think that is unrealistic.

Can I ask you what will be the process if you have the contract which has been drawn up by people who are highly technically competent within Treasury or whatever, and they have drawn up this sort of set of requirements, and then when the thing is on the ground the community finds that it is not being maintained the way they want, it does not meet their needs and they want it changed, where is the line of responsibility?

**Mr GRAHAM** — Can I say that your opening summary there described the lines of communications at the moment and the accountability frames, where you gradually work through a process to get to some decision-maker, who may or may not assist you.

**Ms DAVIES** — That is right.

**Mr GRAHAM** — On the schools project there is a clear accountability frame. We have a contract that says, 'This person is responsible for managing and maintaining the school'. He has a relationship with the headmaster, and from the department of education's point of view there is a project director who is appointed who is responsible for administering the contract. There are two points of call — the headmaster and the project director. The project director can then initiate a change through the contract. It is very simple, very straightforward. At the

moment, yes, you would work your way through a complex procedure to try and find somebody that was going to take responsibility for making the change that you had hoped to be made, and it will become part of a budgetary process. What we have is certainty of delivery to agreed standards.

The first test would be: is it to the agreed standard, or do you want something better than what has been provided elsewhere? Obviously there is an issue there of where we have set the standards, and this has been a function of working through with educators, school principals and so forth what is an appropriate standard that we should be trying to write into our contract to achieve a good quality school whereby the teachers only have to worry about teaching — there is somebody else worried about doing everything else. If the window is broken, he comes and fixes it; if it needs painting, he comes and paints it; if the field needs fixing, he comes and fixes it. There is somebody clearly accountable for the school. There is somebody there keeping security. That is transferred risk from the private sector.

So what we have tried to do is say priority 1 it is a school 24 hours by 7. The second priority is community use under normal arrangements. The third priority is the private sector can use the facility after those first two allocations on the basis of an appropriate use. If they have a football field and it is available for football games out of hours et cetera, or they have a gym and maybe the gym is not being utilised, they can hire it out for gym classes.

**Ms DAVIES** — Are they allowed to make money off that community use?

**Mr GRAHAM** — Yes.

**Ms DAVIES** — As a way of increasing their return?

**Mr GRAHAM** — As a way of offsetting our payment. We are buying the service. We are paying for service. So the extent that they can bring in third-party revenues is the extent that they lower our payments for the service they are delivering.

**Mr RICH-PHILLIPS** — Why would they do that? Why would the private operator bother arranging third-party use if the benefit of that third-party use is going to go to the Treasury rather than to the operator?

**Mr GRAHAM** — It goes to the Department of Education.

**Mr RICH-PHILLIPS** — Or to the department?

**Mr GRAHAM** — There is another rule about this. We give the benefits to the department. We do not take them back.

**Mr RICH-PHILLIPS** — That is novel.

**Mr GRAHAM** — The operator may see that there is a part in there that he can avail of as well.

**Ms DAVIES** — Is there an arrangement for the private operator? Do they share any income, or do you get all of it? Does the Education Department get all of it?

**Mr GRAHAM** — Can I say that at this point in time we are still negotiating the transaction, and I cannot divulge fully how these particular revenue-sharing or third-party revenue arrangements are going to come out. What we are trying to do is achieve the best outcome we can, but basically we have said school use is primary use. Community use under normal arrangements is secondary use, and then maybe you can avail of it after that.

**Ms DAVIES** — Can I posit a hypothetical: you have gone through all your risk assessment and everybody has done it to the best of their ability. The arrangement is settled and then there is something which has not been foreseen, for example — and I can think of this as an example — that because the community no longer feels that they own the facility, you have, say, a sudden upsurge in vandalism.

In Victoria, that happened with the ticketing system. There was a totally unforeseen and very destructive campaign of destroying ticketing machines, which obviously added vastly to the cost in ways that nobody had anticipated. Would you expect that, if there was this unforeseen type of additional expenditure needed on maintenance, the private sector would be prepared to wear that on an ongoing basis?

**Mr GRAHAM** — You will have different categories there. There may be a certain type of vandalism that is regarded as an insurable event, in which case insurance would cover it. If it is done during school hours that are

under the supervision of the school, then obviously you cannot hold the private sector responsible for administering and managing the schoolchildren once they have turned the school over to the teachers and the principal. So if the vandalism occurs in school hours, there is a responsibility on the department to say, 'Well, to some extent I have part of this problem'. Now, it is not as straightforward as saying that vandalism is a problem of the private sector or the government sector. You can identify how to share this risk, and under certain circumstances it will be shared. Under certain circumstances the private sector is fully accepting of it and trying to pass it on through insurance, and in other circumstances the government may have to come in and accept that that risk was under its control at that time, and therefore that responsibility rests with it.

**Ms DAVIES** — Do you expect that realistically to be all clear and negotiated out beforehand? To what extent is normal wear and tear of having 800 adolescents all in one building part of the maintenance costs that they have to deal with?

**Mr GRAHAM** — That is part of the risk they have to assess.

**Ms DAVIES** — Isn't there going to be a considerable — —

**Mr GRAHAM** — It is not like these are completely new facilities that nobody has ever operated before. We have a large number of high schools and a large number of primary schools. The private sector has been asked to go out and look at how they operate, to say, 'This is the environment in which I now have to operate. There is vandalism. There is fire. There is theft. How do I manage my process? I am going to be given responsibility for certain of those risk events. Therefore, I have to put in place a management system that is going to try and minimise my cost of those events occurring'.

Equally, those risks you are talking about, we face day in, day out. We insure through the Treasury managed funds. If a school burns down, we replace it. If a school is vandalised, we fix it up. If computers are stolen, we replace them. There is no difference in terms of the operating environment between the private sector taking a contract to fix up and maintain and what we are doing at the moment.

We have maintenance contracts with the private sector to maintain our schools. We do it at the moment. What we are doing is putting the package together. We build the schools, then we issue a contract to maintain them, to paint them, to fix them up. We have security contracts. We have waste disposal contracts.

**Ms DAVIES** — You also have a lot of voluntary labour and parental involvement, so there is a component of each school's facilities which is paid for through voluntary donation and voluntary effort. Do you expect that voluntary effort to continue once this transfer has happened to the private sector?

**Mr GRAHAM** — It is one area where it is hard to draw the boundary line because from one community to the other, the degree of voluntary contribution and what it is made for varies depending on what the local school community wants to achieve. Obviously, where you start affecting the ability of the private sector operator to perform on his contract there will be an issue of how contributions or new assets should be handled, but clearly that is a negotiated arrangement. You have to have provisions in the contract to allow for those kinds of things.

We are not looking to take away the community spirit. This is their school as well. What we are talking about is a management arrangement that tries to achieve a better school outcome for them. To the extent that they can make voluntary contributions to buy computers and so forth, and software, or whatever they want to do with their funds, that would be encouraged as well. So what we are trying to do is not change the schooling environment and the way that parents and teachers operate. We are trying to provide a better school asset that is well maintained, well secured and is a good environment for learning. That is our objective.

**Ms DAVIES** — That has to make a return on capital for the private sector?

**Mr GRAHAM** — That is part of the outcome of trying to provide a better service as well, but that has been matched off against their ability to outperform what we assess it to be at the moment, and that is what we are looking at. Part of the issue is the cost of capital, yes. That is one thing. But if we go out and borrow to build schools, we still have a cost-to-capital argument that is covered by the whole taxation base, and there is still a cost to capital in building schools.

**Ms DAVIES** — But it is not as much, is it, and there are not the costs of the complex arrangements over the 30 years or 25 years?

**Mr GRAHAM** — That is mainly because we do not price in the full risk that has been taken in terms of delivery of the schools. As I say, we self-insure. We have the taxpayers to back us up when there is a big problem. If there is poor performance, we pay for it. If the school is badly maintained, we pay for it, because the general taxation base comes in there, so truly we have not put a true cost of capital approach to providing a school, but equally maybe we should.

**The CHAIRMAN** — That is what the public sector comparator is supposed to do.

**Mr GRAHAM** — That is what we are trying to achieve through the public sector comparator — the way we do it at the moment, in our most efficient way and allowing for risks.

**The CHAIRMAN** — How many schools do you currently have within this arrangement?

**Mr GRAHAM** — Nine new schools — a mixture of primary and high schools, and one special school for disabled students.

**The CHAIRMAN** — And you still have some 2500 or so that are operating in the traditional public sector manner?

**Mr GRAHAM** — Correct.

**The CHAIRMAN** — So I assume that you will do some form of benchmarking that keeps an eye on what is occurring?

**Mr GRAHAM** — We have a continuous rollout program that is part of the Department of Education's forward capital program, and we have used the historical information on building primary schools and a high school to cost out what it costs us at the moment to put a school together and what it costs to maintain it and give the operating service on an ongoing basis.

**The CHAIRMAN** — I was thinking more of the ongoing ones — your maintenance and so on. All those issues you will be able to benchmark against the system as a whole?

**Mr GRAHAM** — Yes, because we have outsourced cleaning. We have outsourced maintenance for a large number of schools. We have outsourced security in recent days. The package we are putting together is that we are outsourcing a large component of that at the moment through competitive tender, so our comparison is a competitive, tendered, outsourced piecemeal versus the packaged approach.

**The CHAIRMAN** — Can I clarify a couple of issues going back a little bit, and then Gordon has a couple of questions before we must finish. You were talking about the contract and that there will be a contact person named for the principal of the school. Is that person named for the individual school in the contract, so whatever it is — Jamesville secondary, or whatever it is — has a contact person specified to it whom the principal can pick up the phone and contact, and is that known to the school council along with the standards that are meant to obtain in relation to the maintenance, et cetera, of the school?

**Mr GRAHAM** — Can I say the precise operational parameters of how that communication would flow through have yet to be finally detailed, but the principal is obviously a key person at the school for controlling the school in school hours. There is a project director responsible for the contract in the department of education. Each principal knows who that project director is. There will be, we expect, a designated person on the private sector side whom the principals will be able to contact. Major issues should have to go back to the project director, who will be a direct person of contact to ensure that they can do what we require under the contract, but the practicalities of working out day-to-day minor things could be done through a help line arrangement. Now everybody is looking at a one call base back to the service centre, asking 'What's your problem?', and having a plumber out within an hour or so.

**The CHAIRMAN** — Will the contract stipulate those sorts of performance standards?

**Mr GRAHAM** — Yes.

**The CHAIRMAN** — That in this event it must be attended to within a certain period?

**Mr GRAHAM** — Yes.

**The CHAIRMAN** — Thank you.

**Mr RICH-PHILLIPS** — That largely covers the areas I wanted to ask you about, but just picking up on the third-party usage of facilities, in April the secretaries of the New South Wales and Victorian treasuries delivered a paper which touched on that area. Firstly, was it envisaged that that sort of third-party use would apply to other private-sector managed projects, or was it just schools that were in the mind of the New South Wales secretary at the time those comments were made? Are you aware of that?

**Mr GRAHAM** — It is a general principle because it is something that the private sector, through its ideas and marketing, may be able to bring to the table to enhance the bid to lower the cost to government. Obviously it has to be looked at in terms of the objectives and the framework that the government wants to achieve and whether that third-party use is consistent with our policy, but if it is and if it can be exploited without compromising our basic service delivery standards, then obviously that is of benefit to the government because it will lower its ongoing costs.

I can think of examples whereby, for instance, you might have a large site; it may not be fully required for what you are after — a hospital, a school or a police station — and a developer might be able to come to the party and say, ‘I have thought about this and I can acquire the site next door, I can take part of your site, I can do a redevelopment here and attribute part of that across here and still deliver your project within the agreed parameters and lower your costs’.

Obviously that requires the private sector to go out and try to structure an arrangement that can produce some value added to the transaction. That is one type of value added. The other type is if you are using the facility for only a couple of hours of the day during the week and it is available for other things, can that be exploited in a satisfactory way to produce revenue that will lower the cost of the service for government?

**Ms DAVIES** — The cost for all of that is that there has been community benefit.

**Mr RICH-PHILLIPS** — Part of the speech that was given in April was a comment that the private sector is better placed to manage that third-party involvement. Is that simply the case because it is decentralised and the private sector operator will be on the ground where the particular facility is and will therefore be better able to engage community, et cetera, in third-party usage? Is that the basis of the comment that the private sector is better able to do it?

**Mr GRAHAM** — I think it comes from a number of factors. One is from marketing or incentives to pursue third-party revenues — and you are right, the private sector may be contracting to try to achieve those. A second factor is that the managing of those third-party revenues is not a core business of most public service agencies, and so the way they run third-party revenues is not necessarily the most efficient way. The third factor is that through innovation and ideas, the private sector may be able to explore and bring to the table something that the public sector may not think of in the way the facility can be used, in the way it can be designed and in the way the site can be reconfigured and so forth.

That is not to say it will necessarily be fully acceptable. All it is doing is giving the private sector the opportunity to look at these arrangements and say, ‘Can I add value to the transaction that lowers the cost to the community?’.

**Mr RICH-PHILLIPS** — Is the public sector culture ready to accept third-party revenues or deal with the issue of third-party revenues, or is the culture still, ‘This is a school and it is for students’?

**Mr GRAHAM** — We can give you examples. We do have it at the moment — for example, they hire out tennis courts for use at high schools, and people pay to use school grounds for fetes, car boot sales and other things.

**Ms DAVIES** — But then the school gets the benefit, so it is to the benefit of the school.

**Mr GRAHAM** — To the individual school.

**Ms DAVIES** — Yes, that is right. In this case it will not be.

**Mr GRAHAM** — No, it will go to the benefit of the department and the whole school system. At the moment yes, you do have inequities in that some areas can raise lots of money for their particular schools and others are not so aggressive at raising their own third-party revenues or exploiting the use of the school.

**Ms DAVIES** — And then there are also some communities where the community itself is able to make use of the facilities and it is of benefit to the broader community where the school has not charged, but under this arrangement that will no longer exist.

**Mr GRAHAM** — No, to the contrary. I said: primary use is school; secondary use is normal community use that would be expected, and if that was free of charge then it will continue to be free of charge. It comes back to this: if the headmaster had negotiated for the local chess club to use one of the rooms for chess playing on the Wednesday night for no charge, that will continue.

**Ms DAVIES** — But there will not be any new arrangements entered into like that, will there?

**Mr GRAHAM** — There can be. We are saying priority use is school; second use is community users who want to use the facilities; the third use is third-party revenues, if they can be exploited after those two are satisfied. The principal will set his forward timetable on an annual basis. He knows what he will be requiring the school for in the next 12 months — council meetings and normal block times when he requires it on weekends for functions and so forth — and he sets that out in advance.

That is done at the moment. The principal will put that on the table to the contractor and say, 'There is my usage for next year and I would like to also reserve this date and this date. Secondly, we have these community groups that want to use the facility at these times and these hours during the year. Outside of that, do what you want to do'. The degree to which you can negotiate the forward program is set up, the private sector operator is aware of it, and then if he can exploit any of those odd blocks that are available, he can use them.

We are not excluding community groups from using school facilities and we are providing common access, but on the basis that they are not going to wreck the school. It would be provided on the normal basis that if they come in and vandalise it or break anything, they would have to take normal responsibility for that.

We are not taking, if you like, the community ownership of the school environment away from the community. We are trying to reinforce it by providing a better quality asset for the students. We are saying that primary use is to provide a good high-standard educational facility; that is our primary use. To the degree that the private sector may wish to exploit a small amount of third-party revenues, okay, but the schools have to meet that primary use first, and we have step-in rights if they do not. Our primary aim is the delivery of a public service, and if they are not doing that we can step in to the contract and say, 'It is our obligation to deliver the public service'.

**The CHAIRMAN** — Mr Graham, Ms Archer, thank you for your time this afternoon. It has been very useful.

**Committee adjourned.**