

# PROOF VERSION ONLY

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

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

Canberra –24 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

Mr K. Davidson, Staff Columnist, *Age*.

**Necessary corrections to be notified to  
executive officer of committee**

**The CHAIRMAN** — I welcome you to the subcommittee hearing on private sector investment in public sector infrastructure. I welcome Mr Kenneth Davidson, commentator from the *Age*. 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 a witness, you will be provided with a proof version of the transcript shortly after this hearing. Mr Davidson, before going to questions from the committee, is there anything you would like to say by way of an opening statement?.

**Mr DAVIDSON** — Yes, there is. I thought I would make a brief statement and point out a couple of directions that I think, in the Victorian context, perhaps you should look at. I will refer to a couple of things here. This publication, *Dissent* magazine — which I edit — is available in the state public library, I believe.

**Ms DAVIES** — I think we have the article, but I ask you — —

**Mr DAVIDSON** — There are a number of articles. I am going to refer to two issues, no. 8 ‘What’s left?’ — not much! — and no. 9, which is ‘Howard’s way’.

**The CHAIRMAN** — I am advised that we have the second but not the first.

**Mr DAVIDSON** — Right. The first point I want to make is that privatisation and its sort of bastard offspring — public-private partnerships — are extremely unpopular. Opinion polls constantly show that 60 per cent to 70 per cent of the electorate is opposed to them, but they seem to be foisted down people’s necks irrespective of whether they like it or not. A good source material on that is an article by David Hayward whom you probably know. He is from the Swinburne Institute for Social Research in Melbourne and I think that is a very good reference. You may wish to call him to give evidence to this committee.

The idea that there are partnerships is a misnomer: they are not partnerships, they are long-term contracts based on a principal-agent relationship. Public-private partnerships are, in my opinion — and I do not think it has been disproved anywhere — simply a more expensive way of financing infrastructure than the conventional way through borrowing. Governments can borrow at about 6 per cent; private borrowings cost an extra 3 per cent to 5 per cent premium for risk. On top of those costs private firms have to pay taxes, although sometimes these arrangements are constructed in such a way that the tax commissioner is cheated, as for instance in the City Link project.

**Ms DAVIES** — Who is cheated?

**Mr DAVIDSON** — Beg pardon?

**Ms DAVIES** — Can you just repeat that?

**Mr DAVIDSON** — Well, the Victorian government has issued what are promissory notes in effect — concession notes is the term used. They say that the City Link partners owe the government — it is about \$50 million a year — in consideration for giving them the concession to run this road, but the money does not have to be paid for about 30 years. Tax postponed is money gained, and it is about \$50 million a year. The time it will be paid, if ever, will be in the future when all of us around this room will be long dead and I would imagine the present-day value of those payments would be in the order of about \$1 million or so — in other words, a trivial amount. However, it is a device to minimise the tax liability of the concessionaires.

These sorts of projects where they involve private finance involve not only higher borrowing costs but higher up-front costs. Because City Link is in effect one of these sorts of projects I had a look at the prospectus last night before I came along. It shows City Link design and construction costs of \$1.2 billion. In other words, if the project had been financed out of current government revenue, the cost of the project, on the figures of that time, would have been \$1.2 billion. The project probably would have been built, the road and so on would have been built by exactly the same people who ended up building it for the concessionaires. There are no gains there, but on top of that is another \$500 million; the prospectus says the total cost is \$1.7 billion. The reason for that extra money is really up-front costs which have nothing to do with building the road per se but rather setting up this operation. The list includes financing costs, consultancy and sponsor recovery costs, legal and listing costs, initial marketing costs, corporate overheads and marketing during construction. That group adds up to about \$200 million. Then on top of that you have capitalised interest expense and equity infrastructure bond distribution at \$240 million. They started paying a dividend on that project from the day construction began. You can see how that loads into the costs.

The investors, according to the prospectus, were promised a return of 19 per cent. I calculated at the time that in order to finance the road this way, irrespective of whether you think you need the road or not, the toll needs to be twice the rate it would have been if it had been financed by the government. That is the cost to the taxpayer and, of course, that is the carrot for the private investors in these sorts of operations. Mr Brumby has said — it is recorded in the *Australian Financial Review*, I think, and various other places — that he intends to spend about \$4 billion on public-private partnerships. Based on an overall return of 9 per cent, which the private partners would require, compared to say the 6 per cent that the government would have to pay on borrowings to finance this, it adds about 40 per cent to the cost of borrowing. That is equivalent to \$1.5 billion and you do not need me to tell you that \$1.5 billion can build a lot of schools and hospitals. The consequence of that is down the track the state will either be paying higher taxes for a quantum of services or it will be getting less services.

**Ms DAVIES** — I was just going to say — is it all right if I interrupt or do you want me to keep quiet until you finish?

**Mr DAVIDSON** — I do not mind.

**Ms DAVIES** — The witness we had yesterday from Boulderstone Hornibrook said that the private sector wanted at least a 13 per cent to 15 per cent return, not 9 per cent.

**Mr DAVIDSON** — That would be 13 per cent to 15 per cent on their equity I suppose.

**Ms DAVIES** — They said 11 per cent to 13 per cent on their capital plus a 6 per cent to 7 per cent facility manager's return so that is actually on top: if they are both constructing and managing, the return that they are after, that they believe very confidently they can get, is somewhere in the order of 20 per cent.

**Mr DAVIDSON** — I would not dispute that.

**Ms DAVIES** — So your assessment is very conservative compared to what has come out of the horse's mouth.

**Mr DAVIDSON** — I have always been conservative on this because the numbers are so big, so mind-boggling that why governments would go down this route, to my mind, just defies the imagination or credulity. I mean, why?

**Ms DAVIES** — The *Dissent* article that we had, is that yours? The one that says, 'Greenfields projects are aiming for 15 per cent to 20 per cent in the early years, falling to 10 per cent to 13 per cent after five years' — that is winter 2002 and that is your article, isn't it?

**Mr DAVIDSON** — Is it my article? This is spring, is it winter?

**Ms DAVIES** — It is winter 2002 — 'What's left?'.

**Mr DAVIDSON** — That is right. There are a number of articles by Nixon Apple, John Legge and myself. One of your witnesses, I think this afternoon, is John Quiggin; he has also written in this winter issue. He will probably cover some of the same areas as myself, but I will try and keep my submission as brief as possible where I think there will be other people covering the same ground. Of course we know that public-private partnerships involve investment in social infrastructure such as schools and hospitals where most of the risks in construction — that is where the risks are because, as I understand it, we are talking about the physical infrastructure, the buildings themselves — relate to the construction period and the state already minimises those risks to itself by contracting these projects out. They are contracted out to the same people who would be used by public-private partners. The only difference that I can see is the difference in the return that is expected on the construction, on the capital involved and, of course, on top of that, the return to equity that the owner expects.

**Ms DAVIES** — Can I just ask you to explain that term 'return to equity'? I keep reading it, but I am just not exactly sure what it means.

**Mr DAVIDSON** — In most projects a private partner would have probably as little equity as he could. If the project was \$1 billion, he would try and have, I would expect, around about \$600 million to \$800 million in debt, the rest would be equity. The return to equity would be whatever he decides is reasonable but, based on Hornibrook, you could say the midpoint would be around about 15 per cent; they might try for 20 per cent if they can get away with it. Because it is private borrowings they cannot pay 6 per cent which the government can, they

have to pay whatever the private market rate is for borrowings and these days that would be in the order of 8 per cent or 9 per cent. You can work out what the difference is there just in terms of the — —

**Ms DAVIES** — The difference between what he has to pay and what he is getting.

**Mr DAVIDSON** — Yes. It would average out over that. However, on top of that there are all those things I listed there for the City Link. You have a whole range of consultants and financial experts and lawyers and so on and marketing people who are brought into this process right at the beginning but who are not required when it is a government project. Here I wish to quote from a paper which was given last year to the Australian Council for Infrastructure Development, which I believe is having a meeting in this building here today; I saw what I imagined was a lot of these people going into the place because of the very expensive suits. This was the paper given in April, a joint paper by John Pierce and Ian Little. I am sure you have this, there was a truncated version of it published in the *Australian Financial Review* after the paper was given. They say that the difference in interest expense and the return to equity is largely artificial because the government does not price risk into the project. I quote them:

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

...

The difference between the private and the public sectors is that private sector capital markets explicitly price in the risk of a project into its sources of finance. This is not the case in the public sector. Instead, taxpayers implicitly subsidise the cost of a project by bearing the risk of cost overruns, time delays or performance failures, which are not priced into the government borrowing rate.

Public-private partnerships involve governments underwriting a stream of revenue over the life of the project, for 20 or 30 years. It is what Christopher Sheil called in a recent article 'the river of gold for which the private consortia is bidding'. They are bidding for this stream of revenue: we build a hospital, you will pay to use this hospital over the life of the hospital for 20 years. Now where does the government acquire the money to supply this river of gold to the public-private partners? I would have thought it is provided — it is a function of its capacity to levy taxes, is it not? The government pays money to the private partners for these services that are given to them out of its tax revenue. Does it not come from exactly the same source that Little and Pierce are complaining of? It does not come from anywhere else that I know.

**Ms DAVIES** — So the argument would be that in fact it is the same?

**Mr DAVIDSON** — Exactly — so what? I mean, the difference between the private and public sectors is that private sector capital markets explicitly price in the risk of a project into their source of finance. What risk do they factor in? Do they factor in the risk that the citizens of Victoria may get an inferior health service? Do they factor in the prospect that the children of Victoria may get an inferior education? No. What they factor in is financial risks and — I am sorry, but I want to read this bit into the evidence, because I think it is important. I am quoting myself here.

The ideology one can hardly call a theory supporting the financial markets is that they serve to allocate risk. Risk in this context does not exclude the sorts of risks that laypersons fret about — life, fire, theft or objects falling out of the sky — but to the financial markets the most important risk is that assets may fall in value, that the investor may regret his or her investment. Whenever anyone buys an asset they lose the ability to spend the same amount of money on a different asset and they become exposed to the possibility that the asset may fall in value. If the asset concerned is a fixed interest bond and, after it is bought, interest rates rise, the bond loses value and the owner may regret the purchase. If the asset is a parcel of shares in a limited liability company, and by bad management or bad luck the company makes losses rather than profits, the shares will fall in value and the shareholder may suffer pangs of regret. How is a school or a hospital like a bond or a share? Does its value change when interest rates do? Do people value their health more when interest rates are low and do not mind dying on a trolley in a corridor when interest rates rise? Only if you believe the value of public infrastructure depends on the state of the financial markets can you believe that the public-private partnerships are an appropriate way of financing it.

Public-private partnerships are more expensive than public provisions. Simply put, this means that people promoting PPPs will be pocketing money that would otherwise be spent on additional infrastructure or returned as tax cuts. It is claimed that properly structured PPPs shift the burden of risk from the taxpayer to the private investor, but it is the valuation risk, not the operation risk, that the private sector accepts. Essential infrastructure such as public schools and hospitals remain the responsibility of the state, irrespective of how they are financed. In other words, the risk that government should be concerned about is a risk which cannot be transferred to the private

sector, unless you think the private sector should be responsible for the education of children in Victoria, not the state.

**Ms DAVIES** — I would like to ask a few questions, actually.

**Mr DAVIDSON** — Yes, sorry.

**Ms DAVIES** — I am sorry to interrupt; it is just that I am conscious of how much time we have. Are there other points that you want to make right now?

**Mr DAVIDSON** — Yes, there are.

**Ms DAVIES** — It is really important that we ask a few specific questions.

**Mr DAVIDSON** — I will just draw your attention to two things, because I think they are two things the committee should look at. These people who promote these projects are never, it seems to me, held accountable for the failures. There are two. One is a clear failure. This was called the accelerated infrastructure, sorry — —

**Ms DAVIES** — The accelerated infrastructure program?

**Mr DAVIDSON** — Yes, that is right.

**Ms DAVIES** — That was in the 1980s, the early — —

**Mr DAVIDSON** — Yes, the Kirner government said, ‘Look we cannot borrow any more; we are going to have this private partner who will be responsible for raising the money for building these hospitals and police stations’. The cost of this project was so horrendous that the Kennett government closed the scheme down at great cost — I think at a cost of about \$66 million. It is all reported here by your predecessors on the Public Accounts and Estimates Committee — and, by the way, one of the people on it is still on this committee, I see, Theo Theophanous, is that right? So he must know all about this; he signed this report. The assets were brought back at a great cost to the state government, and then the current government resold the assets. Now the person who would have been in charge, I suppose, and had carriage of that would have been one of the co-authors of this document.

Now the Auditor-General, commenting on this — and it is all there; it is all a matter for the record, which you can trace through and then ask these people a few questions — said that they had a consultant look at whether they should resell these assets after getting them back. The consultant concluded — this was from the Auditor-General — that there was no clear advantage in the state — that the state’s capital cost of ownership was 6.4 per cent compared with the market rentals of around 9 per cent. In other words, what the consultants said is that the government would be really silly — I mean an asset which was returning you 9 per cent, why would you sell it, if the cost of the money that you got involved in was only 6.4 per cent? But the government rejected the advice because it applied the principle of competitive neutrality, and said that therefore, because of competitive neutrality, the advantage was negated.

**Ms DAVIES** — I would really like to move on, Ken.

**Mr DAVIDSON** — Right, sorry. The other point — and I will not detail it — is the Spencer Street railway station. I mean, if the state was going to build the station out of its own revenue, would it spend \$350 million building a railway station when obviously the services that go through that station are grossly underperforming? The project is a real estate development disguised as a station, where the developers have got the real estate — very valuable real estate at the end of Melbourne — virtually for nothing, and I have said that in the *Age*. Again, in other documents these people say that all these things should be open and that we do all these comparisons and so on — it is in this document. Ask them how these criteria were applied in terms of these projects, because these people are responsible for them. They are actual projects, I am sorry. That is the end of mine.

**Ms DAVIES** — An issue came up, and I do not know who said it, but they talked about the basic reason why the government started doing these privatisations — and now, as you described them, the bastard brother of privatisation, these PPPs — being this public perception that the government cannot go into debt, which has been hammered in over and over again. Now it occurred to me as a result of reading one of your articles that a lot of the money that is being used for these PPPs from the private sector is actually coming from the superannuation funds, the superannuation guarantee — that is this sort of additional capital that is available for investment at the moment — and at the moment that is being invested in a share market which is going down the gurgler. Now given

these rates of return which are guaranteed over extended periods of time by these projects, do you believe the superannuation funds and the public in general would be very happy to invest in infrastructure bonds as a way of financing these new projects, and that the public are saying, 'We want these projects.'?

**Mr DAVIDSON** — If there were a rapidly expanding bond market at the moment, because government was undertaking infrastructure projects financed in the normal or proper way it would have no problem in raising all the money that it would want at an interest rate of around 6 per cent.

**Ms DAVIES** — So you believe the cost would be 6 per cent?

**Mr DAVIDSON** — Well, whatever the ruling long-term bond rate is. It is at around about 6 per cent at the moment.

**Ms DAVIES** — So the cost of the borrowings would be 6 per cent, and you would not have that component of cost, which is these incredibly complex arrangements? Everybody we have heard has talked about the complexity of these arrangements and how vitally important it is to have an adequately resourced and clever public service that is able to negotiate with these very well resourced and very clever private sector people in all these complex negotiations. So if that were done you would not have that additional cost, additional complexity and additional risk?

**Mr DAVIDSON** — No.

**The CHAIRMAN** — Why would we expect the superannuation funds or anyone else to be more benevolent investors than they currently are?

**Mr DAVIDSON** — Superannuation funds, particularly today with share markets going down and so on, are looking for safe investments. It is one of the reasons. I mean, these public-private partnerships are money for jam.

**Ms DAVIES** — Because they are safe investments?

**Mr DAVIDSON** — They are safe investments, and they get a risk premium for a risk which they do not take. I mean, how many investments do you know of for, say, over a 20 to 25 year period where the return is governed by contract? I mean, that is what these contracts are. You do not have the risk of competition, and you do not have the risk of the redundancy of the asset. If, say, you build a school in an area and because of demographic change there is no longer the demand for the school there, who bears the risk? The state bears the risk because it will be paying out the public-private partnership for the next 25 to 30 years. And incidentally, at the end of the period it will not have a school and the public-private partner will have a real estate development opportunity.

**Ms DAVIES** — A lot of these projects are returning to the public sector after the 30 years.

**Mr DAVIDSON** — Well, some are and some are not; it depends. A number of schools are being built under public-private partnerships in New South Wales, and the teachers union cannot find out anything about them.

**Mr HOLDING** — What about the patronage risk for the private rail operators in Victoria, for example? They have not met their patronage targets?

**Mr DAVIDSON** — So the state picks up the bill. I mean, 'Look, we will walk away from our contracts or give us \$100 million as an interim measure'.

**Mr HOLDING** — But where a superannuation fund is looking for an investment and making a judgment about risk and who has assumed the risk, in that instance the patronage risk still vests with the private operator?

**Mr DAVIDSON** — Well why were they given \$100 million by mistake, if that is the case?

**Ms DAVIES** — And they had their targets relaxed?

**Mr DAVIDSON** — There has been a whole series of changes to the condition of those contracts, all to the benefit of the franchisees. I might add that the franchisees paid nothing — zilch, zero — for those franchises.

**Mr HOLDING** — But if you were assessing risk at the commencement of the project and looking at the face of the contract, in that instance you would still be assessing the patronage risk as vesting with the private

operator, regardless of what has happened since, unless you factored in the view of, 'Well, look, whatever happens the government will come at the end and take some action if it goes pear shaped'.

**Mr DAVIDSON** — Well we have the benefit of hindsight, don't we? We know who is taking the risk.

**Mr HOLDING** — The private investor doesn't have that benefit.

**Mr DAVIDSON** — There is no private investor — there is no private investment in Victorian transport. I mean, they are franchisees, they are responsible for operating the services under certain conditions and so on, but all the money that goes into it, apart from a very small amount of its rates and fares, comes from the state.

**Ms DAVIES** — Did they not make an investment in rolling stock?

**Mr DAVIDSON** — Yes, but who is paying for it? The passengers are not — —

**Ms DAVIES** — It is being paid for over the term of the — —

**Mr DAVIDSON** — Whether the investment succeeds or fails in terms of patronage is irrelevant to whether they get their money back. They get their money back because the state pays. The state pays more than half the operating costs and virtually all the capital costs.

**Ms DAVIES** — Ken, have you been following the Seal Rocks issue?

**Mr DAVIDSON** — No, I have not. There are just some things that I cannot — I mean, that is so obvious that it does not need me to — —

**Ms DAVIES** — So obvious as in?

**Mr DAVIDSON** — Well, it is so obvious as in being a scandal.

**Ms DAVIES** — From whose point of view?

**Mr DAVIDSON** — From the point of view of the taxpayers, and I suppose from the point of view of the environment, whichever way you want to look at it.

**Ms DAVIES** — Do you understand how a private company initially investing somewhere between \$12 million and \$17 million in a facility can end up paying out its total expenses estimated so far — not confirmed by the arbitrator — to be around \$60 million. Do you have any understanding of how that could have come about?

**Mr DAVIDSON** — I assume all this is derived from the contracts which were signed in the first place, is it not? Can I just go back to one point in terms of public borrowing. The rate of interest the government pays on its debt is not related to the size of the debt; because we live in a globalised capital market it relates to the global rate of interest plus or minus the inflation rate plus or minus the exchange risk. Australia has probably the lowest level of public debt in the world. It has one of the lowest; it is about 4 per cent of GDP — 4.5 per cent of GDP — which both the Victorian government and this government boast about as being indicative of their good financial management. But the fact is that Australia has the highest official interest rates in the world within the OECD region. The reason is the exchange risk and the running of a huge current account deficit. That relates back through exchange risk to the interest rates. So government borrowings in order to finance these projects would not of themselves make any material difference to interest rates. The \$4 billion in public-private partnerships that the government boasts of is equivalent to about 2 per cent of state GSP.

So state GSP is about 3 per cent now. I think I wrote that down before I came. Victorian debt under the current government — and this is from their own figures — has gone from 3.3 per cent to 1.4 per cent of GSP. Given the felt needs of the community in Victoria and given the opportunities for investment in Victoria, which would yield a far higher rate of return than 6 per cent, I cannot understand why the state government is not using the opportunity to borrow more — and it is all because of a deficit fetish. You can now find increasingly conservative economists who would also take that point of view.

**Ms DAVIES** — Who?

**Mr DAVIDSON** — Don Stammer. There was an article in the *Australian Financial Review* in the last week or so where he said that in the current situation it is silly for governments not to borrow more. I think he is the chairperson of the Melbourne Institute of Applied Economic and Social Research, but there have been others too.

**The CHAIRMAN** — You said you hold the view that the use of ‘partnerships’ is a misnomer. Tony Harris told us he had a similar view about the use of the word ‘partnership’ as being a misnomer, and I think he tended towards the same view as you — that they were really long-term financing contracts and essentially a principal agent.

**Mr DAVIDSON** — And very expensive.

**The CHAIRMAN** — However, following that through, he came to the view that his problem with PPPs was that they restrict private sector involvement. It should actually be wider than that, but he commenced from the same point. He also said in relation to another issue you were raising — that of contracts and the inability of the contracts to meet all of the requirements that you may like to tick off — that his view was that every contract which has been written successively actually builds on the previous one rather than being back at the start. So he argues that each contract — and he was particularly talking about motorways in New South Wales — was actually an improved contract on the one that went before it. So he was arguing that there is an improved practice in these things. I was wondering about your comments on those conclusions. As I say, he agrees with you on the fact of partnerships actually being a financing mechanism. He comes to a different point at the end saying that their real problem is they are restrictive.

**Mr DAVIDSON** — In terms of the nature of the social infrastructure that is being provided, no government — nobody — has the foresight to see all the things that might happen in the next 25 to 30 years. The world could be transformed in lots of ways, so no contract can cover all those contingencies. There is no way the private sector can borrow money as cheaply as government. Even in the most profligate country in the world with the highest interest rates you will still find that within that environment the government can still borrow more cheaply than the private sector. During the so-called worst days of the Cain-Kirner period, when Victoria was supposed to be going broke, the Victorian government could still borrow money more cheaply than BHP, so even though these contracts may be getting better — and with roads it is a much simpler contract — it is still not going to be cheaper to run privatised toll roads rather than public toll roads.

**Ms DAVIES** — One of the arguments that we heard yesterday was that theoretically you borrow cheaper because you are a government, but then what you should do is add in the actual cost of self-insurance and unforeseen changes that have to be made because populations change or government policy changes. Do you believe it would be possible to do the sums over a period of time of how much a public sector infrastructure costs when you add both the initial cost of the borrowing plus effectively the risk management, so what it costs when a school accidentally burns down or what it costs when you did not predict properly and things have changed and you have to change the arrangements? When you add in that amount, do you still believe that that would be cheaper than private sector costs?

**Mr DAVIDSON** — The government self-insures in terms of schools, and quite properly so too. It has all schools all over the state. Perhaps one will burn down, perhaps it will not; that will occur whatever the ownership structure is. But if you have a private-public partner who, say, owns one school, if his school burns down he is done for if he has not got it insured; he has the cost of the insurance and the cost of the money tied up in the insurance, and his risk insofar as fire is concerned is greater than that of the state. Again, this is another one of the comparative advantages, it seems to me, that the state has and why properly it should be involved in these projects. There are no private sector efficiencies that I can see a private operator can bring to a school. You build a school. The school is there. You have a caretaker for the school. You have people come in and clean it and so on. You can contract out all those services if you wish. You can capture the private sector efficiencies via contracting out.

**Ms DAVIES** — Without being tied up for a contract for 25 to 30 years?

**Mr DAVIDSON** — That is right; and at the same time if the demographics change and so on you are far more flexible in terms of switching your investments around; you can possibly use the school as a community hall or something, I do not know. But if a private person owns it there is a specific purpose. It is also 9 to 5; there is a question of what they do with the school after hours and so on. These contracts introduced, in my opinion, unnecessary complexity and therefore unnecessary risk into the project.

**The CHAIRMAN** — Are you aware of the Arthur Andersen study from England that concluded there was a 17.5 per cent saving?

**Mr DAVIDSON** — I have not seen it. Have you seen it?

**The CHAIRMAN** — It keeps being referred to. That is what I was going to ask you. That is why I asked you are you aware of it.

**Mr DAVIDSON** — All these things are said. The comparator is being brought out. There is an old joke about three men who are marooned on an island and all they have is a tin of beans. One is a chemist, one is a physicist and one is an economist. The chemist says, 'We will deal with this. We will put the can of beans in the water. The tin will rust and we will get the beans'. The physicist said, 'No, we will get a rock and we will bash the can until it opens'. The economist said, 'No, no, you guys have got it totally wrong. What we do is let's assume we have a can opener'. What the comparator does is assume there is a 20 per cent automatic efficiency by having things done by the private sector.

**Ms DAVIES** — You mean there is no working out that has been done on that at all? There is no way that somebody can demonstrate that, in fact?

**Mr DAVIDSON** — In all these things the proof of the pudding is in the eating, and if you look at what has happened in the UK with privatisation in terms of the health system, the government has spent more money on health and they have less hospital beds now than they started out with. The way I think of it is this: the reason why people get away with this stuff is it is like tax avoidance. It is a complex industry. It has a language all of its own, which is virtually impenetrable to ordinary people; and it has to be that way, otherwise they would get a gun or some sort of force to get away with it. Think about public-private partnerships this way: 5 per cent on the top. There is an article here by John Nixon Apple which is very good. It is about the 5 per cent club. Let us assume it is 5 per cent. It is exactly the same when you strip away all the comparators and all this language of risk and so on. It is exactly the same as the way the Mafia operates in Sicily. As I understand, public infrastructure does not get built in Sicily unless the Mafia gets a cut off the top. It is as simple as that.

What we are moving towards in Victoria — and Victoria is leading the charge — and the rest of the states is a system where no public infrastructure will be built in this country unless the finance sector somewhere or other gets a 5 per cent cut off the top. Stripped of all the verbiage it is simply a Mafia operation. If these people really believed that was the way to go they would be advocating public-private partnerships for the private schools that they are sending their children to, would they not, if there really were all these gains? I do not see it, and I think they would be shown the door very quickly if they came up with these sorts of projects. But this is the public wheel, it is the public tit, and if you have politicians who are desperate to be seen to be in bed with the big end of town this is the sort of policy you are going to end up with.

**Ms DAVIES** — It is like the privatisation fervour of the 1980s and 1990s. Now PPPs are all the rage; it is the dominant ideology of the moment. There are very few voices continuing to offer any dissenting view. What do you see as being the key element which will show people the truth as you see it if you say that the only reason that governments have been able to get away with this for so long is because of the complexity and the obscurity of the language and the fact that it uses nice fuzzy words that people think are superficially okay? 'That's a fuzzy word, that is okay', like 'partnership'.

**Mr DAVIDSON** — I think it is up to the media and politicians to explain them in ways that ordinary people can understand. That is the reason why you have these sorts of inquiries. That is the reason why in my spare time I do something like this, but I think that it would be better understood if some of these projects that are already in place were examined. Why not?

**Ms DAVIES** — Which ones?

**Mr DAVIDSON** — There are two — there is the accelerated infrastructure one and Spencer Street.

**Mr HOLDING** — You have been critical of the information that has not been made available in relation to the assumptions that you would want to have access to in order to be able to make a judgment about some aspects of the Spencer Street project. Which information would you be seeking to have available and what sort of processes can be put in place to make sure that in relation to these projects in the future someone who is like a reporter looking at these sorts of things from your perspective can then make a judgment about whether or not the public interest is being served?

**Mr DAVIDSON** — The first thing you do not do is mix up a railway station redevelopment with a real estate redevelopment. Untangling that is the first step. I basically said that what this is — I can say it here — I think is a scam which essentially gives a large area of land at the top end of the CBD to a group of developers for between \$60 million and nothing.

**The CHAIRMAN** — Is that not, though, a transparency and accountability issue? If a government says, ‘We want to do that, but as part of that we are also going to allow this’, what I am saying is, is that not really an issue of transparency and accountability rather than an issue that is implicit in the nature of the agreement or the nature of the transaction?

**Mr DAVIDSON** — I am not sure if I understand the question.

**The CHAIRMAN** — It is not a factor of the financing, that is what I am saying; it is a factor of other things and about transparency and accountability.

**Mr DAVIDSON** — Yes.

**The CHAIRMAN** — Not about the financing structure?

**Mr DAVIDSON** — There is no way if the state said, ‘Look, we want to build a railway station in Spencer Street, and we are going to spend \$360 million on it’ — I think from memory that is the figure that I came to — that anybody would agree with that given what is needed, say, in terms of regional trains which were promised in the last election and now the promises have been recycled again apparently. You would have the trains before you refurbished the station, I think. The other thing is if you decided that it was in the interests of Melbourne to redevelop that — it is a very large block and I do not have the figure in my head — you would properly put it out to a tender. You would have some very clear idea of what sort of development you would allow there and what you would want and then you would call for expressions of interest, and I am sure you would get expressions of interest that were worth more than — —

**The CHAIRMAN** — And essentially that is what I am saying to you — that is a legitimate public policy decision.

**Mr DAVIDSON** — Of course.

**The CHAIRMAN** — It is the transparency and accountability area. I thank you for making your time available and in fact shifting your time to accommodate us.

**Mr DAVIDSON** — It has been an advantage to me, because I am now about to drive to Melbourne.

**The CHAIRMAN** — Thank you very much for your attendance.

**Witness withdrew.**

# PROOF VERSION ONLY

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

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

Canberra – 24 October 2002

#### Members

Mr R. W. Clark  
Ms S. M. Davies  
Mr T. J. Holding

Mr P. J. Loney  
Mr G. K. Rich-Phillips  
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Executive Officer: Ms M. Cornwell  
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#### Witness

Professor J. Quiggin, Australian Research Council Senior Fellow, School of Economics, Australian National University.

**Necessary corrections to be notified to  
executive officer of committee**

**The CHAIRMAN** — I welcome Professor John Quiggin from the Australian National University 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 a witness you will be provided with a proof version of the transcript shortly after the hearings. Professor Quiggin, before going to committee questions, would you care to make a brief statement to the committee?

**Prof. QUIGGIN** — Thank you, Mr Chairman. Thanks to the committee for taking the trouble to come to Canberra to listen to witnesses. I would like to speak fairly briefly about the main points.

First, I would like to refer to the phrase ‘public-private partnerships’, which is one of the many phrases that have been used to deal with this kind of arrangement, and make the point that in a mixed economy — an economy in which both government and the private sector are engaged in the provision of goods and services — some form of private-public partnership is inevitable. There is a boundary between the activities of the private and the public sectors; however you describe that, it is clear that interactions of one form or another are going to take place either through markets or through contracting arrangements. That said, I am concerned about some aspects of the proposals for private finance initiatives and public-private partnerships that have been proposed in most Australian states recently, developing on earlier sorts of initiatives along the same lines but drawing largely on ideas developed in the United Kingdom. My biggest concern is that the policies are being politically marketed on one set of grounds while they are being advocated by economists on another totally different set of grounds.

The political case for public-private partnerships, in any popular discussion of them, revolves around the notion that by entering into these sorts of arrangements, governments can get public services delivered without incurring debt. It is fair to say that no serious economist — whether in favour of these arrangements or opposed outright to them or whether they take a mixed view — would take that argument seriously. Indeed, when looking at the documents prepared by the Victorian Treasury on public-private partnerships, I could not find any mention of public debt.

When you look at the kinds of criteria for entering into these schemes, the impacts on public debt and the various cosmetic effects of these arrangements are not mentioned at all and their focus is entirely on getting the allocation of risk right; yet if you read a newspaper reference to these reports, it would be extremely rare to see a statement that governments are interested in public-private partnerships as a means of efficient allocation of risk. Almost invariably these reports say they are interested in them as a means of reducing debt.

**Ms DAVIES** — Would that be because people do not understand them or just turn off?

**Prof. QUIGGIN** — I think it is because there is a big concern about public debt and there is obviously also a necessity to deliver public services, and for the last 15 years governments have been looking for better but also easier ways of solving that problem. Ultimately, one way or another, public services have to be paid for either by the users of those services or through taxes. In most cases, in one form or another, governments are going to be providing the collection mechanism, whether it be through taxes or through specific user charges like road tolls. Government has never liked that, and governments throughout the world and in Australia have therefore been under particular pressure in the last 15 or 20 years. So the political appeal is the apparent ability to do this without taking on a debt and without explicitly — in some cases not at all — spending public money. Of course that is particularly true in states like Victoria and South Australia, which have experienced a lot of political dispute over levels of public debt and concern over public debt in the past.

**The CHAIRMAN** — As part of that argument, are you differentiating between different types — for example, between the privatisations that took place in Victoria, where there is a very clear change of ownership and an actual sale and payment and so on, and where there is an effect on the debt that is shown on the public balance sheet? Would you differentiate between those?

**Prof. QUIGGIN** — Yes. In both cases there is some degree of misleading, in the sense that although, of course, debt has been reduced there has also been a reduction in income-earning assets, but there is still a very different case. In the case of privatisation we are giving up an asset and reducing a debt; in the case of public-private contracts we are simply taking on the same debt in a somewhat different form.

**The CHAIRMAN** — Is part of the differentiation that there is a clear — or clearer — accounting treatment, so you can actually see the transaction on the public balance sheet?

**Prof. QUIGGIN** — Certainly over the years we have substantially improved the treatment of privatisations and asset sales in the public balance sheets, so that when the first privatisations were undertaken the treatment was very bad indeed and the money was simply treated as if it were tax revenue that could be spent in the same year. I can quote Bob Hawke, for example, saying, ‘We can sell Qantas and spend the money on single parents’. Where you are selling an income-earning asset, that simply is not correct. But over time we have improved that, first by using underlying measures of budget balance and then by making the move to accrual accounting. But both in the public and private sector we have the problem that with obligations that are essentially debts by their nature, taking on long-term leases with commitments to make payments a long way into the future can be kept off the balance sheet. That has been misused.

**The CHAIRMAN** — That is the point I was coming to: they may not be shown either on balance sheet or on budget.

**Prof. QUIGGIN** — Exactly.

**The CHAIRMAN** — If they were shown on both, or if there were an accounting standard that required that they be shown on both, what does that do in terms of the argument?

**Prof. QUIGGIN** — Then it improves the transparency of the process and that leads to better decisions. Looking in retrospect at build, own, operate and transfer (BOOT) schemes, which are a very similar sort of thing, we can see a number of very bad investment decisions which were made because the schemes were represented in such a way that it appeared the public was getting something for nothing. Not only did the private operators build the assets, but they gave them back to the public at the end of 30 years. On a superficial account that looks like a deal that is simply too good to refuse; of course such deals do not exist. What happens is that the cosmetics of the deal take over in the formulation of it, so you get bad investment decisions and bad allocations of risk in the pursuit of a deal which looks good for all concerned. In some cases like the very early ones, such as the Sydney Harbour Tunnel — Tony Harris might have mentioned this — the deal was so fraudulent that the Auditor-General demanded that it be unwound and shown as a publicly owned asset on the books.

So yes, I have recommended that states should adopt an accounting treatment in which the obligations associated with these proposals are treated as if they were interest to be paid on debt and valued in a similar fashion, and if that were the case then we would have a much better chance of picking out those projects which offer genuine economic benefits as opposed to those which are simply there to make the public sector books look good.

**Ms DAVIES** — We had some discussion yesterday about recommendations of different accounting standards or better accounting standards, given that there seemed to be an absence of that. Do you have specific recommendations that could be made for how these arrangements should be properly accounted for?

**Prof. QUIGGIN** — I should say I am not an accountant, but I understand the theory.

**The CHAIRMAN** — I would not ask you to write an accounting standard.

**Ms DAVIES** — No. I mean, do you have any specifics that you believe should be written in?

**Prof. QUIGGIN** — I would refer you to the International Standards Board, the main international body, which has been considering for some time a private sector treatment of leases, because Enron and the telecommunications companies are examples where these lease obligations have caused significant problems in the private sector. There is an accounting standard under development. That is some way off so there is not an ideal answer, but it certainly is an issue that is being actively explored and is widely recognised as a problem in an environment where generally more aggressive approaches to accounting have started to be adopted in both the public and private sectors.

**Ms DAVIES** — Do you believe there is evidence that the type of arrangement that is happening in Victoria or New South Wales as far as PPPs are concerned is similar to the sorts of leasing arrangements undertaken by Enron and other failed multinationals?

**Prof. QUIGGIN** — Enron, of course, undertook large-scale fraud, and I certainly have no evidence to suggest that is happening, but it is similar in the sense that the motivation is to enter into a transaction because it will make the books look good rather than because it is an economically sound transaction is clearly there.

**Mr HOLDING** — You are saying that the budget papers in Victoria do not reflect that because they are driven not by on-budget or off-budget paper considerations but rather by things in relation to risk allocation?

**Prof. QUIGGIN** — Not the budget papers, but the Treasury documents setting out the criteria under which these projects should be entered into speak exclusively about risk allocation. I have some criticism of the specifics of the way they have argued that, but it is clear in principle that they are exactly right. That is the right principle for deciding where the boundary between the private and the public sectors should be drawn.

**The CHAIRMAN** — There are issues about that?

**Prof. QUIGGIN** — There are issues about that. When the debt is not a simple fixed annual payment there are complicated issues about the way in which you value a debt with some underlying contingency. But the base point is that the criteria that Treasury says it is applying have nothing to do with public debt; the public debate is all about public debt. That is precisely the situation of the US firms that engage in aggressive accounting in the sense that their business, after all, is to make sustainable profits in the long run, but these transactions have been entered into with the purpose of making the books look good in the short term.

**The CHAIRMAN** — But of course in the case of Enron there was also significant fraud involved.

**Prof. QUIGGIN** — That is quite true. I certainly have not seen anything of that kind, but it is a generally bad practice to engage in transactions where the motive is cosmetic. As we have seen, the Enron frauds were made possible because everybody knew that these aggressive accounting practices were being pursued.

**The CHAIRMAN** — That leads me then to the other part of the question I was asking. We were then talking about, if you like, a government accounting standard that would make clear those elements of it, both on balance sheet and on budget. In the private sector — the other half of the partnership, if you like — there is no accounting standard that requires the private sector to identify the revenue stream in their accounts.

**Prof. QUIGGIN** — That is quite right. There are problems with some of the things that have been described such as — I think the term is now a bit out of fashion — financial engineering in some of the deals which the private sector has marketed. I have concerns about that from the point of view of whether the investments that have been marketed are as sound for the individual investors as you might like. But there is certainly a big problem when you have two parties who can decide essentially inconsistent treatments of the same data. Of course, again, the Telecom example provides that, where you had in that case matching transactions but each side put the profits or the revenues up-front and left the cost to come onto the balance sheet over a long period. I have not looked in detail at the way in which the private parties have done their accounting, and of course historically there have been problems with commercial confidentiality.

**The CHAIRMAN** — They tend to aggregate their revenue, such as the case you were mentioning, the Sydney Harbour Tunnel.

**Prof. QUIGGIN** — It is very hard to work out what is going on there.

**Ms DAVIES** — John, there is a lot of discussion about the public sector comparator which, as far as I have been able to work out, nobody is actually sure of. It is like a complicated mathematical formula, and I do not know what it is made up of. Do you feel you know enough about what is in that public sector comparator? What sorts of questions need to be asked about that? We have heard some people say that the Victorian public sector comparator is very favourable to the private sector. Do you have any view on that?

**Prof. QUIGGIN** — I am better informed about the UK one, which has been in operation for a long period, and it is clearly unsatisfactory. It is clear that the comparisons are indeed weighted in favour of the private sector, both in terms of the criteria but also in terms of the clear political message that is given to those undertaking the review, that if they do not come up with the answer that the private sector project is the right one, they will get no project.

**The CHAIRMAN** — You are saying there, if I can paraphrase you, that it has a weakness both in parts of its structure and also by political direction?

**Prof. QUIGGIN** — That is right. I have seen some examples of clearly unsatisfactory projects — hospital projects — and the relevant member of the Labour government said, ‘Well, I’m sure if you asked the people they would have preferred not to have a hospital at all’, which is a very clear ex-post statement that obviously in those circumstances no-one is ever going to find the superiority of the public sector comparator, because it will not get built.

**Ms DAVIES** — But in Australia, in the examples we have heard about in Queensland, New South Wales and Victoria, treasuries have not said that; they have said there will be a choice to go with the public sector, if the public sector comparator comes out that way. So forget that particular argument that has been a weakness of the UK ones, what about the public sector comparator itself?

**Prof. QUIGGIN** — Sure, okay. There are two big problems in the public sector comparator as I have seen the arguments, for example, in the Victorian Treasury documents. The first relates to what happens in relation to wages and conditions. It has long been an issue in the context of competitive tendering and contracting that it seems very easy in the short run to get substantial cost reductions but on inspection a lot of those cost reductions turn out to come from the fact either that people have been paid low wages or that there has been an increase in work intensity in the sense that the same number of people with the same tools are being asked to do more work for the same pay, or to complete more work. A third possibility, of course, is changes in service quality, and I have looked at all those things. Most of the comparators take a pretty optimistic view of the efficiency benefits of private sector delivery.

**Mr HOLDING** — How do they do that?

**Prof. QUIGGIN** — The late Som Sonderberger, a colleague of mine, popularised the view that there was a 20 per cent cost saving associated with competitive tendering and contracting across the board. That cost saving explicitly included reductions in wages and conditions, and he was quite clear about defending that as a potential source. The Australian practice in terms of industrial practice has been to say, ‘This is not a legitimate or allowable practice’, and I think in economic terms it is clear that it is not a saving to society, it is a transfer from one group in society to another.

**Mr HOLDING** — Can you explain to the committee how PSC manifests that 20 per cent assumption into its consideration of a project?

**Prof. QUIGGIN** — As I understand it the public service comparator includes an assumption that the public sector will — and these are of course projections, and as I understand it they include an assumption that the public sector will be less efficient in delivering actual services than the private sector.

**Ms DAVIES** — But that is not worked out, that is just stated, this assumption that they will be 20 per cent more efficient?

**Prof. QUIGGIN** — I looked at a number of different states but 20 per cent is the actual figure. If you look at the kind of evaluations that have been done by the Productivity Commission and other bodies, the 20 per cent has been widely used — —

**The CHAIRMAN** — I think the question that Tim is asking though is: if we go to the actual construct of the PSC where do we find that in the construct?

**Prof. QUIGGIN** — I must admit that it is a while since I have been through the details, but of course there has to be an estimate, and I think you will find in the estimate that there is an assumed efficiency benefit. That has to be imputed because we obviously do not actually have the public sector comparator to apply. Of course we do not have sufficient historical experience to do anything, so it is an imputed figure.

**The CHAIRMAN** — Would not the person arguing against that — say, Treasury or whatever — say that if that were the case, no project would ever be done within the public sector, yet there are many projects still being carried out within the public sector?

**Prof. QUIGGIN** — There are various factors. Firstly, of course, we have not seen systematic applications of these things. If you take reasonably reputable advocates of the likes of Gary Sturgess, who was a senior officer of the Greiner government and is now working for Serco in the UK, I think he would argue very strongly the position that the public sector should be completely out of the business of providing goods and services.

**The CHAIRMAN** — I accept that many people argument that, and indeed Tony Harris argued to us yesterday that the problem with public-private partnerships is not that they involve the private sector, but they actually restrict the private sector. So there are people — I accept what you are saying — that do argue that there should be far greater involvement, but the question I was asking was: if we say the public sector comparator is automatically and unrealistically biased against the public sector, how then do we explain the cases where the public sector still carries out the project?

**Prof. QUIGGIN** — I must admit I have not got a lot of historical experience. There has to be a private component. Let me step back: there are a number of issues that come up in these evaluations and there are a number of potential biases. I think the majority of biases tend to be against the public sector. I will mention the second major one which relates to cost of capital, and this is controversial — —

**The CHAIRMAN** — We did actually interrupt you, you only got to one — — .

**Prof. QUIGGIN** — There is an ongoing controversy within the economics profession as to whether the costs actually paid by the public sector to put greater interest on government bonds is the correct cost of capital to the public sector or whether we should impute a higher cost, not the cost actually paid but a higher cost, in effect to wipe out an apparent source of cost advantage to the public sector by making the public sector bear the same costs in this respect as the private sector would. I have argued this is a real cost advantage — I have argued that at length in the submission and I will take questions on that — but I make the point that when I made this point people came back at me with the precise point, ‘If this is true, why doesn’t the public sector win everything?’.

If we look at actual projects, the private components are expecting a rate of return substantially above the bond rate and in some cases above the rate of the cap-in model that is going to be used in the evaluation of the private sector comparator, and that will also support it. That may be the one reason you may find that even the biased section of the public sector will come out ahead. There are a number of points on which I agree with Treasury on the allocation of risks and that leads to the conclusion that there are projects better suited to the public sector than the private sector, as you would expect in the context of a mixed economy.

So, for example, the more policy and regulation risk there is, the less willing the private sector is going to be to invest in a project. While there is indirectly some hint that public sector projects should also be regarded as subject to regulation risk, I think that is mistaken. Nonetheless the allowance is likely to be a good deal less than the premium a high-risk investor would require for a project where there is a substantial risk ... It is quite possible even with bias in a project, given that there are some areas where the public sector has a very clear advantage — and other areas where it has a clear disadvantage — that is reflected in the fact that we see much of the same break-up of public and private sector activity throughout the world as we are going to see even in a biased process of evaluation. We are not going to see results coming out 100 per cent one way or the other.

**Ms DAVIES** — Can I ask you about risk allocation that everybody keeps talking about? It has been suggested that there is a very major risk for the public sector in entering into long-term arrangements with guaranteed rates of return to the private sector, that that in itself is a very major risk for the public to take on? Do you see that as in itself a dangerous risk that can be avoided by other more traditional financing methods?

**Prof. QUIGGIN** — It is certainly true that inappropriate contracting creates risk where it was not existing previously. If, for example, you take on a guarantee when the risk is under the control of the private sector contractor, you are creating a risk that was previously internalised, and obviously you are going to pick up a concern that there is going to be a loss; some of the big contracts in the past have fallen into that. The old cross-cost style contracting that the public sector used to undertake was an example of inappropriate risk application, that the risk that something would go wrong in the construction was taken on by the public sector when it should have been left to the private sector.

**The CHAIRMAN** — The argument put to us in Queensland was that that risk was always there and often realised, but was never allocated against the project as such. You actually had, if you like, a miscalculation of the project costs because the risk was never added on to it. They gave the example particularly in the contract area that you are talking about of inappropriate contracts; their argument was that even under traditional procurement there were some very poor contracts written which exposed the state significantly and ultimately led to blow-outs in the project or to significant legal expenses, but many of those risks which actually resulted in a cost did not end up being allocated against the project itself and so gave it the skewed view of traditional procurement.

**Prof. QUIGGIN** — As I say, I very much endorse the general principle that the ... document states. There have been big improvements in traditional public procurements over the years. If we were comparing ... and public-private partnerships proposals being put up today behind the public procurement practices that were standard 20 years ago, you would find very few cases where you would want to go with the old system.

**Ms DAVIES** — Are there improvements that you can see that should be in those Partnerships Victoria documents that are still not there? Are there detailed listings that you think should still be there?

**Prof. QUIGGIN** — I think there were wrong principles.

**Ms DAVIES** — Which ones?

**Prof. QUIGGIN** — In particular clearly incorrect is the suggestion that whether demand is coming from the public sector that nonetheless there should be an attempt to shift that risk onto the private sector contractor. That is a very strong straightforward violation of the stated principles that risk should be best apportioned to the party — and if, for example, the government is going to be the one to decide what hospital services are going to be provided and where, they should write a contract which ensures that the cost of that is borne by themselves and not by the contractor. If they do shift they will be paying a premium in the price of the project which will more than offset the benefits.

**Ms DAVIES** — Can you think of any examples?

**Prof. QUIGGIN** — A very specific example that has been made very clear is the art ... projects. That point has been made repeatedly not only by myself but by the Productivity Commission and the House of Representatives committee — and Tony Harris has been very strong on it — the idea that you allocate a variable revenue on a road to a corporation, the only way they can do it in essence is if you have more toll collectors. All decisions on that road are going to be made by the state government. It is simply a token mistake on the calculation of risk and clearly inferior to a ... contract in which the ... enterprise is handed over with or without a toll — —

**The CHAIRMAN** — Would you also agree with Tony Harris — and I think he starts off with the end four in sight, or something — in saying that in his view that was a very bad deal and he then goes through, I think, in ones, twos, fives or whatever from there on. He postulates that each contract began at the end point of the previous one so that each contract, in his view, improves on the one that came before it.

**Prof. QUIGGIN** — One could argue that the Sydney Harbour Tunnel ... in a sense that the cosmetics were so great that it really was a piece of traditional public sector contracting procurement wrapped up in ... Yes, there have been steady improvements and I think it is fair to say that those have slowed. As the contracting procedures have improved, the enthusiasm of the private parties to enter into deals have tended to — —

**Ms DAVIES** — Are there any examples in Victoria that you can think of that are the equivalent?

**Prof. QUIGGIN** — City Link is a — —

**Ms DAVIES** — Do you see that as a bogus?

**Prof. QUIGGIN** — It is not a bogus; a bogus is a misallocation of risk. If you look at the present value of tolls that were required to induce Transurban to go into it, they announced \$4 billion when the project cost was about \$2 billion. So because Transurban are unlike ... there are very genuine risks but they are demanding a substantial premium. In addition to that ... is also a public policy cost which is that decisions that ought to be left for future governments are being taken in advance in order to make a contract reasonable for the parties. I am not blaming Transurban for that. If I were making decisions I would be demanding those guarantees as well. It clearly meant that you had bad public policy. It is particularly inappropriate in the context that in general governments find it very difficult to bind themselves to public policy. What we get is one set of policy decisions going far into the future that have privilege, for example, over legislation, over election commitments and over all sorts of obligations because there is a contract that exists. These commitments are much more binding than any of the other commitments that a government is in a position to make.

**Ms DAVIES** — Do you think that the current ... list of Victorian documents would stop, and are sufficient to stop, the misallocation of risks that happened in a project like City Link?

**Prof. QUIGGIN** — I think there are significant problems particularly here in the allocation of demand risks for government procurement to the private party. That is essentially what happens given that that is a stage in the contractual arrangements.

**The CHAIRMAN** — In the case of City Link or ... in Sydney, and I understand the contracts are roughly equivalent, can some of the demand risks be dealt with by windfall clauses? I understand there were not windfall clauses in either contract.

**Prof. QUIGGIN** — Windfall clauses certainly shift the risks and presumably match them ... Obviously there is guaranteed payment ... If the contract called for a fixed set of annual payments, it is just like ...

**The CHAIRMAN** — I take your earlier point that it must be on budget.

**Ms DAVIES** — Is part of the reason that it is so attractive to the private sector that it is virtually a guaranteed revenue?

**Prof. QUIGGIN** — No, this is why ... What you had in the earlier deals is what appeared to the private sector taking on whereas they were getting guaranteed payment probably at a higher rate of return than they would have got if the character of the transaction had been recognised as a bond. These deals have been hugely profitable not in terms of the long-term economic profit but in terms of the immediate benefit to the parties undertaking negotiations — obviously entrepreneurs looking to negotiate deals of this kind, so they have been very keen to respond to criticism in a sense that each deal had to be agreed and designed to insulate against the criticism made of any previous deal. In some respects they have taken the notion of this transfer too far, that is what it is all about, and transferred risk that should have remained with the public sector.

**Ms DAVIES** — They failed once — public hospitals that had to be taken back over.

**Prof. QUIGGIN** — That is a further issue that has come up in a number of these things. It appears from the documents — and you could argue this to a certain extent about the public transport contracts in Melbourne — that the public sector has walked away from the deal entirely, that if the company goes bankrupt that is their loss, but the public sector is no longer involved just as, for example, when the government sells a clothing factory or something, if the factory closed down in five years time, that is pretty sad, but there is no issue. But, of course, in the case of a hospital that is not the case.

**Ms DAVIES** — Or public transport?

**Prof. QUIGGIN** — The government simply cannot say, ‘The market was broken, we are sorry for the customers and for the company’.

**The CHAIRMAN** — Is that not an issue of identifying the risk?

**Prof. QUIGGIN** — It is.

**The CHAIRMAN** — That risk in the example you are talking about — it is also not the same on every project you do?

**Prof. QUIGGIN** — No, it is not.

**The CHAIRMAN** — On some projects that risk may actually be minimal for a government.

**Prof. QUIGGIN** — Quite so.

**The CHAIRMAN** — You could well walk away without any ...

**Prof. QUIGGIN** — As a general principle ... If the contract was such that the government would be willing to contemplate the closure of a business at some point in the future with no public replacement, I would not see this as a general rule, but that is a pretty good guide to things which probably can be — —

**The CHAIRMAN** — I am pretty sure it was Tony Harris — and somebody could correct me — who proffered the theory that much of this was about an imbalance of negotiating skills, and there was the one occasion when the New South Wales government brought the Transfield negotiator and put him on the government side of the table, and they actually got the best deal they had ever written, which was on Homebush Stadium. He says that has left the government in a terrific position with that stadium. How much of that is a factor of being able to identify the risks correctly and then being able to negotiate a contract according to your risk assessment?

**Prof. QUIGGIN** — I think a great deal of that. That is why I am so strong on the issue of getting the debt out of the way. When you have negotiated with a party that you know is desperate to deal, you are going to get very favourable arrangements. If the parties are superficially talking about this transfer whereas in fact we know that one party is desperate to get the debt off its books, of course it is going to get a very bad deal.

**Mr HOLDING** — This goes back to comments you made in your opening remarks as well as some of the things you said in your submission, and this goes to the nature of the things that I guess the public sector does well versus the nature of the things that the private sector does well. You mentioned in your submission the experience of the Second Fleet coming to Australia, that it was a privately run enterprise with reference to the number of convicts who died. You then mentioned the number of state-run butcheries in Queensland in the early 20th century.

In both instances I took it that you were basically saying there are things that inherently the public sector is good at while there are things that the private sector is good at. Can you provide the committee with some guidance or information on your views about which sorts of projects have attributes that lend themselves to a partnership between the public and private sectors in terms of the committee being able to look at things and make judgments about what sorts of characteristics a project ought to have to make it inherently favourable to going down that path?

**Prof. QUIGGIN** — I will start by looking at things that should be in the public sector and things that should be left to the private sector, which will give the committee some guidance. Yes, public-private partnerships are going to be a mixture of those things and the object is to get the balance right. A first point is whether you are dealing with customer focus, or what the political scientists call voice. So if basically the issue is that you have complicated demands out there, and that comes through the cash register and you respond to that, the private sector is very good at that. On the other hand with some sorts of services that does not work very well. What you need is for people to have a voice through government or through consumer advocates to get behind the services they want.

**Mr HOLDING** — Do you mean like fashion?

**Prof. QUIGGIN** — Yes. Where people are concerned with things like fashion, the whole processes of the public sector are not designed to respond to that kind of thing, and restaurants would be an obvious example. On the other hand where it is difficult for people to make their concerns felt, simply by taking their business elsewhere — for example, the education of school children — —

**The CHAIRMAN** — Or the health system.

**Prof. QUIGGIN** — Yes, then you want something where people are responsive to some sort of process. Where the private sector has gone into that has been typically in non-profits where it has spent a long time building up the same sorts of relationships with its clients or patrons as the public sector has, so the competition has not been between profit-oriented firms. Responding to customers, whether you call them clients or students, and parents in that sort of capacity has been the focus. That is the first criterion — that sort of fast movement response to markets as opposed to accountability through, broadly speaking, political processes, including those of community organisations.

The second is capital intensity versus labour intensity. In general the public sector, I have argued, has cost advantages in raising capital. On the other hand historically it has had cost disadvantages in relation to labour for a variety of reasons. Both those differences tend to erode a bit and become blurred, but certainly historically that is the case, and it is still significant.

The third is all the various categories of market failure that lead governments to intervene in things, so monopolies, externalities, and so forth. The more the government is going to be dealing with the business, regardless of whether it is in public or private ownership, the more regulated risk there is going to be and the more concern there is. The advantages are simply taking the whole project into the public sector and internalising it. I think monopoly is one kind of example. If we look at the question of what happens if we get regulated electricity prices wrong, in New South Wales what happens is that the New South Wales government — say, if they are too high — gets too much money in tax revenue, New South Wales consumers pay too much; they are the same people, so really getting that decision wrong is not a matter of great moment. Although, of course, the corporatised companies do their lobbying, it is a relatively civilised process because at the end of the day no fundamental transfer of wealth has really taken place.

In Victoria the same decision, if it is too high, means a transfer of large sums of money from Victorian households to foreign companies. If we look at the case where it is too low, one way or another the New South Wales government is going to ensure that the investment takes place, whereas, of course, if the prices are set too low in Victoria, then the return is not going to be sufficient to attract investment. There are arguments going the other way, but certainly that concern is one that suggests if you are primarily going to be the recipient of regulated prices, and you cannot guarantee what those prices will be a long distance into the future, then that is a case for public ownership. Similarly, where there are large-scale environmental concerns or other sorts of concerns that will keep the government regulating this sort of enterprise more closely than the general run of occupational health and safety and Corporations Law that applies to all companies, so that it is going to be tightly regulated, again that will be an issue.

Finally, of course, if you are providing services and the demand is determined by discretionary public policy decisions, again that is a proper argument for keeping things in the public sector.

**Ms DAVIES** — Like schools and hospitals and police stations and things that change with government and with fashion and with trends?

**Prof. QUIGGIN** — Yes.

**The CHAIRMAN** — Within that do you discriminate between the delivery of the service and the structure in which the service is delivered?

**Prof. QUIGGIN** — The crucial question is long term versus short term — for example, there are arguments in favour of and against contracting out the cleaning of police stations or hospitals, but it has been clear — —

**The CHAIRMAN** — Or the building.

**Prof. QUIGGIN** — The construction of the building, certainly. This is one area where I am happy to be reasonably definite and say the best procedure for buildings is a stand-alone contract in which the building is built and then handed over to the public. I think it is a mistake, even if there are to be private operators in there afterwards, and we lose transparency by trying to bundle the construction and the subsequent operation into a single phase.

**Ms DAVIES** — Yet that is a very clear priority of both New South Wales and Victoria.

**Prof. QUIGGIN** — It is.

**Ms DAVIES** — They want construction, maintenance, and long-term servicing all in the same bundle. Whereas originally the main argument for this was that it was cheaper for the private sector to do it, over the last couple of days we have heard less arguments about that. It is more in terms of it being good to have the maintenance managed by the person who built it because it is in their interests to build it properly in the first place so as to reduce their maintenance. So they are talking about their being benefits of having it bundled and you are actually saying there are benefits in not bundling.

**Prof. QUIGGIN** — I draw a distinction between maintenance and operations.

**The CHAIRMAN** — That is what I was asking you: what you are defining as operations?

**Prof. QUIGGIN** — Sure. There is indeed a case for bundling in looking at the extent to which the maintenance is largely fixing up things that went wrong, or the extent to which the maintenance costs are significantly affected by the construction process. But that typically does not relate at all closely to the actual services that go on in the building. That is the standard practice of the private sector. They might well hire the building firm to continue doing the construction work subsequently, but they would be very unlikely to hire the same firm as their building manager, or to get them to provide accounting services and so forth and a range of other ancillary services in the same building. So there is a case for some maintenance being tied into the construction contract, but as soon as you move significantly beyond that you are losing transparency rather than gaining it. You are running the risk that costs will be shifted from one part of the operation to another and so you cannot really tell whether you are getting good value for money.

**Ms DAVIES** — Does that mean effectively all you are doing when a government enters into one of these long-term contracts, or their department or whatever, is that instead of the government supervising the letting of the contract to do the building and then the letting of the contract to do the maintenance and the letting of the contract to do blah, blah, blah, you are effectively paying another layer of management on the top because that is all they will do. They will not do the work themselves either. So what you have done is instead of having the public sector up here, and those who are actually doing the work down at the grassroots, you have another layer of administration and profit taking and organisation and complexity, which is the private sector manager of the financing arrangements, the construction arrangements, the maintenance arrangements, and all the rest of it. You have created another layer of costs.

**Prof. QUIGGIN** — That is precisely right, and in fact in many of these cases — —

**The CHAIRMAN** — But that is not necessarily so.

**Prof. QUIGGIN** — It is because — —

**Ms DAVIES** — It must be. They do not do all that themselves over a certain period.

**The CHAIRMAN** — Your public works department would be removed.

**Ms DAVIES** — We have not had a public works department for a long time.

**Prof. QUIGGIN** — Let me go back. I will start at what I call modern public procurement, which is a term key contract, possibly allowing for some maintenance. Bundled into the same contract is a whole bunch of ancillary services that would normally be provided by a combination of building manager but possibly also in many cases a lot of the ancillary staff services. Then, of course, there would be costs. It is not that we are adding something and not taking anything away, but we are putting a layer of private sector contracting between the public and what they are getting.

**The CHAIRMAN** — That is right.

**Prof. QUIGGIN** — It is not so much the cost, but the loss of transparency.

**The CHAIRMAN** — It is not necessarily that there is no corresponding recommendation.

**Prof. QUIGGIN** — No, there would be.

**The CHAIRMAN** — You can argue about the level.

**Prof. QUIGGIN** — What we are doing is outsourcing. But in terms of the classic distinction that is frequently made between steering and rowing, what we are doing is outsourcing the steering. If you take the principle that the public's business is to get the best value for money, it is highly unlikely that will be done by doing it on a building-by-building basis, outsourcing the outsourcing, which is effectively what has happened when you do this contract. Indeed, typically there is no benefit to integration, because the construction firm typically tries to sell on as soon as possible. As soon as it has finished the building it tries to sell on.

**The CHAIRMAN** — In some ways that becomes an argument for doing the entire school system that way so you are only dealing with one rather than a number.

**Prof. QUIGGIN** — Certainly my view would be that there is a far stronger case for outsourcing the entire road system than there is for doing individual contracts for individual roads. If you had one company that owned all the roads, it would indeed be internalising a lot of risks that are currently in the public sector. It would be making a lot of decisions. Clearly when you have an integrated system and you start contracting out individual bits of that system, you are creating risks that did not exist previously.

**The CHAIRMAN** — Thank you, Professor Quiggin, for making the time available to come and meet with us. It has been useful to the committee.

**Witness withdrew.**

# PROOF VERSION ONLY

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

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

Canberra–24 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 M. Watson, Group Executive Director; and  
Ms T. Long, Director, Performance Audit Branch, Australian National Audit Office.

**Necessary corrections to be notified to  
executive officer of committee**

**The CHAIRMAN** — I welcome Mr Michael Watson and Ms Tina Long. All evidence taken by the 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. Mr Watson, would you care to make an opening statement to the committee before going to questions?

**Mr WATSON** — Yes. By way of background, I am in charge of the financial audit for the Australian National Audit Office, and Ms Long is an audit manager on performance auditing. In the financial context we are more concerned about the accounting arrangements prevailing with the financing arrangements that particular bodies enter into. We are not so much concerned about the value for money type of issues, which are covered by our performance audit people. The commonwealth hitherto has not had a lot of application with what we called PFIs — private financing initiatives. The ANAO has done two audits on information technology outsourcing and property sales, which involved elements of lease transactions. That is the opening statement.

**The CHAIRMAN** — Thank you. Perhaps you can go straight to the issue you raised about, rather than accountability mechanisms, the accounting treatment. Is there in your view a need for a new or different accounting standard in the public sector which will ensure that any public-private partnership is shown both on balance sheet and on budget? Are the current accounting standards sufficient to deal with the new generation of PPPs as they are now being expounded?

**Mr WATSON** — On a statement of principle, there are 45 accounting standards that regulate the accounting arrangements for all entities — private sector and public sector. We have a commonwealth framework that picks up the core framework and takes into account all of those standards. The particular accounting standard we have at the moment is accounting standard 17, dealing with leases. That covers the lease accounting requirements with financing arrangements, and in my view it is quite satisfactory and reasonable regarding arrangements entered into by the various entities.

Depending on the way the lease transactions are defined — that is, operating leases as opposed to financing leases — you then come into this area of the off-balance-sheet type of transactions. There is a view unfolding in the accounting profession that they want to move away from the off-balance-sheet type of transactions to put them all on the accounts, depending on when the lease classification occurs. So the profession itself is moving somewhat towards getting everything on balance sheet. If that were the case, then the lease accounting arrangements would have to change.

**The CHAIRMAN** — I know we are dealing somewhat in the academic because there are very few PPPs that have been pursued so far within Victorian jurisdictions, but is there, at least in theory, a proper way in which they are accounted?

**Mr WATSON** — If in fact you do take the view, as some commentators see it, that they are not in fact partnerships in the traditional commercial sense but rather are financing leases, the answer is that there would be a view because this will depend on what the risk is. If you define where the risk is you treat it accordingly, but if, later on, you find that that view is not a shared view, and depending on some subsequent incident that unfolds, then in the legal construct it is different to what was being thought about, and this will give rise to the need to get this off-balance-sheet type of arrangement put on. It is all tied up with debt financing and gearing and this type of thing. If, for example, we were talking about renting something, then that has a clear message that I am just paying for the use of something, but if it unfolded that the risk was really with me as distinct from with you, then the whole accounting should have been done differently so all those costs that hitherto I have just picked up as a rental cost are sitting somewhere else but in effect they are with me. Therefore it then comes down to the issue of why we have put it that way, and there has obviously been some issue in terms of the definition of that arrangement. So if the lease standards can be simplified to take that away then you get a much clearer position.

**The CHAIRMAN** — I guess the proponents of the argument for a new or a clearer accounting standard put forward the argument that the current generation of public-private partnerships are stated to be motivated by risk and allocation of risk rather than by transference of debt; therefore, if it is about that, clearly they should be shown somewhere. That is the basic argument. Is that a view that broadly the audit office would accept? I understand we are talking in the hypothetical here.

**Mr WATSON** — I think the answer would be yes. If the substance of the transaction is the way you describe, then that has to be portrayed properly on the accounts rather than in some sort of distortion.

**The CHAIRMAN** — Can I take you into a slightly different area but still on accounting treatment, and ask whether the office has a view about whether the accounting arrangements on the private sector side of the partnership are adequate for disclosure? It has been put to us that at the moment if an interested person wanted to follow the revenue stream, it is very difficult to do so through the private sector accounts; it is not shown.

**Mr WATSON** — I do not think I could comment on that. The symmetrical relationship between a commonwealth account or balance sheet and the private partner — we do not really look at the private side.

**The CHAIRMAN** — Even though that is a payment of government money?

**Mr WATSON** — You initially asked the question about whether we have a view on the private sector, the accounting treatment in ABC Company's accounts; we do not really go into that.

**Ms DAVIES** — You don't even go into that if — —

**Mr WATSON** — That is what I was trying to get to initially. But in terms of — —

**The CHAIRMAN** — I was asking in terms of having a disclosure regime that is fully transparent. Do you lose some of that transparency if the regime is only applied to one part of the partnership?

**Mr WATSON** - In concept the answer would be yes, you probably would lose the transparency.

**The CHAIRMAN** — To take it a step further, the question is whether the accounting treatment shows the payment from governments sufficiently. And then I guess the other side of that is: in the private account, the revenues are clearly stated as well as the transfer from the government.

**Mr WATSON** — In construct that should be the way it would unfold, but again whether the transaction is shown clearly in the government side depends on what we call the lease classification. Where this becomes involved is that when you look at a government set of accounts you have your standard balance sheet and statement of financial performance which is prepared in accordance with the accounting framework, particularly as applied to AAS 17, and there are rules about risk transference, value streams and all those types of things to give you the answer of whether it is a finance lease or an operating lease, and then the accounting takes over. Then when you get to the government budget, and the GFS — government finance statistics — and the national account, depending on the way this is unfolding you get different descriptions in there. It is all tied up with fiscal balance and those types of issues.

**The CHAIRMAN** — Can I take you then to the next issue, and that is the audit office role in a public-private partnership — where it might appropriately commence and what it should be? There are a number of stages going through — the preparation of the public sector comparator, the application of that to a particular project,; the tender process and the completion of the tender. Should the audit office have a role there, or is its role properly or post-completed tender?

**Mr WATSON** — The response from the ANAO would be ordinarily that we have commonwealth policy principles for private financing, so the Australian National Audit Office would always take that policy as given and see whether or not it had been faithfully executed and faithfully applied in practice. I would believe after that tender is struck.

**Ms LONG** — Those sorts of issues would normally been looked at on the performance audit side of things, and our policy has been with trade sales and privatisations not to actually get involved in a transaction until it has been completed.

**The CHAIRMAN** — I understand that, and generally in most jurisdictions it has been a retrospective look rather than a concurrent — —

**Mr WATSON** — Yes, and when we do look retrospectively at those sorts of things — private sector comparators, discounters — all those types of things feature in the performance audit analysis, and these sorts of reports go through a lot of that type of issue, so there is a complete accountability of the process.

**The CHAIRMAN** — So would your post-audit then go to things like: had the public sector comparator been correctly constructed; were its assumptions correct?

**Ms LONG** — Yes, that would be one of the things we would look at. As Mr Watson was saying, we have not actually had a private financing transaction at the commonwealth looked at, and we have not done detailed planning on how we would do an audit should one occur, but we have got some similarities we can draw from audits we have done in other areas, such as in outsourcing arrangements, assessment of sale of properties, trade sales of government business enterprises like the old gas fleet et cetera. In those audits one of the common themes we looked at was the substance of the risk allocation within the deal that was finally struck and whether that risk allocation was appropriately accounted for on both sides of the business case.

**The CHAIRMAN** — How did you do that? What was your methodology?

**Ms LONG** — It depends on the transaction, so in a way it depends on how it has been constructed. For example, in the audit that we did of the information technology outsourcing initiative we looked at four of the tenders that were let under that particular initiative, and one of the stated objectives of that initiative was the achievement of savings. An important element of it was constructing a business-as-usual case and separately looking at the tenders that you actually received from bidders and comparing the two, and looking at the methodology that was used to do that.

A couple of the issues that that arose in that audit were the proper identification that the bidder's proposals actually represented finance leases in our view for the equipment such that the commonwealth retained the risks associated with loss of residual value and basically guaranteed that residual value to the bidders if the contract was terminated, or pure PCs, whatever were needed. That manifested itself on both sides of the business case: on one side in calculating what was the actual cost associated with striking a contract with a particular tenderer, that obligation to basically keep the tenderers whole. They had a book value of dedicated equipment and they were basically guaranteed return of that book value, which meant that basically the commonwealth's obligation was the difference between that book value, whatever it may have been at the time, and the proceeds of any sale of the equipment — so the difference between the fair market value of the equipment and the book value of the equipment. That particular obligation, that cost, was not taken into account in the evaluation, and we looked at it and saw that that would have had a material impact upon the evaluation of the value for money associated with that contract.

The other aspect associated with that was because of this low risk associated with the leases that the vendor was carrying they were able to therefore present lower prices in terms of the specified evaluation period because they could push that residual value obligation out and it was not considered in the actual evaluation.

One of the aspects of the business-as-usual side of the business case, which is similar I suppose in a lot of ways to a public sector comparator in a private financing, was a requirement to apply competitive neutrality adjustments to the costs that would have been outlaid by the agency to simply continue doing it themselves. The principal one of those was attributing a rate of return requirement to the agency. The principle behind that was that the bidders would have been needing to earn a rate of return on the capital that they invested in the equipment, and so you apply the same to the agencies to get a competitive neutrality.

The issue that we identified in that regard was that the risk premium that was basically attributed to the agencies in calculating that rate of return did not take account of the fact that the vendors actually had a lower risk profile associated with that particular part of their bids, and so we thought it was inappropriate to assume that the weighted average cost of capital you would apply on the agency side would be at that higher risk level. We thought it should have been at a lower risk level — the risk-free rate plus some smaller risk premium. Again, applying a lower risk premium in attributing a rate of return to the agency side of the business case shifted the value-for-money considerations.

**Ms DAVIES** — Do you know of other cases where that has been misallocated as well so that the private sector has been able to say, 'Well, we are coping with a higher level of risk and therefore we are going to get a premium', but in actual fact when you do the sums you realise that they are not actually coping with that risk at all? That was the information technology outsourcing. Are there any other cases?

**Ms LONG** - Yes, I suppose there are two that come to mind. One is the one that Mr Watson mentioned, which was an audit we did on the commonwealth program of property sales. A clear element of that process was establishing a hurdle rate, as in a rate of return that a property had to demonstrate in order to continue in ownership. If it did not receive that rate of return it was to be sold. There were issues that we identified in that audit in terms of identifying what was an appropriate hurdle rate of return to set. Again, the issue that was associated with that was that these were long-term commonwealth occupation leases representing low risk and yet a quite high rate of return hurdle was set to achieve the number of properties that would be put up for the sale. So again that issue came

through of identifying an appropriate risk premium when in trying to attribute what rate of return you should be gaining from a commonwealth house.

**The CHAIRMAN** — So was your assumption that the elements of the comparator were not right or that the elements were all right but the way in which the application was done was wrong?

**Ms LONG** - It is more towards the latter — the methodology itself was probably flawed but the concept was correct.

**Ms DAVIES** - So do you think there are sectors now in Australia or elsewhere that have got both the methodology and the application right or is it always going to be an inexact exercise?

**Mr WATSON** — I think that we do not really have the experience to answer that question. We do not know about the other sectors. The rigour with the methodology is the answer to the question, and that depends on each particular case you get to.

**The CHAIRMAN** — Did you actually look back at that, with the rate of return calculation, and ask them where they got that from?

**Ms LONG** — Yes. In both those cases we sought to identify the basis for the methodology that was actually applied and the professional advice that might have been obtained as a basis for that.

**The CHAIRMAN** — What was the offer in relation to that? In your view it was clearly out. What was their explanation in relation to the way they had obtained that figure?

**Ms LONG** — I can give you copies of both those audit reports and from that you will be able to see that those particular findings were not agreed by the relevant departments involved. We put forward our findings, and we made recommendations along those lines, but the department involved did not agree.

**The CHAIRMAN** — Within that then, did they actually offer their explanation of how they constructed it?

**Ms LONG** — Presented in the audit report is the information they gave us or we were able to obtain from the fieldwork we undertook. There are slight differences between the two audits to the extent to which there was a direct response by the department to those particular findings.

**The CHAIRMAN** — I am not trying to — —

**Mr WATSON** — No, no. All we used to do was say what the departments said — —

**The CHAIRMAN** — I understand that. I was just wondering what explanation they offered as to, for example, your view that they were 2 per cent out or whatever on that calculation. They must have had an explanation.

**Ms LONG** — I think the general answer to that would be that they were acting on advice received, and they still considered that advice to have been correct.

**The CHAIRMAN** — Reliable advice. You will get suggestions that some of these figures are plucked out of the air.

**Ms LONG** — I could not comment on that.

**The CHAIRMAN** — I am not asking you to comment.

**Mr HOLDING** — Mr Watson, you had in your hand before the commonwealth policy principles for the use of private financing. I wonder if you could tell us a little bit about that document. Firstly, that document is obviously not an Australian National Audit Office document, that is commonwealth policy. What did that policy come into effect? When was it introduced?

**Mr WATSON** — As we talk — June 2002 it has been signed.

**Mr HOLDING** — Did that replace a previous policy or is this the first-up version of that, if you like?

**Ms LONG** — I believe that is the first.

**Mr WATSON** — That is the comprehensive policy instructed from the bottom up.

**Mr HOLDING** — If the commonwealth were to go down the path of attempting a private finance initiative or a public-private partnership that is obviously the document it would apply to assessing it, and the document you would look at in terms of establishing whether or not it was consistent with policy et cetera. How does that policy compare to the Victorian document?

**Ms LONG** — I have had a bit of a look at the policies put out in other jurisdictions. I think it would be fair to say that there are considerable similarities in the important principles espoused in terms of value for money being the underpinning principle, transparency, accountability. They are all very similar in those regards.

**Mr HOLDING** — Does the document provide a good basis for protecting the public interest? You would be satisfied from an ANAO perspective that that document is a sound document for the development of public —

**Mr WATSON** — As I said, we take the policy as given, but my reading of this document in coming to it is it does reflect the sensible, prudent way to go with this type of arrangement. However, as I said, the Auditor-General's office would always take that policy as given and make sure it had been consistently and faithfully applied. We are talking about things like risk sharing, innovation, better asset utilisation — that is what this particular policy document encompasses.

**Ms DAVIES** — So there is no real close effort made to look at other jurisdictions and learn lessons from other jurisdictions?

**Mr WATSON** — As I said, on the financial side I am more concerned with the way the transaction is described and whether it is appropriately represented in the accounts. Our performance audit people really have a look at the value for money and the management practices associated with the project. They invariably have to make judgments and critique judgments about risk transference and the like. As Ms Long was saying, as part of their reference points obviously they would take account of other jurisdictions, but we always come back to the principle of the guiding principle being the commonwealth documentation in the particular area in which we are interested. I mean the ANAO has, in our language, better practice guides, so if we are actually going to come up with better ways of doing things we will come up with types of better practice guides that cover the more progressive types of findings in other reference points we look to. If we think they are sensible then we make recommendations that the commonwealth consider the adoption of those. Is that —

**Ms DAVIES** — yes.

**Mr HOLDING** — Perhaps this is a question for Ms Long in her capacity of involvement with the performance auditing side of it. We took some evidence on Tuesday which suggested that there was more work to be done in some jurisdictions in relation to the probity auditing or probity oversight side of the development of some of these sorts of initiatives. The idea was talked around, if you like, of the possibility of the Auditor-General's office in one of the states being involved in some way in terms of potentially playing something of a probity role. In terms of some of the transactions or some of the activity that you mentioned earlier, is there a need for a greater focus on the probity auditing side of it? Is there more work that needs to be done there in terms of developing systems and processes for addressing that side of some of these transactions, given their complexity?

**Ms LONG** — The IT outsourcing initiative had a probity auditor appointed, and that was one element of what was looked at in that particular audit. Again, I can leave you with an audit report on that. What we identified in that particular aspect of the audit was basically pointing to some lessons that need to be applied in future tender process in terms of having clarity about the role of that probity auditor, particularly in regard to the type of sign off that is going to be sought at the end and therefore making sure that the tasks that are carried out throughout the actual tender process itself are aligned with being able to provide the level of assurance you are actually going to be looking for at the end. That was looking very specifically at the role of that particular probity auditor under that particular consultancy agreement in that particular initiative. We are currently finalising a performance audit on the probity aspects of a subsequent tender in that particular initiative, and that report is as a result of a request from the Senate committee that actually did an inquiry into the initiative and requested the Auditor-General to conduct an audit. That is looking more closely at probity auditing in general as well as in specifics in regard to that particular tender. That report, which will shortly be tabled in the Parliament, will draw actually on other jurisdictions as examples of good practice in that sort of area. I think we will have more to say on that after that report is tabled.

**Mr HOLDING** — Is it your view from that experience, particularly with what you have said about the IT outsourcing side of it and the experience that you had in investigating the probity auditor's role and the consistency between the sign off and the duties and stuff during the audit, that there is no role for the Auditor-General's office pre-emptively or during a process like that, or is it your view that it would only be after the event?

**Ms LONG** — The Auditor-General has had requests for probity auditing services, and they are considered on the merits at the time. However, I think as a general rule the office is concerned to ensure that there is no later conflict in our capacity to appropriately audit the transaction and all the actions that were taken in the transaction. That is a material consideration for us in considering whether we would be involved in providing probity auditing services to a particular transaction.

**Mr HOLDING** — Do you ever provide advice to departments or agencies on probity auditing? Would you ever put yourself in that position?

**Mr WATSON** — Hitherto I do not think we have. Just on the general question of advice — —

**Mr HOLDING** — If an agency came to you and said, 'Look we are running this transaction, and it is complicated — —

**Mr WATSON** — As I said, this question of independence and the objectivity of it, that is one of the articles of faith; we really honour that, and we have to be fairly careful if we do give some pre-emptive advice, to use your word. On one hand we want to be progressive and support reform, on the other hand we have to be detached and objective ordinarily. If we do do that sort of thing, we have to look at a particular case on its merits. If we were to do it, we want to make sure the different agencies do it. A recent experience: in charge of the financial auditing, with this pre-emptive issue that you talked about, we will often think about that, because at the end of the day we do not want a transaction entered into that is, for want of a better word, not efficient and effective, because it is really not going to help the government, or help the cause of anybody.

When the PFI for patrol boats was being thought about very seriously by the Department of Defence, it came to us and asked us to look at the particulars of the issue. Again we went to the argument about finance lease versus operating lease, which is rental versus on-balance sheet versus off-balance sheet, where the risks and balance of risks lie and that type of thing. So we gave some advice on that particular transaction or the particular arrangement they were thinking about. It was a big arrangement with big dollars over lots of time frames and there were some very complex — some of the sorts of questions you have been asking us today — issues in that.

**The CHAIRMAN** — One of the previous witnesses — I think it may have been Bob Sendt, the New South Wales Auditor-General — put to us that he drew a clear distinction between probity adviser and probity auditor in these processes. I think he said that his view was that most of what we are calling probity auditors in this are actually probity advisers and are part of the transaction team and are employed in that way, and that he would have a real difficulty being in that position because it may clearly compromise his ability to audit post the — —

**Mr WATSON** — I think that we would agree with that, as in the auditing construct as well. That is why we — —

**The CHAIRMAN** — But if that is the case, then how do you get a probity auditor of note on the project, using his differentiation between the two?

**Mr WATSON** — I guess the probity auditor would have to come from what is called the departmental side of the issue, that they put some objective, independent third party on the process, as distinct from the external auditor, given that article of faith about the independence not being compromised.

**The CHAIRMAN** — My follow-up question to that is: given that these days you probably have the big four firms, I think?

**Mr WATSON** — Yes.

**The CHAIRMAN** — We are down from the big six, it is the big four — and they are probably the places where you would seek that sort of expertise?

**Mr WATSON** — That is right.

**The CHAIRMAN** — But as they are probably also the places that are advising each party to the transaction, how do you get this independent auditing advice.

**Mr WATSON** — I suggest as a general observation that they have particular specialisations within their various practices, and again part of the language you will hear from the private sector is the Chinese wall. So if you get the investment strategists from Ernst and Young, for argument's sake, or Pricewaterhousecoopers, that is clearly separated within their practice. That is a view — arguably there is not a shared view about that, but that seems to be the push back you will get, the language you will get back from those firms.

**The CHAIRMAN** — They believe it will set up appropriate — —

**Mr WATSON** — Yes, and then they keep it separate and different. In relation to your question, Ms Davies, about the patrol boats — no, they did not proceed with that financing arrangement.

**Ms DAVIES** — Can you tell us the specific reasons given?

**Mr WATSON** — I do not know.

**Ms DAVIES** — You do not know?

**Mr WATSON** — I do not; I cannot really say that, no. But one of the arguments would be: where does the risk lie? When you get into particular assets, the nature of some assets can lend themselves to operating-type rental arrangements and operating leases; some of the other particular natures of assets make it a very involved policy issue, especially with military-type assets.

**Ms DAVIES** — Yes; you would have to say that the risk is always going to stay with the government.

**Mr WATSON** — That is part of the issue by the Chairman earlier on. In the accounting arrangements — I talk in very simplistic terms for clarity — with an operating lease I go and rent that off you and I pay a fee for it, that is it. But all the ownership issues — the maintenance, the insurance — that is with you, let's be clear about it. But sometimes that is not as clear as what people think it is. So if you have an incident that breaks, it is really with — yes, and that depends on where the balance of this lies, the premiums that you pay for that type of thing.

**Ms DAVIES** — Do you have a general rule or a general concept of whether risk can be effectively transferred? I mean, we understand that there are some risks that can be and some risks that cannot be. Do you think that that can be satisfactorily worked out ahead of time? Or do you think that it will always stay fairly inexact? My particular concern, I suppose, is with long-term arrangements and whether it is really genuinely possible over a long term to satisfactorily work out where risk really lies.

**Mr WATSON** — There are two answers to that question. This comes back to Mr Holding's question about at the front end of that transaction there has to be clearly understood agreement about where the risks lie and the benefits that are involved. I think — I am not trying to be evasive here, but that really at the front end of the transaction is a function of experience and judgment; where you get your order or your specialist coming to that argument and then you have the reference point to say, 'Yes, we are clear'. But like everything, as that unfolds, depending on the way that contract is struck, the legal implications have to be clearly understood.

**Ms DAVIES** — Do you have some examples of — —

**Mr WATSON** — As I said, the only two that we — —

**Ms DAVIES** — Successful ones that — —

**Mr WATSON** — No, the commonwealth at the moment has not really got into any PFIs. We have the two we brought up today — the government IT outsourcing and the asset sales program. As I said, the one that I was involved in from an accounting advice perspective was military assets — where does the risk lie with that ownership?; and questions of insurance. We had a view about that, and some of those things are quite complex.

**Ms DAVIES** — The complexity is where the more complex the arrangement, the more difficult it is to say that it is transparent so that enough people can understand it to make a sensible judgment?

**Mr WATSON** — Yes.

**Ms LONG** — I think the other issue that we have noticed in regard to that is, particularly for complex contractual arrangements, making sure that both parties have the same understanding of what the deal actually is.

**Mr WATSON** — Yes.

**Ms DAVIES** — And that they keep that understanding for the 25 or 30 years of the arrangement?

**Ms LONG** — That is right; indeed.

**Mr WATSON** — That is right.

**Ms LONG** — With a large contract over a long period of time corporate memory can go, and suddenly the deal becomes something quite different after a few variations.

**Ms DAVIES** — That is an additional risk that actually needs to be factored in from the start as well?

**Ms LONG** — Yes. Ongoing contract management is something that we have looked at quite a lot, and if the commonwealth were to go into a private financing arrangement it would essentially represent another large contract, and those same contract management issues would apply in terms of — —

**The CHAIRMAN** — It is not a unique group?

**Ms LONG** — No.

**The CHAIRMAN** — And particularly in the military area?

**Ms LONG** — Indeed.

**The CHAIRMAN** — Where you have many contracts that are spread over a long period — take, say, the F111 contract or the Collins class submarine contract, which is an example of a traditional procurement contract, I suppose, that went horribly awry and resulted in a lot of litigation. That sort of thing can still exist within a traditional procurement method?

**Mr WATSON** — Exactly, yes. I mean, the capped expend in the commonwealth Department of Defence is, say, two and a half billion. Most of that is done by direct procurement, so all the project management risk attached to that procurement is clearly there, and they have what we call a long-tailed business, so some of that stuff can go from zero to 20 years and managements can come and go. So the discipline is the standard of project management being employed by the department, and some of that could be outsourced in particular contracts. Irrespective of that, you still have those same issues, and whether or not that was then under a financing arrangement, the same behaviour and characteristics would apply.

**Mr HOLDING** — Looking at a lot of these transactions — you have mentioned a couple already — and perhaps drawing on the experience in terms of the advice you were able to provide to defence about the patrol boats, do you believe departments retain sufficient expertise — maybe defence is a particular separate case because of capital procurement being such a massive part of what they do — to be able to successfully manage a document like the principles contained in that document? Is there the expertise there, particularly with the huge turnover in staff that has occurred in not just the commonwealth public service but in public services across Australia?

**Mr WATSON** — Again, not trying to be evasive, the answer is it depends. It depends on the subject matter experts that reside currently in departments, and in construct there would have to be some, and if there was a shortfall then they would obviously avail themselves of some subject matter experts from the private sector.

**Ms LONG** — I think the Auditor-General has made some observations in the past that that is a risk area and an increasingly important risk area with a number of activities being contracted out, outsourced, or whatever variety of peculiar activity is going on. So I think it is an issue of ongoing importance.

**Ms DAVIES** — Can I ask if you believe it is a myth that governments can borrow more cheaply than the private sector, or do you think borrowing is actually cheaper — —

**Ms LONG** — In fact if you go to our principles, the commonwealth private financing principles make the point that it is generally more expensive for the private sector to raise capital through private capital markets than for the commonwealth to do so directly, and as a consequence of that — —

**Ms DAVIES** — So you accept that that is the case even when you factor in self-insurance or other things? It is just cheaper?

**Ms LONG** — That is the view, and as a consequence of that I was just going to point out that the principles make the point that arrangements which involve little or no transfer of risk — for example, a finance lease — are unlikely to provide government with value for money given the relative costs of capital. So the commonwealth private financing principles have identified that as an issue.

**The CHAIRMAN** — I was going to ask you again, that document is the commonwealth government document, not the ANAO document?

**Mr WATSON** — No, no.

**The CHAIRMAN** — I just wanted to get that clear that what you are quoting from is not an ANAO document.

**Ms LONG** — No, it is the policy document put out by the Minister for Finance.

**The CHAIRMAN** — What you are quoting is the commonwealth government position?

**Mr WATSON** — Yes, because the audit office does not make policy. We make sure the application of it is consistent with what is stated.

**Ms DAVIES** — I do not know if this is an appropriate question to ask you, but you can always just say, ‘No, it is not’, but do you believe that governments would be able to raise funds through infrastructure bonds in a way to fund public infrastructure?

**Mr WATSON** — We are not really going to comment on that. It is a financing efficiency argument. We do not really come into that from our perspective.

**Mr RICH-PHILLIPS** — Can I take you back to the issue of the public sector comparator. You touched on competitive neutrality. Does the audit office have a view as to whether that is a legitimate adjustment to make when comparing private sector cost with public sector cost?

**Ms LONG** — Competitive neutrality is a policy, and we do not question the policy. We look at how effectively that policy was applied to a particular transaction, so were the adjustments appropriate adjustments given the context of the transaction, and were they calculated in a way that appropriately identified the risk allocation within the transaction?

**Mr RICH-PHILLIPS** — The Auditor-General in an extract from a speech he gave last November — —

**Mr WATSON** — This is the commonwealth Auditor-General?

**Mr RICH-PHILLIPS** — Yes, Pat Barrett stated that the initial benchmark of the project for comparison purposes is often the incumbent public service provision of similar goods or services. However, it is not uncommon for such benchmarks to be adjusted to improve comparability — for example, we have a requirement to ensure competitive neutrality with potential private sector providers. I got the impression from the Auditor-General’s comments that he was suggesting that that was skewing a legitimate comparison. I was wondering if you could expand on that?

**Mr WATSON** — My sense of that conversation is we have competitive neutrality. It is an element of the comparator. We would say take that as given and make sure that the adjustments or the arithmetic around that have been sensibly applied. The fact that it is inappropriate or short or long, I do not think we would ever make a comment about, because it would be a policy posture that is taken, so I would have to read what Mr Barrett said to you.

**Mr RICH-PHILLIPS** — Do we have the full speech?

**Ms CORNWELL** — Not here.

**Mr RICH-PHILLIPS** — I was hoping to get an expansion, but — —

**Mr WATSON** — I would have to read it.

**The CHAIRMAN** — I guess that is an interesting point of looking at the methodology as opposed to the element that has imposed. But could that lead an audit office — and again just in theory — to say, ‘Having looked at this, there is no way of constructing a reasonable proposition in regard to this’?

**Mr WATSON** — I am just trying to respond naturally to that.

**The CHAIRMAN** — What I am asking is: is that a question of methodology or does that become a criticism of the policy?

**Mr WATSON** — If it was adjudged to be a question of methodology, then an objective auditor would critique that, and that would be a judgment to say it is more of a demerit against the methodology than a criticism of the policy because auditor-generals will not critique the policy. Not knowing you would ask these sorts of questions, I did bring some articles from the *Australian Financial Review*, and they are actually talking about this comparator and the sorts of things that you have been raising. The article at face seems to say that as a general rule a project in partnership with the private sector will not proceed unless the whole-of-life costs adjusted for the risk assumption in the service standards bid by the private sector are below that of the public sector comparator.

**Ms DAVIES** — That is the theory.

**Mr WATSON** — That is right — part of the theory. Ms Long was talking about the hurdle rate. If you cannot get over that, then the cost of finance as a principle seems to be cheaper and more efficient from the government level. So when you read about the UK experience, notwithstanding that, they then moved into the project management issues and the deliverables. Notwithstanding those differentials, they get there, so the service delivery argument seems to be the ... to say, ‘Yes, notwithstanding that the cost is dearer, they got there and the projects skills, the implementation deliveries, have occurred’, so that then comes to the policy argument, and what does this really mean?

**Ms DAVIES** — Which article are you referring to?

**Mr WATSON** — I brought them.

**The CHAIRMAN** — I guess the — —

**Mr WATSON** — The UK and the Northern Territory. I am happy to leave them.

**Ms DAVIES** — We have seen a few of them.

**Mr WATSON** — But that is the sort of thing.

**The CHAIRMAN** — Can we have both?

**Mr WATSON** — They are exactly the sorts of questions.

**The CHAIRMAN** — I guess the proponents of PPP would argue that after the process and risk assessment is done and the patrol boats were then determined to be done within the public sector shows that it works. Any further questions? I thank both Mr Watson and Ms Long for their attendance here today, and for the information they have provided to the committee.

**Mr WATSON** — There is that article. I think they did refer to the Victorian experience in there, but that was a very interesting article that was picking up some of your themes. There are the two reports, and I think we can make that available. That is on the web site. There is not a lot of change from my perspective. I audited the Commonwealth Bank before it was sold and now I audit Telstra, and all this sort of stuff is what we call on-balance sheet and off-balance sheet. Let us put aside the risk for a moment. All the gearings are different because the debt is different, so if you then call it current debt or non-current debt, there is a real reason for that because it affects all credit ratings of your particular business, and that is a real tension in financing about how that is described. Even before you get to the operating realities, some of your questions such as ‘Where does the risk lie?’ and ‘Are you going to end on a deal that might take 10 to 15 years?’, all specifications in the contract have to be very clear, and that means there is a lot of legal definition within it.

**Ms DAVIES** — And then life changes anyway.

**Mr WATSON** — The corporate knowledge moves and so on and so forth, but if you then have an incident like that British warship that hit the top of Norfolk Island, when you get into those sorts of questions, the questions become one of insurance. Who picks up the tab for that? It is simplistic to say, 'The government does', or go to the shipbuilder and say he does. You can imagine the different premium I would pay for the renting of that ship for 20 years.

**Ms DAVIES** — Huge.

**Mr WATSON** — Or conversely, what happens if there is a war on and I want that back, and I do not own it because you own it?

**Ms DAVIES** — And they say, 'You can't use that ship because you might damage it'.

**Mr WATSON** — That is right. So it is not simple.

**Ms LONG** — 'We are a multinational, we are on the other side'!

**The CHAIRMAN** — 'There's a conflict of interest'!

**Mr WATSON** — We would say then as an adviser, 'Seriously, if you cannot overcome those hurdles of insurance and ownership then clearly you must be talking about a finance lease, because the risk is really with the government.'

**Ms DAVIES** — It is all about making sure you have the right standards in place; everybody knows if you are speaking the same language.

**Mr WATSON** — Accounting standard AA17 does talk about that sort of thing, and when you take something like patrol boats, which might be worth a billion dollars, for argument's sake, the issue is that you do not take delivery of that until year two or year three, and it might be that you are taking delivery over the next 10 years. When do you put that on your balance sheets? There are some really complex questions in there. Accounting standard 17 is one of the hardest accounting standards in the 45.

**The CHAIRMAN** — To apply?

**Mr WATSON** — Yes, because of the judgments about where the balance between the substantial risks and rewards lies. I think the initial question was, do I want to have a look at that; I want to actually get them on what we call on-balance sheet, because it is just a myth, it is just a financing issue, and your balance sheet should reflect the reality.

**The CHAIRMAN** — My question was predicated on the fact that it seems at the moment that various governments are not accepting the argument that it is a finance lease, and so one of the Enron results that is being seen is to develop a new government accounting standard for PPPs. That is why some of this work is being done, because various auditors — Tony Harris and Bob Sendt — have said and continue to say when they have audited that this is their view, but that view has not yet been accepted.

**Mr WATSON** — Yes. I think that is fair. The other thing about the Enron example, the classic off-balance sheet argument, is that you enter into all these deals, but when you talk about substance and form, the substance of the transaction gives you the answer. That is what you really have to go to and then account for it in substance, not the legal form — that is really just a red herring, in a way.

**Ms DAVIES** — There has been a bit of a — —

**Mr WATSON** — Particularly in those sorts of things, because they are special vehicle devices. But, again, it is all tied up with the way your balance sheet is constructed to convey your different debt figures and your different equity figures and all the financing attaching to that. It is very different. But here you are selling something you do not own, and all this type of thing.

**Ms DAVIES** — Thank you very much.

**The CHAIRMAN** — Thank you.

**Committee adjourned.**