

# CORRECTED VERSION

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

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

Melbourne – 24 September 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 P. Kennelly, Research Officer, Australian Education Union, Victorian Branch.

**The CHAIRMAN** — Welcome. I would also like to introduce members of the delegation of the Public Accounts Committee of the Zambian Parliament: Mr Joseph Kasongo, Chairman; Mr Nedson Nzowa; and Mr Cameron Pwele.

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

Mr Kennelly, before going to questions from the committee, are there any opening statements you would like to make?

**Mr KENNELLY** — No. I think all our positions on financing public infrastructure are contained in our submission.

**The CHAIRMAN** — The Australian Education Union has made a submission to the inquiry; it is listed as no. 34.

I will begin with a few questions. In your written submission you state that extending public–private partnerships into hospitals and schools while reducing current funding expenditure will potentially interfere with the primary purpose of these facilities. Can you outline to us what you see as those primary purposes, what are the AEU’s main objections to school PPP projects, and what are the key risks to the public that you would say are associated with PPPs in school projects?

**Mr KENNELLY** — Firstly, the AEU is committed to the notion of providing first-class public infrastructure facilities, whether they be for hospitals or schools. A large part of this issue goes to the mechanism for funding. Nothing I am about to say would indicate that we are in favour of any mechanism which would reduce the quality of infrastructure in schools and other public services like hospitals.

If we go to the primary purpose of public hospitals and public schools, I do not suppose it needs me to go on for too long as to what that is. In terms of schools, in Victoria we have a long history of public provision of education facilities which are available to all children, largely without fees — not totally without fees these days, many of which are regarded as voluntary — and the access to those facilities is available to students regardless of where they live in Victoria as well. In a state the size of the Victoria that is a very important component.

We see that the problem with extending PPPs into schools, where there does not seem to be an immediate for-profit capacity for a private operator, is that, firstly, it may interfere with the primary purpose of schools — that is, interfere with the day-to-day running of the schools, whether it be in the normal school hours or even outside the school hours for the extracurricular activities which the schools run; and secondly, it may mean that there will be increasing pressure on schools in fact to charge fees in order to meet the costs associated with a private operator.

We know that there are examples in the United States where private operators have tendered to run public schooling. We also know that those operators have come under great stress when they have been unable to raise additional sources of funding, either through fees or some other mechanism, in order to fund their initial outlays. In a number of cases those private operators have had to hand back their licences to run those facilities. Where the private operators of public schools have been successful, they have chosen a particular demographic area in order to run their schools, which has enabled them to get additional voluntary levies or fees paid by those schools in order to enhance the facilities, and also therefore enhance the attractiveness of their school in comparison with others. This has happened in concert with or not as a consequence of the development of charter schools in the United States. I do not know whether the committee wants me to explain them in detail.

**The CHAIRMAN** — I am certainly aware of charter schools.

**Ms DAVIES** — What are they?

**Mr KENNELLY** — Where charter schools are established, basically a school community can determine to set up and run a school outside the normal school board mechanism, which is the usual way of service delivery of public education in the United States. It is far more decentralised than it is in Australia, so you have local school boards generally providing educational facilities. A community can decide to develop a charter school — that is, develop its own charter and spell out what it sees to be its core values — and obtain funding from the various sources, state and federal. The one thing they cannot do is charge compulsory fees. They also ostensibly have to

accept any students who wish to apply, but as I said, one mechanism for limiting the potential enrolment is to establish in a particular area. As we know from our own experience, depending on where the school is, local fundraising activities can vary quite substantially

**The CHAIRMAN** — Is it the AEU's position that it is not possible to separate private involvement in the building and maintenance of the building from the rest of the activity within the school?

**Mr KENNELLY** — I think it is. We certainly know it is possible to separate the building cost because that has been the mechanism for the provision of building infrastructure for many years. It is also possible to tender out some of the operational components of it. The question would be whether those operational components can be extended to the provision of program — that is, a tendering out of teaching as well as the administration of the school. As we say in our submission, we know that private operators can run schools because we have private schools. Some are for-profit schools as well as not-for-profit schools — religious or other sorts of schools. It is not as if we are unaware of models that will provide education facilities in a for-profit mode. But we also know that those schools that operate on that basis do so generally on an exclusive basis — that is, they choose the students who come to the school or they have the capacity, and generally do, to charge compulsory fees. If the aim is to make profit the linkage is to be able to charge some sort of fees in order to take up the margin between that which the government is providing you and that which you are getting at the local level.

**Mr THEOPHANOUS** — The issue is that it is a question of value for money and a question of at the same time maintaining the integrity of the public school system. We had a recent example with the County Court, which has been let out as a build, own and operate system, but it does not have any impact on the ongoing running of the County Court in terms of the judges and the people who work there, and so on. What it amounts to is build, own and maintain, and in the case of schools I would argue you would need to have a transfer component as well. If a government is able to distinguish those elements so it essentially becomes a funding mechanism, do you have any strong objection to that happening?

**Mr KENNELLY** — One of the differences between schools and, say, the County Court is that the capital cost of the County Court is a lot higher than any single school. I cannot imagine there would be too many private companies that would be interested in funding one school as the capital cost is just not enough for them to go into the deal. You would be looking at a number of schools in order for this to occur. The notion of that would be somewhat contrary to the development of devolution, which is something that has occurred in Victorian schools over probably the last 25 years, where school communities have a local say in not only what sort of program is provided but also what sorts of facilities are provided.

For instance, in the late 1980s I was deputy principal at the Lavers Hill P-12 school in the Otway Ranges. It was a small school with about 120 students yet it was able to get first-class facilities. It had a magnificent gymnasium and an indoor heated swimming pool. All that was developed through the community by establishing cooperatives, and those facilities were fully booked by the community in the Otway Ranges for the whole week. That was an initiative of a community. It was not necessary to have a private company come in and say, 'We will provide educational facilities in the Western District at this particular level', because in fact the facilities at Lavers Hill were in advance of the facilities at most schools. There was an incentive for the local community to do something.

I cannot imagine how any build, operate, own and transfer system would provide any better facilities for that school. If it were contracted to provide schools in the Western District some schools may get better facilities and others may get worse, but I think the local communities would feel they were being cut out of part of the process. I do not think they would be too happy about that.

**Mr THEOPHANOUS** — What do you say to the argument that governments have a limited amount of capital available to them for any of these projects? Perhaps you may want to address two issues. What if the BOOT scheme in this instance was one that came in cheaper than the government could do it for themselves? This could be for a range of reasons, because I understand the argument about profit, but there are counter arguments in relation to tax concessions and so forth that the public sector does not get to have. It may well be that looking at a project as a whole it would be actually cheaper through a BOOT scheme. At least the comparison should be made, is the argument, to see which is cheaper or what is better value for money. Secondly, given that there are limited resources available to government would not your members like to see, say, 10 extra schools that otherwise would not be built, built through this mechanism?

**Mr KENNELLY** — I recognise that private operators see their margin through commercial development. I think the Spencer Street station redevelopment is the classic example of that. As we say in our submission, we

think that that proposal is a real improvement on what has gone on in the past, with a few provisos in terms of transparency mechanisms throughout the process. Clearly the private operators are there to see their margins will come through the commercial development associated with the station, not through the provision of platforms and ticket booths and things like that.

Private operators would also then be very tempted to see that their margin in schools provision would be through commercial development as well, whether it be through the traditional provision of, say, tuck shops but also might be extended into retail commercial development alongside or potentially accommodation development on the same site. Now you start to get into the issue of prime function and interfering function. On the one hand it is legitimate to say that the retail development at a station — or accommodation development — is not interfering with the prime function of the station — trains still pull into the platforms and then leave. It is unclear as to the interference of commercial development within the precincts of a school. That has not even developed in private schools, as I see it, but it would seem to me to be the great temptation for a private developer to enter into the arrangement. Otherwise I cannot see where their margin is.

**Mr THEOPHANOUS** — If it does not stack up, it does not stack up. The point is that if it does and if it is better value for money, the question I am asking is: are you then still objecting to it?

**Mr KENNELLY** — It is convincing people that it is better value for money. It gets to be an article of faith, though, doesn't it?

**Mr THEOPHANOUS** — There are tests which are applied to these things by the government and even by the Auditor-General.

**Mr KENNELLY** — Are they ever made? As I mentioned in the submission, the education department went to Nauru House and the Rialto, and now it has finished up back at Treasury Place. I do not know whether any analysis of that move was ever undertaken or whether the government — and this may have been legitimate — in order to get those major projects up thought it was worthwhile spending the additional money to guarantee that they were built. But it needs to be made clear that that is the use of government money, rather than saying, 'We are actually saving money by doing this', and hoping that people will buy that line.

It is legitimate for government to be forthright and come out and say, 'In order to get this project up we are prepared to put in this amount of subsidy'. You mentioned before about the private operators having a tax concession. While that may not be a cost on the state government, it is certainly a cost on the commonwealth government, so the taxpayer bears that cost at some stage along the process. Once again, that may be a legitimate mechanism in order to get a major project up.

To go from obvious major projects like the Spencer Street development to schools, I think, is a leap of faith. I do not think the argument has been made that it is more cost effective. In fact, I would argue that we have over 100 years of example showing that by and large the mechanism for funding of schools has worked, that they have been able to be funded from within budget. Indeed, outside borrowings have rarely been necessary for any school projects.

**Mr THEOPHANOUS** — Some of the schools would say their facilities are not exactly up to scratch.

**Mr KENNELLY** — There would be a lot of schools that would say that, but I am not sure whether private financing is about to change that.

**Ms DAVIES** — The submission talks about the Delfin–Lend Lease Caroline Springs experiment. I am interested in what you know about that. Do you feel that there is an additional and hidden state subsidy going in there? Is that a de facto PPP?

**Mr KENNELLY** — Our problem is that we do not know. I think that gets to the issue which tends to surround these sorts of arrangements when commercial confidentiality comes into it: that you do not actually know what the costs are or, in the case of Caroline Springs, what the licence agreement is. It may be a good deal for the state. On the face of it, the notion of establishing an education precinct where a number of schools share facilities such as ovals or other specialty areas is good. It would tend to be a sort of commonsense argument that there must be some sort of savings there. If there are, though, I think the joint arrangement agreement and the licence arrangement with the department of education should be more easily available to parties who want to see what the advantages are. We know that private schools get substantial capital money from the commonwealth government when they are establishing new schools or new campuses. What the AEU would be interested in knowing is how

that is effected by an arrangement with the state government, where the state government comes up with the initial amount of money and then gets a licence fee or rent over the next 50 years in order to recoup some or all of that cost. We are not in a position to know that because we have not been able to get access to the agreements.

**Ms DAVIES** — Mr Chairman, would the committee be in a position to ask the education department or Treasury to provide us with a copy of the licensing agreement?

**The CHAIRMAN** — We are always in a position to ask, Ms Davies.

**Ms DAVIES** — Could I ask that we ask?

Do you have any concerns about that, beyond the fact that you cannot see the arrangement? Do you know of issues where you think that it is potentially more expensive for the state to provide the school than it would be under the standard sorts of arrangements?

**Mr KENNELLY** — I think it is too early to tell. The facilities are still being developed and there is long way to go. I have to say that if we are arguing for establishing better class facilities than would otherwise be provided through the normal practices, I have been out to Caroline Springs and it is not the case that they are world best facilities. They are the normal sorts of facilities that are provided for schools — that is, they do not have airconditioning and all the rest of the things. They are quite good standard facilities, but they are the normal sort of standard facilities that you would see for government school provision in Victoria. It has not resulted in higher quality facilities than would otherwise be provided.

It also does not seem to have resulted in the facilities being provided any more quickly than they would otherwise be provided. They are being provided as each year level goes up. They are at year 4 or year 5 at the moment. The aim is at that site for the government provision to go to year 8, and there will be a separate facility — which will also be an arrangement such as this — provided at Caroline Springs for a year 9 to year 12 site as well. That has not started yet, as I understand it.

**Ms DAVIES** — I know of another Delfin estate that is being developed, near Pakenham. Do you know if there are any other arrangements such as this within Victoria at the moment?

**Mr KENNELLY** — I do not believe there are.

**Mr CLARK** — Those who support PPP provision of schools often cite the Glasgow cluster in the UK, where, as I understand it, the bulk provision of a number of schools of a fully serviced nature with the capacity for flexibility of reconfiguration of the schools and ongoing maintenance, IT, et cetera, is alleged to provide significant benefits. Have you studied that cluster, and do you have any comments to offer on what the advocates say about it?

**Mr KENNELLY** — I have looked at it. I think it is fair to say that it provided an initial capital injection in excess of what had been anticipated up until that stage. There was certainly a notion that a substantial upgrading of facilities — and additional facilities in some cases — has resulted, but it is unclear as to whether that has been at a saving to the public purse or at an additional cost. One of the difficulties with these arrangements is that it is only after the period of the lease or the licence or whatever arrangement has been put in place has expired that you are able to make an objective or detailed analysis of it.

I know that there are lot of unknowns over a 30-year period. It would probably be unfair to say you need to know down to the last cent. I think you can factor in inflation rates and demographic changes, which is a big problem with schools that does not exist with some sorts of infrastructure. A 30-year period for schools is a long time, particularly in a major city, because as we have seen in Melbourne you can have unknown demographic changes with ageing populations or shifts in the design of housing and suddenly something is thrown up that was unplanned for. In Melbourne, for instance, we went through a completely decentralised notion where people were moving out and the inner cities were becoming sparse with children and therefore inner city schools closed, yet in the last 10 years, with the massive development in inner-city living, we then have seen the reverse. A lot of the schools that were closed are now something other than schools and are not owned by the state government.

If you are now going to be providing infrastructure back in here, there will be a significant cost. Where does a 30-year term come in that sort of planning? Spencer Street station: we will always have a station. And we will always have the law courts. Certain things lend themselves more to this long-term approach than others. I suggest schools are probably more susceptible to demographic change.

**Mr CLARK** — Some of those who advocate private provision would say that adjusting to that uncertainty or bearing the risk of that uncertainty is one of the virtues of private sector involvement in that whether or not the school is in public or private ownership, if you build a school that later proves to be too small or too big there is a cost there — hidden or exposed. It is sometimes argued that if the private sector takes on that volume risk or some aspect of that volume risk through an ability to diversify the building into other purposes or through its willingness to use its judgment as to what the volume demand may be and its expertise in estimating future trends, it can add value to the process and that that is one of the virtues of private sector involvement in provision. Do you have any views on that argument?

**Mr KENNELLY** — I am not anxious for any particular group in the community to be left holding the bag, whether it be public or private interests. As a community we should be prepared to accept the planning process and to bear whatever costs that planning process or demographic change brings. There are a whole lot of decisions of government that are made that will impact upon the viability of a particular school — for instance, if governments change the planning regulations and allow for a certain type of housing or development to be built, that will impact on the number of people living there and therefore the number of children. I am not quite sure why it is a good idea that government in making that decision can then rub its hands with glee and say, ‘Weren’t we lucky to have left somebody else holding the bag in terms of the operational risk?’. That does not seem to me to be a virtue in the process. At the end of the day, risk in the provision of public services will always lie with the government anyway, because the public is unwilling to say, ‘Okay, it is somebody else’s problem. We don’t care that that service is not provided’. The public will say, ‘You are the government and you cannot rely on what some other government in the past has said. We expect you to provide the service, one way or the other’.

**Mr CLARK** — In Australia, in Victoria particularly, we have a strong system of school councils which to me — and other members here may share the view — add enormous value to the educational system. One of the issues that arise is whether or not school councils and the private provision of facilities mesh together well, in that school councils have traditionally done a lot of work towards facilities. Do you have views on that issue?

**Mr KENNELLY** — As I said earlier, in Victoria in particular we were very much a leader in the world in the devolution of authority to school councils — in fact it started in 1975 when the old advisory council system went and we had school councils set up that had real decision-making authority about large parts of the budget. There is always a tension between what is cheaper to do on a statewide basis and what might be more expensive to do but which involves the local community. We could probably mount an argument for getting rid of various layers of government on that basis — be it local government or state government, so far as that goes — but people would then lose what they believe to be their right to influence the decision making in their area.

As I said earlier, the notion of what would need to be a large development — not just one or two schools but a large operator operating a whole number of schools — could run counter to the notion of school councils inputting into decision making even though for some schools, as I said earlier, it may result in better facilities than they may be able to generate through their own resources. That is a possibility, I admit, particularly for those communities that do not have strength in raising local funds, but I think the solution to that, rather than the partnership arrangement, is for government to provide additional resources, differential resources, for those schools so that minimum standards are met throughout the state.

**Mr RICH-PHILLIPS** — One of the complexities of this issue is that there are so many different models of private sector involvement in public infrastructure. But at the simplest level one of the models would be the sale of public assets to the private sector and then the lease back of those assets by the government with no impact upon service delivery. If a model like that were implemented with respect to schools, whether it be a cluster or a group of schools in a region where the department simply sold the infrastructure to a private sector financier and then leased them back for 20, 30 or 40 years or whatever the appropriate time frame was, how would the AEU feel about that sort of private sector involvement, where there was no impact on service delivery and it was simply a financing transaction by the department?

**Mr KENNELLY** — We would probably think it is a more expensive way of doing it. We have had experience with that in Victoria. The previous Labor government sold and leased back public transport — the trains — and it was the Kennett government that bought them back into public ownership and then transferred them back out again through privatisation.

The arrangement of lease-back of facilities can potentially work where what you are leasing has a fairly short life span. There is a good financial argument, for instance, in relation to the operation of car fleets. Most of the buses in Victoria are subject to lease-back arrangements through the operators, and I am not certain about it but I imagine

that the private operators of the trains and trams are also financing their arrangements through lease-back operations as well; I do not know. But all of those things have a defined life span, and you would expect to replace them at some particular stage. A school would not be like that.

**Mr RICH-PHILLIPS** — If the model, though, provided the necessary financial savings to the department — by whatever criteria that was assessed by the Treasury or the department of education — and in turn capital that was freed up through the initial sale was available for further investment in the education system, would the AEU object to that?

**Mr KENNELLY** — The AEU would need to know how it is going to work, because if you were to do it as a short-term mechanism in order to fund something else, then at some stage you are going to pick up the residual cost. If you said, ‘We’ll sell the schools and lease them back for 10 years’, obviously you expect the schools to last more than 10 years so at some stage — that is, in 10 years time — you are going to have to either renegotiate the lease or buy them back. I cannot see how that is in the state’s interests.

**Mr RICH-PHILLIPS** — But assuming the financial parameters did stack up — by whatever criteria Treasury or the department set — and that it was agreed that there were financial benefits to the state, would the AEU object to such an arrangement when there was no involvement by the private sector in the delivery of services?

**Mr KENNELLY** — The AEU would object to it because we believe that public schools should be owned by the state because in the long run that is the way that we ensure that public education provision remains the sole focus of that facility.

**Ms DAVIES** — There was an article in the *Age* on 20 March this year that talked about public going private. It talks about the New South Wales government that has 18 expressions of interest in a controversial \$83 million plan for nine new government schools to be built and owned by private companies. It also discusses the comments of critics who say that that still leaves the government with long-term liabilities to pay leases and that the final cost is likely to far exceed the cost of building the school itself. There is also another submission that we got from the Australian Research Institute and prepared by Professor John Quiggin, a senior fellow of the Australian National University. It talks about this argument that it is better to get the private sector to provide the capital rather than to have to budget for a vast capital outlay by the state. This *Age* article says that it would be a more genuine reflection of the true budgetary system if the cost of the lease and the other associated costs with these build, own, operate-type systems were included in the budget. At the moment, if have you the state bearing the capital cost of a school, that is a cost on the budget, but the figures are not properly in the budget when it is an ongoing cost; it is disguised. Do you have an opinion about what the New South Wales government is doing? Do you think that it is possibly just going to end up costing more than it would have for the state to build the schools in the first place?

**Mr KENNELLY** — We have an opinion about what the New South Wales government is doing. We believe that if a government is going to go down this path, it has to do go down it 100 per cent or not at all because the problem as we see it in New South Wales is that some schools are going to be developed in some areas with a certain flavour of school and end up being selective schools.

**Ms DAVIES** — Do you think that these that have been tendered at the moment are going to end up as selective schools?

**Mr KENNELLY** — It is unclear and the government in New South Wales has not spelt out how they see these schools finally ending up. At the moment they are obviously getting expressions of interest from people to say what they are going to do. It will be up to the private developers to indicate where they think they are going to get their margin. It gets back to associated commercial activities which may be involved on the site. It is potentially possible that many of them will say, ‘We’ll be able to offer greater use of school facilities and arrange a greater use of school facilities than school communities currently do’. The same sort of argument was run by some local councils in Victoria when they privatised their school swimming pools, but that has not worked, either. There are some things that would seem to be more obvious for a private operation than a school. There are just some facilities that lend themselves to sole purpose use and not additional commercial use.

**Ms DAVIES** — What do you know about the New South Wales ones? In what sense will the private developers need to make a margin? They are going to build the schools, so they will presumably need to make a profit on the actual building of the schools. They are going to own them, so they will presumably get a lease payment from the state. Do you believe that they will also be looking for a further margin of profit above what they will make on the building and above what they will make on the leasing?

**Mr KENNELLY** — Yes.

**Ms DAVIES** — What sort of concrete evidence is there that there is the capacity in these contracts to make that margin on top of the building margin and the leasing margin?

**Mr KENNELLY** — From the documentation that I have read from the New South Wales government, what the New South Wales government is interested in is in them providing a certain level of facilities at a particular cost, but there is no prohibition on them extending their own development of that particular site in some particular way. If we were to take the example in Victoria of Spencer Street station, I just do not think you would have got any tenderers if the invitation was: we just want you to build a station. There is no margin. I do not know of any example in the world where a simple provision of a public facility like that has occurred.

**Ms DAVIES** — We have private companies building schools all the time. They presumably make a margin on their building of the school.

**Mr KENNELLY** — Yes.

**Ms DAVIES** — So there is a building margin.

**Mr KENNELLY** — But they are not paying a premium for the operation of it over the next 20 or 30 years. They have provided their commercial development, which is the building of the school, and that is it — they are off doing some other building.

**Mr THEOPHANOUS** — Isn't the issue really about the transparency in this? You have to be able to see what the real cost is on both the models. That is what it is really about. Once you have identified that, you can talk about whether it is more or less using one model.

You made a comment earlier about the disempowering, effectively, of the local community. What do you say to the argument that in fact this can lead to an empowerment of the local community in the sense where there is a contract with a private operator to build the school and then maintain it to a certain standard, with penalties for failure to do that, and where payments can be withheld, for instance, if the contract is not abided by? What do you say to the argument that the local community can actually be empowered, as opposed to the public model, where facilities might be allowed to run down for years and years and where schools keep coming trying to get any government to maintain them properly or fix them — that it is a different kind of struggle, if you like, to achieve that? What do you say to that argument?

**Mr KENNELLY** — Where is the evidence that it occurs?

**Mr THEOPHANOUS** — If the building is not upheld to a certain standard there are penalties associated with it. It must be maintained to a certain standard in order for the payments from the government to take place. There is a very comprehensive set of arrangements around which that building has to be made available, kept, and so on. If arguably it was run by the state maybe there may be a tendency not to fully maintain it.

**Mr KENNELLY** — I would say that what we know about local school communities is that they work very hard in a voluntary capacity to ensure that the best facilities are provided at the schools. I have been part of it, and I am sure many of you would have been members of working bees and would have spent many hours on school council committees to establish facilities — all that is time and effort that is not costed. The notion that we can let somebody else run it and it would be cheaper does not really stack up. It may provide greater certainty but I think it would be at a cost rather than a saving. If the argument from government was, 'Look, we don't think the facilities are good enough, we want to spend more money to improve them and this is the way to do it' perhaps there may be less sceptical people around. But if the argument from government is, 'We want to find a cheaper way of doing something and improving facilities' people will be sceptical because they know about the amount of voluntary work they put into schools to maintain them at the standards they currently are.

**Mr THEOPHANOUS** — I would argue whether it may not be better for that voluntary work to go towards the running of the school, to have more teachers and so forth rather than the facilities that should be reasonably done by the state?

**Mr KENNELLY** — Yes and no: just as there was a lot of time involved in the working bees, the committees and whatever, at the end of the day it is great for a school community to actually come to an end of a Saturday and see the playground that has been developed and put up by their hard work and toil, because they feel that they have invested something into the school and it is part of their community. That is an element of the

equation that you can never cost out one way or the other — that is, the feeling of belonging that developing the school actually engenders.

**The CHAIRMAN** — Thank you for your evidence. There may be some matters that the committee may seek to follow up with you in writing at a later date.

**Witness withdrew.**

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#### Witness

Mr D. Johnson, General Manager, Victoria, Thiess Pty Ltd.

**The ACTING CHAIRMAN (Mr Theophanous)** — I welcome Don Johnson, general manager for Victoria of Thiess Pty Ltd, to the committee. The Chairman has had to leave the hearings, so I will be conducting the proceedings at this point.

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

**Mr JOHNSON** — By way of introduction I should outline where Thiess's interests lie in this forum — that is, we are one of the largest providers of infrastructure and infrastructure services within Australia. I am responsible for our operations in Victoria, South Australia, Tasmania and New Zealand. We have a large exposure to the provision of infrastructure in Victoria, hence our interest in the process.

By way of opening statement, I understand there are a lot of questions that you would like to ask, so that should take up the majority of my time. The theme we need to develop is one of certainty — that is, certainty for all parties involved in the provision of infrastructure. That goes from government to contractors and end users. I know this forum specifically is dealing with the provision of private moneys into the infrastructure provision, and perhaps some of my comments may stray slightly from that. If we develop that theme of certainty we need to look closely at risk allocation and appropriate risk allocation between the parties involved in any of the infrastructure provision. We need to look at the timing of the delivery and the overall process to make sure that that timing does enable us to get the best outcomes for the total community. I think we can do better, in my view, in terms of our longer term planning for the provision of infrastructure so it does come on stream at appropriate times and perhaps does consider the level of work that the private sector is generating for the infrastructure industry at any particular time.

We need to carefully consider delivery methods. There is a range of delivery methods going from basic construct-only work through to the softer dollar, as we call it, which is construction or project management-type deliveries, and then you go into the PPP-type delivery where you have private sector moneys involved and private sector taking significant risk for overall development. We need to get acknowledgment of the costs of the process for all parties. They are very significant and escalate quite rapidly once we get into the PPP delivery. It is also useful to talk about the concept of total project management from the conceptual stage of the project through to the operational stage — the role that the organisations play within that overall scheme of delivery — and from private industry's point of view, the stage at which we get involved in the process and we can add value from there on. I mean not just add value due to our skills, but a lot of the value comes from the interactions of the team by the end users, by the government authorities that are charged with delivery of the project and the skills and knowledge that the private sector has to work as a team.

All those key points are tied into the issue of certainty of delivery. I was not intending to say more than that, but perhaps that can be the theme for some questions. I will leave it to the committee.

**The ACTING CHAIRMAN** — You have stated in your submission that all too often promised time frames are not complied with or inevitably departments set unrealistic time frames for the private sector, yet they fail to comply with the timed program for their own part of the work or deliberations or whatever. Are you able to point to any experiences of Thiess in Victoria in relation to that statement?

**Mr JOHNSON** — I can, otherwise I would not have made the statement.

**The ACTING CHAIRMAN** — Would you like to expand on that to the committee?

**Mr JOHNSON** — For sure. One that is a very topical at the moment is the Eastern Freeway tunnel. I am not sure that a lot of expansion is required on that; that has all come out in the press in the last couple of days. We go back to the latter part, the last quarter of 2000, when we submitted a pre-registration for that project. Now it is almost two years later and the process has been suspended, cancelled or changed. We have had a two-year period where we had the industry going through preregistration, awaiting the tender list, tendering the project, re-tendering the project, for ultimately the project to fall over. That is one current topical example.

**The ACTING CHAIRMAN** — Didn't the project fall over because you could not bid under the requirements of what the government wanted?

**Mr JOHNSON** — We did not bid for the project; we preregistered. We did not make the tender list, so I am not coming from that angle. But yes, that is ultimately why it did fall over. This comes back to my point about

total project management, that we have started with what seems to be a disconnect between the expectations of government in what could be delivered for a price and what ultimately the industry has been able to price, complying with all the particularly difficult requirements for, particularly, ventilation, tunnel waterproofing and the complexity of that tunnel construction.

A more recent one relates to Berwick hospital. We were one of three tenderers for that. That process is still ongoing but we have been advised on that one that we will not be successful. We were faced with a very short tender period for that project and one in which the total suite of documentation was not available for the tenderers at the commencement of that tender period. Faced with a short period, it really did make the task of compiling a tender difficult. Going back to the theme of certainty, governments do not want tenders that have not been thought through because they come back to bite us later on: the tender period in our view was inadequate, particularly when coupled with the late release of important documents.

**Mr HOLDING** — In relation to a related topic, could you give us an insight from Thiess's perspective on how you go about evaluating the costs associated with preparing a bid for a project maybe like the Eastern Freeway extension — the tunnel, et cetera — or any other project? How do you evaluate the costs associated with bidding for it? Can you tell us also to what extent the costs associated with preparing a bid might become a disincentive for developing a bid in the first place? A question related to that: the current threshold or the minimum value in the Partnerships Victoria document is \$10 million. Could you provide a response to the committee about the view Thiess would have about raising that threshold to maybe \$100 million or some other figure? How would you respond to that proposition?

**Mr JOHNSON** — The costs of bidding projects increase quite dramatically as we go through the spectrum of delivery methods. If we talk about a construct-only project, that would probably involve just our internal resources, with our own estimators: we have been given a design, we take off quantities; we obtain prices; we put a price in. If we go to design and construct (D and C), we are obliged to get an external firm of design consultants to assist us prepare a design. Construction companies generally do not have in-house design skills so we get an external firm in and they are paid for the work that they do during the tender period. If we then go into PPP-type projects, we have added expense there, where we need lawyers acting for all levels of the transaction, so the special purpose company, D and C, the banks — they will all have legal expenses. We will have financial modelling expenses which involve accountancy firms — the Pricewaterhousecoopers and the KPMGs of the world. We may have rating agency costs, depending on the financial structure that is adopted. So when we get into PPP-type projects, there are a hell of a lot of external costs.

We find that the other groups involved — the lawyers, the accountants, et cetera — all seek reimbursement for their effort during the tender period. That is a cost that is really borne by only the construction companies. Generally there is no-one else for that cost to come from, unless you have already identified your equity investor up front, and in some cases they are willing to make a contribution, but not always. Those costs are a hell of a lot more than if you go back to the construct-only model, where we are just putting our in-house resources into it. So we need to get a return from the projects for those additional costs. When we make a decision as to whether to proceed with a project, we need to know the parameters on which the project is going to be bid. If we do not have the certainty so that we know the process we are going to be following through and that as a company we have specific skills and we can see a competitive winning edge, we will think very carefully about whether we proceed with that.

There is also the issue that oftentimes when we are making the decision about whether to become involved in the project, all the information related to the delivery method of that project is not known. In other words, we may not know how many tenderers the authority is going to short-list for a project. We may not know whether they are aiming to proceed with one or two preferred tenderers, which is another huge level of expense — to take two tenderers right to financial close. We may not know how the financial transaction is going to be structured. Particularly with the PPP projects — if I can talk about the Berwick experience, the abatement regimes for failure to provide the service to the required standards led to some very heavy abatement regimes that did make the financing of that project particularly difficult in some respects. If that was going to be the case on all projects we would have to come up with a particular way of dealing with that. But we do not know what sort of abatement regimes and so on exist before we actually get right into the process with the majority of our tenders.

**Mr HOLDING** — What do you think of the \$100 million threshold? I know you mentioned it in your submission.

**Mr JOHNSON** — With the process contemplated by the guidelines for Partnerships Victoria and certainly the more recent examples of the way government wishes to conduct the process, it is just not viable to be

doing \$10 million projects from any party's point of view. You would have to bundle a number together and say, 'There's a number of \$10 million; we will bundle them up'. But we really see that about \$100 million is the minimum amount. There are just so many fixed costs in setting up financial models and whatever that do not vary terribly depending on whether you are dealing with a \$10 million or a \$100 million job. Your legals do not vary because you still have to have the total suite of agreements, from special purpose vehicle, down through D and C, operations and maintenance, and back with government, et cetera. So there are fixed costs. Really the only difference is the size of the project and the design costs that vary, and those fixed costs just make it unsustainable at \$10 million. I would suggest that is the case for the government as well. To be trying to conduct those transactions it needs to be at the bigger end of the scale.

**Ms DAVIES** — Given those very high costs and that the only fairly limited details there have been about theoretically how much cheaper the private sector can provide some of this infrastructure for — that evidence is pretty vague but they sometimes talk about it being maybe 7 per cent cheaper for the private sector to provide some infrastructure, as opposed to the public purse direct — given that you have all those extra costs, then surely that would negate the factor of so-called making it cheaper for the private sector to provide something. It would basically negate it, would it not, given that you have extra costs in preparing all the very complicated documents and given that you have extra costs in that you have to provide a return to investors and a return for any services or maintenance that you might be doing, surely the argument about it being cheaper just disappears out the window?

**Mr JOHNSON** — I am here as a construction company guy, not one of the Collins Street bankers, but I can address some elements of that question. The normal structure we have is a special-purpose vehicle with a contract with a D and C contractor. That D and C contractor is always going to exist, whether it is carried out by PPP or other methods there will always be the D and C component and a profit margin.

**Ms DAVIES** — That is fixed whichever way you do it?

**Mr JOHNSON** — Operations and maintenance are likely to be the same. Whoever maintains it there is a cost to maintaining it, and there is a margin on the services provided; whether they be independent cleaners and facilities maintenance people or whether they are lumped together there will be a margin emerging from the provision of those services.

**Ms DAVIES** — Unless they are directly provided by the state, in which case — —

**Mr JOHNSON** — The state employs the labour directly?

**Ms DAVIES** — Yes, then there is a cost, but there is no margin on top of the cost.

**Mr JOHNSON** — You then lump that together with the D and C level, and certainly there is a requirement for payment and a return on equity. The debt is probably at similar rates to what the government normally gets its money for, but the equity returns would be a bit higher. How does it all stack up? It does come down to risk and the transfer of risk to the private sector and the management of that risk. That will be different on different projects. I am not here advocating either way. PPP is certainly not the way to deliver every project. There needs to be a thorough understanding of the risk profile of particular projects and, I guess, of government budgetary concerns and then a putting together of those to work out the most efficient method of delivery. If you are trying to do the wrong risk transfer or the projects just do not have risk there your statement is probably right, but when you get into projects involving complex risks and there is an adequate transfer of those to the private sector, and the private sector can adequately manage those risks — in other words, they are a manageable unlike some that have passed our way that we cannot manage — that gets the economies right down so that it does pay off.

**Ms DAVIES** — This argument about the transfer of risk happens all the time, but if you are talking about an essential service, even if — —

I know the theory that you transfer the risk to those who are most capable of dealing with that risk, but in an ultimate sense a commercial enterprise will never accept an ongoing risk. If you contract to continue to provide maintenance on a building, for example — and theoretically you have the risk of miscalculating how much that maintenance is going to cost you — if you are a private enterprise and you have miscalculated, and people do miscalculate, or circumstances change and you have not taken them into consideration, ultimately in what sense can you as a commercial operation say, 'We have fully accepted that risk', because at the end of the day if you are not making money you will say, 'We are going broke', or, 'We are not going to provide this service any more', and the state will absorb the risk because the state will say, 'Well, we have to continue to provide this service, so we will bail out the company', or, 'We will buy out the company', or whatever? In what sense does a commercial

operation ever fully accept the risk because a commercial operation will always in the end have to cut its losses if it has miscalculated?

**Mr JOHNSON** — It comes down to the balance sheet strength of the companies with which you engage. If Thiess were successful on a project, and we opted out of the provision of the ongoing maintenance — not that that is an area we are providing as part of these consortiums, but if we did — our future dealings with the government would be very limited. They are not going to give us another project when we have said, ‘We can’t afford to keep going on the last one’. That is why balance sheet strength is important; and reputation and ongoing business is also important.

**Mr RICH-PHILLIPS** — I take you back to the question of bid costs. You indicated that in your view that projects between the current \$10 million threshold and up to around \$100 million are not viable because of those costs. In your view would it be possible for the government to develop a package of template contracts and template tender processes to address those fixed costs you spoke about and therefore make those projects in that \$10 million to \$100 million range viable?

**Mr JOHNSON** — It would certainly help on the position we have at the moment. I guess we would need to understand how much repetition there was between each of the projects. I think \$10 million is still a very low figure, even with standard forms of contract. I would be suggesting that if you had those perhaps with your \$40 million to \$50 million range you might start to get there, but certainly you would want a lot of repetition. You have to get to that \$100 million level if we want to reinvent the wheel each time we bid for one of these things.

**Mr RICH-PHILLIPS** — A related issue is the government reimbursing the private sector for some of these bid costs. I know that in the United States, particularly with defence contracting, there are very high values involved and some of those costs are reimbursed by the government. Do you have a view on how that would or could work with the sorts of projects that are covered under the Partnerships Victoria here, whether it is viable once a tender has reached a certain stage for the government then to assume the final tender costs?

**Mr JOHNSON** — I will answer that question in two parts. The first part is that a lot can be done to make the tender process more cost efficient for tenderers, so you reduce the cost outlays of all parties. That comes down to a full knowledge of what the government requires before it goes to tender; and it has tested those assumptions, and it should be pretty comfortable that the tenders it will get back comply with its requirements.

Once a tender assessment has been done the government selects one party to move forward with. Unfortunately we have seen some examples where we have had multiple bidding processes that the first time around did not achieve the objectives, so there has been a culling of perhaps one tender and then we have moved forward with a couple and then re-bid. There have been examples where two bidders have been taken to financial close, which means a huge expense to do final legal and financial documentation.

I would argue that if the government sees fit to take two bidders to financial close for the purpose of competitive tension in the transaction the payment of some of the costs incurred by the losing tenderer is offset by the gains made by the state with that competitive tension. I have no difficulty with that concept at all.

Further, you will find that there is often a significant benefit from access to the IP that may exist in a losing tender. To say that the winning tender is best in every field is unlikely. If payment were made and perhaps access gained to some elements of design IP, for example, there are two compensations for the state — one is the competitive tension that remains in the process and the other is some value that may be picked up out of one of the losing tender bids.

**Mr RICH-PHILLIPS** — It sounds as though one of the key issues in the early stages has been a failure of the government to clearly identify what it wants through these projects. Is that correct?

**Mr JOHNSON** — There are certainly examples of that, yes.

**Mr CLARK** — I follow up on a particular aspect of the costs caused to bidders in projects — namely, when the government does not actually go ahead with the project so there is no winning bidder and that is, of course, an issue for traditional D and C contracts as well as for PPPs. In your experience of traditional D and C contracts in Victoria is there a provision for government to meet the costs of bidders if the project is withdrawn? Similarly, is there such a provision in Partnerships Victoria? What sort of guarantees do you think government should give or what sort of reimbursement mechanisms should governments provide for when projects do not go ahead?

**Mr JOHNSON** — The first issue is that collectively the process needs to be improved so that nobody has a litany of projects that do not proceed. That is no good for anyone. So let's improve the process so that that does not happen. I guess we are then dealing with more of a hypothetical that says, 'If we are going to improve, then it does happen'. Bidders go forward on the basis that we need to win a certain number of jobs. We have a strike rate. We have to win one in three or four, whatever it is, to cover our expenses. Fundamentally, if a government withdraws a bid they should be compensating the bidders for costs for that because no-one has any chance for recovery out of that. That is not the commercial risk that we seek to take. The commercial risk is that we do not win our strike rate. If the job is not awarded, no-one can get there.

I am from Queensland. We were involved in one a number of years ago for the tram project in Brisbane. There was a change of government in the process and both governments had a crack at that, and we actually bid twice. It got pulled both times. The industry was not particularly happy about that and rightly pursued government for some costs emanating from that process.

**Mr CLARK** — Take a project like the Eastern Freeway extension, which is topical. Is your understanding that the parties would have any right to seek reimbursement from the government for that contract being withdrawn?

**Mr JOHNSON** — We were not a tenderer, as I said earlier. We tried to be. I am not familiar with the conditions for tendering for that project so I cannot comment on that, other than to say it is not something that we would normally look at in the conditions of tendering because our expectation is that if government puts something to tender there is going to be a project to deliver. It is not the first thing you look at, to say, 'What happens if it doesn't go ahead?'. If that provision were there on every job you would be seriously questioning whether you would bother to bid for that project. Payment for costs is one thing. Let's say that the government made a payment to each of the tenderers for the Eastern Freeway tunnel. The issue is not only that, it is more about what other opportunities have they not bid on in the meantime while they have been putting their efforts into that tender.

**The ACTING CHAIRMAN** — But if there is a change so that the project is going to go ahead but it might be with another project which might actually be bigger and better, why would the tenderers that have bid not have some advantage in being able to bid for the bigger and better one, if you like?

**Mr JOHNSON** — This is getting very specific to a particular project. We are not involved other than as a very interested contender for the Scoresby corridor, so I would like to be a bit careful in how we go about it. It is a different process. Sure, there is some intellectual property there. I know for a fact that not all the groups that have been bidding for the Eastern Freeway tunnel are currently aligned in consortia that may be getting ready for the Scoresby corridor. That is a different project. While you could be reasonably sure that perhaps two of the Eastern Freeway tunnel bidders would be interested in Scoresby, I am not sure about the other one.

**Ms DAVIES** — How does that relate to this concept of the public sector comparator then? If a government at the same time as offering a project in the private sector is, as this government says it is doing, also developing a comparator so they can see whether the project could be just as easily or cheaply or efficiently or effectively offered by the public sector, and if at the end of this process the government said, 'The public sector can do this better than the private sector, so we are not going to go with the private sector', would you regard that as really unacceptable?

**Mr JOHNSON** — No, because that is clearly the guidelines within Partnerships Victoria.

**Ms DAVIES** — Are you one of the companies that said you should have access to the comparator details?

**Mr JOHNSON** — Yes.

**Ms DAVIES** — You do not think that that then gives the private sector an unwarranted advantage over the public sector in the sense that you have details of their estimates and costs and you can bring yours in just a bit lower than that fairly easily?

**Mr JOHNSON** — Isn't that to the benefit of the state, if that happened?

**Ms DAVIES** — If it is accurate and if the lower cost is then sustainable. Isn't that the problem that comes up with some of the other earlier privatisation projects, where bids were competitive — there was a pretty strong competitive element? For Latrobe hospital, say, the successful bidder did come in nice and low but ultimately that

was a failure because it was not sustainable, so there was that commercial pressure to come in a bit lower on that one.

**Mr JOHNSON** — I cannot comment at all on Latrobe hospital; I know nothing about it. Going back to your question about a public sector comparator, there are various elements in that. You have the raw PSC and then you have the risk-adjusted one. On the PSC, I understand your question, but I also think that it works the other. If we say it is a totally unrealistic PSC, why should we put our resources into bidding for a project?

**Ms DAVIES** — So you need to know enough to know whether it is realistic?

**Mr JOHNSON** — That is right.

**The ACTING CHAIRMAN** — We are running right over time, so could you just finalise your answer, Mr Johnson?

**Mr JOHNSON** — The risk-adjusted one I do not believe we are going to get access to in any of the projects. That is really the one where you would think there is benefit in both the government and private industry fully understanding the whole suite of stuff that is tied up in risk and allocating it appropriately. There is nothing to say that what we value as risk is valued by government as risk in their PSC, and a meeting of the ways with that would be for the long-term benefit and certainty.

**The ACTING CHAIRMAN** — Thank you very much. It has been a very interesting contribution.

**Witness withdrew.**

# CORRECTED VERSION

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

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

Melbourne – 24 September 2002

#### Members

Mr R. W. Clark

Ms S. M. Davies

Mr T. J. Holding

Mr P. J. Loney

Mr G. K. Rich-Phillips

Mr T. C. Theophanous

Chairman: Mr P. J. Loney

#### Staff

Executive Officer: Ms M. Cornwell

Research Officer: Ms C. Williams

#### Witnesses

Mr J. Myers, Head of Business Strategy; and

Ms S. Gandur, Head of Communications, National Express Group.

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

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

Welcome to the committee. Do you want to make an opening comment before we go to questions?

**Mr MYERS** — No, I do not think so. Thank you for inviting us. We have made a submission and stand by that submission and are very happy to try and answer any questions you have on that.

**Mr HOLDING** — If I could start by taking you to one of the comments you made in your submission. In terms of identifying some of the issues associated with the metropolitan rail franchise, your submission states that you found some of the components of the franchise arrangements too prescriptive. Can you provide the committee with some further details about how you found it to be too prescriptive — which components or which part of the arrangements?

**Mr MYERS** — There are two areas I would comment on, one is in terms of the timetable process and the passenger service requirement and the other is in respect of the infrastructure maintenance arrangements. Taking the passenger service requirement first, it is set in such a way that there is relatively little flexibility for the operator to change the level of service without going through an intensive bureaucratic process.

**Mr HOLDING** — Would you describe that process to the committee? What is required?

**Mr MYERS** — We need to put a detailed submission to the Director of Public Transport. That is reviewed, and we are asked to substantiate our proposed changes in terms of customer service delivery and passenger requirements. I think whilst the principles are sound in terms of protecting the public interests of service delivery, the actual process in practice, we would argue, has been relatively inflexible. We would probably seek a greater degree of freedom in the setting of the service and being able to change services more quickly in order to meet passenger demand.

**Mr HOLDING** — It takes too long to be able to go through the process?

**Mr MYERS** — Yes.

**Ms DAVIES** — Is that for cuts and additions?

**Mr MYERS** — Yes, the same process applies. It is fair to say we are freer to add services, but nonetheless timetable changes need to go through the approval process, which is fairly detailed and lengthy.

**Mr HOLDING** — On maintenance?

**Mr MYERS** — Maintenance relates again to relatively prescriptive inputs. It is a combination of the input and output measures, but in respect of infrastructure maintenance plans, we would see that in order to deliver or result in more innovative solutions we would prefer more output-based measures to allow operators the flexibility to develop different approaches rather than necessarily being prescriptive about, say, kilometres of track to be upgraded per year, so the emphasis in some areas is on defining the amount of spend rather than necessarily looking at the end of result that would be the desired outcomes.

**The CHAIRMAN** — You said ‘output’; I presume you meant ‘outcome’? You said you would like more output-based measures: I assume you actually meant more outcome-based measures?

**Mr MYERS** — Yes.

**Mr THEOPHANOUS** — What do you say to the argument that these contracts were entered into and risk was calculated at the time of these and various other contracts, and that once that occurs if the private sector wants to renegotiate that, they are really wanting to have a second go at something that they miscalculated the risk on? If there are losses to be made, they should simply bear those losses?

**Mr MYERS** — The general response is that the world tends to be different both for the government and for the operators than was originally foreseen. If the government wishes to change the nature of the services to be provided, it seems only fair that the nature of the arrangements, including remuneration — that there should be provision for those terms of the contract to be renegotiated.

**Mr THEOPHANOUS** — I understand that, but I am asking in a theoretical sense, if there isn't any change to the service provision aspect or any other aspect, that the private operator or the private partner has gotten into trouble, if you like, by the fact of bearing certain risk, and that risk has meant an additional cost to what it expected, shouldn't they simply have to bear that risk?

**Mr MYERS** — In general terms that is the case.

**Ms DAVIES** — Given that one of the risks that the private operator accepted was their calculations on the increase in the number of people who would use the system — for example, you based your calculations on an assumed increase in patronage that then did not happen or did not happen to the extent it was estimated it would happen — in what sense are you still bearing that risk when in fact the whole process has been renegotiated and you are now going to get more money?

**Mr MYERS** — I think patronage is one area of a whole range of factors that impact on the results of business. We seem to be moving from a theoretical question to, by the sound of it, a more actual one. I am a little nervous about making comments when we are continuing to be in discussions with government, but I will try to give a constructive answer.

The patronage question is part of a bigger picture. Also, there were a number of factors which at the time both the franchise bidders and the government had a certain view about, such as the ticketing system and such as the level of fare evasion, and while it may have been that the best information available or provided was as it was at the time, with hindsight, as I say, life has turned out to be different. There is the basis for a reasonable discussion as to what was an appropriate view to take at that time based on the information available, but in the light of subsequent information is it reasonable to expect that the risk should fall entirely in one particular direction?

**Mr CLARK** — I follow up from Mr Theophanous's and Ms Davies's questions. I do not want you to prejudice your discussions with the government. Can you tell the committee what changes to the franchising arrangements you have negotiated to date with the government compared with the original arrangements? What is your group's position in terms of where you believe changes should go from here? What further changes have you publicly called for? Are you able to say to the committee what changes you would like to see made in future to the franchising arrangements?

**Mr MYERS** — I do not think we have had any public statements about what we have negotiated thus far and what we continue to negotiate. Both the government and our company have made statements that some of the issues under discussion are the ticketing system and the impact of the ticketing system, the impact of the GST — they are a number of issues that have had an impact on us.

In terms of things we have negotiated with the government thus far during the period of the franchise, despite my comments earlier about the complexity or the time taken to introduce new services we have introduced services broadly about 7 per cent above the required level and more than the franchise requires.

We have changed the rolling stock that we were required to purchase and have negotiated the purchase of the new diesel vehicle multiple units for the V/Line franchise at substantial additional cost to us.

We have taken on more in terms of managing fare evasion, and we have recruited an additional, I think, 80 staff. We have developed station infrastructure fairly substantially above the contracted level. There are a number of things we have done outside the original terms of the contract, and those are positive constructive things that I can comment on. I do not think it is appropriate to comment on — —

**Mr CLARK** — I understand you received a \$55 million payment from the government at one time? Is that correct?

**Mr MYERS** — A settlement in March, I think you are referring to.

**Ms GANDUR** — I think it was \$45.9 million.

**Mr CLARK** — What was that the settlement of?

**Mr MYERS** — That largely related to a number of historical issues that arose around the time of franchising.

**Mr CLARK** — There were also some press reports — —

**Ms DAVIES** — Could you clarify what you mean by that?

**Ms GANDUR** — The settlement of some, I think it added up to a quantum of 42 outstanding claims. I do not think we would have the details of every one of those claims today.

**Ms DAVIES** — Over what periods of time were those claims?

**Mr MYERS** — Largely since franchising commencement.

**Ms DAVIES** — In?

**Mr MYERS** — August 1999.

**Mr THEOPHANOUS** — These were claims by you on the government?

**Ms GANDUR** — That is correct.

**The CHAIRMAN** — And related to the franchise agreement?

**Mr MYERS** — Yes.

**Mr CLARK** — A press report a few weeks ago alleged that the government had changed the terms of the incentive payment structure to make it easier for companies to receive bonuses. Is that in fact correct? If so, what is the rationale for that?

**Ms GANDUR** — That press report was inaccurate. The *Track Record*, which is a quarterly report by the government and produced by the Office of the Director of Public Transport, reports on our punctuality and reliability for the previous quarter. The way the information was displayed in that report was indeed different in this issue, and unfortunately it was misconstrued by the journalist. But there has been no change to the operating performance regime that makes it easier for us to get bonuses at all. Indeed, it was inaccurate.

**Mr CLARK** — Arising out of your experience of changes or handling the process of change and unexpected developments under your franchise, do you have any suggestions as to how PPP contracts should be structured to allow more flexibility to adapt to unfolding circumstances? Clearly parties are at liberty to renegotiate freely and change any prior agreement, but do you think there should be any form of structured arrangements within a PPP contract, such as a franchise arrangement to allow for changes to meet changing circumstances?

**Mr MYERS** — I think there should, but the natural next question then is: what should they be? It is a very hard balance to find. If you leave the provisions too open from the government's point of view that potentially leads to a lack of certainty, which is one of the reasons for entering into these contracts. Equally, if you close the door completely from the private sector's point of view they would regard it as an expensive way of managing risk on behalf of the government so that inflexibility would be likely to be reflected in the contract price.

Some of the measures that I have heard talked about in other contexts have been predetermined exit prices throughout the contract period. That would be under circumstances where both parties in defined circumstances realise that events have occurred beyond both their expectations, and again you need to be pretty clear about what the limits of those circumstances are. Generally these contracts have provisions for what happens at the end, and because everybody has a positive view at the start nobody anticipates or makes provision for what might happen in the middle. So provisions that foresee at least and predetermine a cost of exit make it much clearer. Whilst a cost of exit or changing or stopping the arrangement might be expensive, it might be a better alternative than having to negotiate an exit. At least everybody knows where they are at any particular point in time.

**Mr LONEY** — Just going back to that very brief discussion about outputs and outcomes, et cetera, I want to make up some issues around that. How much involvement did National Express have in the development of the original measures? Was this a consultative thing between both, with agreed performance measures et cetera? You were talking about the amount of track laid. Was that a consultative process and an agreed performance measure at that time?

**Mr MYERS** — The infrastructure leasing arrangements and the condition index around that were all designed prior to franchising and were part of the requirements — to bid against those requirements. Indeed, as I recall the franchisees were required within six months of commencement to produce a detailed asset management

plan for delivering the requirements of the lease, including meeting the various key performance indicators (KPIs) — the output measures.

**Mr LONEY** — In your view then to get to a good set of outcome-based performance measures, as you said before, would you have in mind a process that might better lead to that during a public-private partnership discussion or negotiation, where might it fit into the process and how you would achieve that?

**Mr MYERS** — I think probably greater private sector involvement during the planning process. That is a difficult balance to tread for both parties. There are probity questions about who is involved and whether everybody or only a selective group can be involved. There is also a bit of a game of cat and mouse from the private sector's point of view as to how much information it might regard as proprietary or to its special advantage that it would wish to share in advance and therefore everyone else gets the benefit of it. Whilst in general I think greater involvement of the private sector could lead to better outcomes of that nature, it is not as straightforward as just saying more involvement would necessarily lead to those better outcomes; but it should help even if we just have to manage some of those difficulties.

**Mr LONEY** — Is there provision within the current arrangements for periodic renegotiation, if you like, of the KPIs, and should there be?

**Mr MYERS** — I do not believe there is provision for renegotiation of those KPIs. I think we would argue, coming back to an earlier question, that some sort of regular reset mechanisms could help alleviate some of the risks, but it also perhaps creates the uncertainty of reopening more widely than the government might wish. From our point of view, yes, I think we would welcome that, but I can see from the government's point of view that may cause some concern.

**Mr LONEY** — That depends on how you have done it. The public interest may well be served by having regular KPI reviews, as it does with government departments et cetera.

**Mr MYERS** — Yes. If they were negotiated resets then we would be comfortable; if they were unilateral resets — —

**Mr LONEY** — That is what I was suggesting, a process of both parties looking again at the KPIs. Following through from that, what is your view of both the KPIs — the outcome measures, whatever — and the payments that are made against those appearing in the budget documents or annual reports or being tabled in the Parliament?

**Mr MYERS** — Sorry, can you repeat the question?

**Mr LONEY** — What is your view of having the actual performance measures and payments made against those performance measures becoming a part of either the budget documents or annual reports or being subjected to being tabled in Parliament? I raise this because one of the issues that always comes up — and I am sure you are aware from your recent history — is the issue of transparency around those things. I guess what I am asking about is the transparency of the process and what your view is of getting a more transparent process in place there, with those things being available.

**Ms GANDUR** — As long as it does not breach any commercial-in-confidence issues; we fully support being accountable for our performance through the department to the Parliament and also through the government's Public Transport Customer Charter Committee to the public. Equally, our UK parent company is listed on the UK stock exchange and we have to be mindful of rules around there.

**Mr LONEY** — I might say we have had the perverse effect in Victoria, where things that have been available to stock exchanges elsewhere in the world have not been made available to the Victorian Parliament because the companies claim them to be commercial in confidence — that is, under previous contracts, such as the electricity contracts, for example. So the issue of commercial in confidence is a very significant one. I guess what I am asking is what is the view around those things. Maybe it is not something that you are particularly prepared to answer today. You might like to think about it and provide the committee with some further thought on it. But in general is there a more transparent regime that can apply so that the public itself can see what money is being paid and precisely what is it being paid for?

**Mr MYERS** — I think in practice we would be happy with that, subject to, as Simone said, our own stock exchange requirements. But in the current case a lot of the variable payments are reported in terms of the operating

performance, punctuality and reliability payments. The majority of the subsidy or the government grant is actually fixed and those fixed payments are also publicly available. So there is not necessarily the direct correlation between payments and performance outputs that you are seeking.

**Mr LONEY** — They tend to be aggregated at the moment.

**The ACTING CHAIRMAN** — I will allow Ms Davies to ask a quick question, and then Mr Rich-Phillips can ask his question.

**Ms DAVIES** — I am asking you to look, with the benefit of hindsight, at the contract you originally signed, where you took on the risk for patronage but you did not have any control over the ticketing system, which subsequently fell in a heap. You took over some of the risk for patronage in rural areas but you have no control over Freight Australia, which controlled the railway lines and the condition of those railway lines. You signed a contract where they had a contract that did not even provide for any condition report on the lines before they were signed over. They are pretty basic flaws in the contract. With the benefit of hindsight do you look at that now and say, 'That was a fundamentally flawed contract that we signed.'? That is my first question. Secondly, is it recoverable? Are you going to be able to get out of that mess with these discussions? Are there things in that original contract that you look at now and think, 'That was a bit dumb.'?

**Mr MYERS** — I think we look at the contracts and see areas where we would like to improve them. On the question of being able to improve them, in discussions with government we are hopeful that will be the case.

**Ms DAVIES** — Do you have any chance of taking control of the ticketing system in the foreseeable future? That would surely make a difference?

**Mr MYERS** — The Onelink consortium has an existing contract with the government until 2006–07. However, we are working with the government already — that is, we and all the franchisees — in planning for what happens after that and how we might improve the ticketing system.

**Ms DAVIES** — You would aim to have control over the ticketing system that is going to affect you in the future?

**Mr MYERS** — We are certainly aiming to be very much involved in how the new system will be developed. One of the issues we are discussing collectively with the government is the question of control — should it be government controlled or operator controlled? Those are the issues that are under discussion. They are not necessarily straightforward, but we would certainly wish to be involved, and plan to be in the future.

**Ms DAVIES** — What about the track maintenance issue — that you again signed up knowing you would not have control over that, and you did not even know what the track was like because nobody had done a condition report?

**Mr MYERS** — I think we envisaged that the measures in place under those contractual arrangements would work more effectively than they have. We are working with both Freight Australia and the government to improve those arrangements. The regional fast rail infrastructure upgrade should help the general quality of the infrastructure in the country and as part of those arrangements I believe the government is negotiating with Freight Australia some general changes to infrastructure condition management under Freight Australia's lease from the government.

**Ms DAVIES** — That has stayed with the public sector rather than the private sector? The ultimate risk of needing to put that extra investment in came from the public sector rather than the — —

**Mr MYERS** — The decision to upgrade was a government decision — Freight Australia has been the beneficiary — that in order to run the higher line speed some substantial replacement and upgrade works needed to be done. That also has the natural benefit of improving the network generally. It is a slightly different issue than I think you were suggesting.

**Mr RICH-PHILLIPS** — My question is related to Ms Davies's question. In your submission you mentioned the infrastructure and contrasted the management of the metropolitan and rural infrastructure, and said rural infrastructure management has been far less successful, to use your term. I am aware that Freight Australia was critical of the government in terms of the sovereign risk issue and changing the rules after the contract was in place. What is the nature of your concerns with the rural infrastructure relative to the management of the metropolitan infrastructure?

**Mr MYERS** — To be clear, on the comment that it has been less successful, certainly it has been less successful for National Express. Generally speaking Freight Australia is abiding by its contractual requirements in terms of the work it does on the infrastructure, and I would not wish to imply otherwise. However, as a passenger operator we believe we require higher levels of infrastructure maintenance to improve and maximise performance for the network than are being delivered under the current arrangements, whether that is line site growth clearance, ballast renewals, rail grinding or whatever it might be. Both the ride quality and the general infrastructure maintenance, we believe, need to be at a high level and specified in terms of the sort of output measures we discussed earlier in more detail than is currently encapsulated in what is called the Victorian quality index, which is a fairly high-level measure that is averaged over the entire network rather than small sections. To give an extreme and simplistic example, you could have a gap an inch or two wide on the rail which would cause a significant jolt as you went over it, but the impact on ride quality is measured over 200 kilometres or 300 kilometres of track. The impact of what is a significant problem is all but eliminated in the averaging methodology that is currently employed.

**Mr RICH-PHILLIPS** — Would you prefer a regime where you had control and responsibility for the infrastructure?

**Mr MYERS** — Yes, but I recognise that is not possible at the moment. We are much happier in the metropolitan franchise arrangements, where we are masters of our own destiny, if you like, in terms of managing the infrastructure that impacts on our services.

**The ACTING CHAIRMAN** — I will have to wind up, but I have one question before I do that. You said in your submission that there were significant savings achieved and that that is not disputed as a result of the franchises. The government expected savings of \$161 million, which is the figure that was bandied about. However, since then the government has announced payments of \$110 million and additional payments may also occur. In that context are you able to say what the actual savings are to the government of the contract, since you have said in your submission that savings are not disputed?

**Mr MYERS** — I think that opinion was based on general commentaries about the processes. There have been savings, and I do not think that tends to be disputed. The argument tends to be around the quantum. Given that we have not concluded our discussions with government in terms of arrangements going forward and that those figures in the table in the submission are for the life of the franchise, I do not think I can give you a figure for the total savings.

**The ACTING CHAIRMAN** — Significantly less than the \$160 million, is that correct?

**Mr MYERS** — The \$160 million? It is billion. I think it is \$1.6 billion in total.

**The ACTING CHAIRMAN** — Yes, it is \$161 million per annum. It is significantly less than that?

**Mr MYERS** — We will wait to see what the difference is.

**Ms DAVIES** — How long will it be before that will be viewable?

**Mr MYERS** — It is as much a matter for the government as it is for us. We hope it will not be very long at all.

**The ACTING CHAIRMAN** — Thank you for your attendance.

**Witnesses withdrew.**

# CORRECTED VERSION

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Private Sector Investment in Public Infrastructure Subcommittee

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

Melbourne – 24 September 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

Ms C. Smith, Chief Executive Officer; and  
Ms C. Atkins, Policy Analyst, Victorian Council of Social Service.

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

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

We have received your written submission. Before going to questions based on that submission, is there any brief statement you wish to make to committee?

**Ms SMITH** — No, the guts of what we want to say is in the submission.

**The CHAIRMAN** — Firstly, do you discriminate in your comments between the provision of physical infrastructure and the provision of services through public-private partnerships?

**Ms SMITH** — I guess the approach we have taken has been around the impact on consumers, particularly for low-income and disadvantaged consumers, so from that point of view we think from the consumer impact point of view. We also think about what is the role of the public sector in providing essential services for the Victorian community. From that point of view I guess we have commentary which is based on a broader perspective, not just on impact on low-income and disadvantaged consumers.

**The CHAIRMAN** — Following that through, do you have an awareness of the County Court project?

**Ms ATKINS** — Not significantly, no.

**The CHAIRMAN** — So you would not be able to comment on that and say whether there has been an effect on services as a result of the provision of physical infrastructure?

**Ms ATKINS** — We would not be able to here. We would probably need to get some more information, then we might be able to provide comment, but not today.

**The CHAIRMAN** — I have a couple of other issues I wish to go to. Firstly, what does VCOSS consider to be the key risks associated with public-private partnerships or private provision?

**Ms SMITH** — The key risks from our point of view are the means of protecting equity and quality of service for particularly the group that we advocate on behalf of, which is disadvantaged Victorians, and I think also some broader public interest concerns, as you will see in our submission. Right at the end of the submission we talk about right-to-know legislation, which I think is a broader concern about the risks of private sector investment not demonstrably meeting public interest in terms of the information that is available about it.

**The CHAIRMAN** — Just on that, firstly, do you have details of what VCOSS would expect to find in community right-to-know legislation, and, secondly, is there any other jurisdiction that you can point us to that is doing that?

**Ms SMITH** — That is probably something we would have to come back to you on. It was actually my predecessor who was involved in writing the submission. We could certainly come back to you in terms of content of right-to-know legislation and the sorts of suggestions that we would make about that.

**Ms DAVIES** — You talk in your submission about community service obligations of accessibility and affordability. Do you have any particular examples of where you really believe those community service obligations have not been able to be met? You talk about City Link as being one of those where the costs have risen far above and beyond the inflation rate. That was one of the projects that was supposed to be successful because the costs borne by the company during the delay were actually borne by the company, but then the subsequent financial reward is helping them meet those costs. Are there other projects where the affordability and accessibility obligations are not met?

**Ms SMITH** — The reason that we focused on the particular examples of City Link and public transport fares was that they seem like particularly strong examples to us. I am sure we could find you a number of other examples to illustrate those points. In terms of public transport fares, looking at the dramatic increase in fares, which goes way beyond increase in average incomes particularly of that broad sector of people using public transport, particularly in metropolitan Melbourne, I think that is a very good, classic example.

**Ms DAVIES** — What about the hospitals?

**Ms SMITH** — Yes. We limited this submission to a small number of examples. We would certainly be able to document examples beyond that.

**Mr THEOPHANOUS** — Does VCOSS have a philosophical objection to private investment in public infrastructure or are you satisfied that if such an investment resulted in a better community service you would not object to it?

**Ms SMITH** — Our primary concern is that we support private sector investment if there is clear evidence that there are significant improvements, in terms of equity and responsiveness to consumers, particularly to disadvantaged and low-income Victorians. So I guess you could say we do not have an ideological opposition to it, but we have not seen any evidence to show that our concerns are being met necessarily, and we are seeing evidence the other way, which is that privatisation is actually leading to greater cost increases and increased lack of transparency in terms of public interest concerns.

**Mr THEOPHANOUS** — Even under government ownership there was a significant move to have transparency in what were called the community service obligations of publicly owned utilities. So if you wanted to have a benefit for pensioners or something, then the government should not expect a government-owned business to simply provide that but rather it should be done in a transparent way through a community service obligation.

**Ms SMITH** — Through concessions, yes.

**Mr THEOPHANOUS** — Why can that not be done for privately owned systems, if you want to give a pensioner rebate on the public transport system?

**Ms SMITH** — That is right; they could increase the level of rebate to match the increases in fares. I guess there is a practical issue. We imagine there would be limitations on the amount of funding available for the community service obligation, particularly when it is called the community service obligation. There are many different limitations on the amount of money available to spend. If one could limit the requirements on that, then that means it has a greater capacity to support those consumers who most need it, rather than spreading out into a very wide group of, for instance, everybody over a certain age. If you have to subsidise that a whole lot more, that is less money available for something else, which may well be groups of disadvantaged consumers who have greater need.

**Mr CLARK** — You mentioned hospitals briefly earlier. We have heard quite a bit about the Latrobe hospital. Are you able to tell the committee anything about the Mildura hospital and how that is operating under its current arrangements?

**Ms ATKINS** — No, we are not briefed on that at all. We have not been doing significant work around health, but we have been working with the Health Issues Centre and could certainly get back to you with some information regarding how that example in Mildura has been working compared with Latrobe.

**Mr RICH-PHILLIPS** — One of the issues you touch on in your submission is adequate safeguards and structures to ensure public interest is protected. In terms of mechanisms to do that, is that not simply something that needs to be included in a contract between the private and public sectors? And if it is dealt with there, it should not be an issue with the private sector operation of public infrastructure?

**Ms SMITH** — Yes, in theory.

**Mr RICH-PHILLIPS** — Rather than it being a concern about the government correctly managing and specifying contracts?

**Ms SMITH** — Managing the process, yes.

**Ms ATKINS** — Guiding what may be included in any contract the government may sign with a private operator I would think there should be clear principles and guidelines which are to be followed. There should be general key principles that should be incorporated into any investment partnership the government may undertake on behalf of the public with the private sector.

**Mr RICH-PHILLIPS** — In the same way the community service obligation could be handled through that contractual arrangement, whether it be through a mechanism such as Mr Theophanous described or through the private sector operator bearing that cost? That could still be managed in that initial contractual arrangement?

**Ms SMITH** — I imagine some of the issues would come up would be the nature of the CSO, the parameters and requirements of it, given that one of the key elements of its definition is that it would not necessarily be done as part of a primary commercial interest. I think the parameters for the requirements of the CSO and how they are interpreted would need to be very clear, so that it did not become a public favour to the community that was being done by a generous operator but was in fact a statutory requirement, if you like, of the contract. That would need very careful handling and the parameters made very clear.

**Mr RICH-PHILLIPS** — In that sense the mechanism that Mr Theophanous described of the public sector subsidy, if you like, would get around the perception of generosity on the part of the private sector operator?

**Ms SMITH** — Depending on how the generosity was expressed, yes. I guess one of our issues in terms of consumers but also thinking of the broader overview is that if the government ends up being required to subsidise a wide range of private sector operations to meet CSO requirements, that would potentially leave large areas of unmet need that the government was not in a position to subsidise in other areas of society where there is a need.

The overall policy framework for government subsidy of CSO would need to be carefully thought through to ensure that the most disadvantaged sectors were supported, given the high profile that some public-private projects might have. There might be a move towards increasing levels of the CSO in one particular discrete project that might take funds away from somewhere else where there was a need.

**Mr RICH-PHILLIPS** — But that would be a question of government policy as to where that CSO was directed. That could be quite separate from the merits of a public-private partnership discussion.

**Ms SMITH** — That is right, but the public-private discussion is being held in the environment it is in, I suppose.

**Ms ATKINS** — They are not clearly separate.

**Ms DAVIES** — In the public-private partnership discussions that are happening between business and the current government do you believe you are having any input into what the CSO should be and what the parameters of the partnership should be?

**Ms SMITH** — I cannot think of a good example. Sorry, this is my third day in the job. I think the answer is yes, but I could not tell you directly. I would have to come back to you.

**Ms DAVIES** — So there is a specific time and a place where you are able to have input into what the arrangements might be and what the obligations might be regarded as being?

**Ms SMITH** — I would certainly hope and expect that there would be room for the community service voice to be part of that process. One of the issues is that the nature of public-private negotiations is such that they tend to be private and the whole issue of commercial — I guess our submission would be that the forum for such discussion would allow for community sector involvement to some extent.

**The CHAIRMAN** — But surely you would not want to do that on a case-by-case basis. You would want to have a discussion with government as to what its community service obligations were.

**Ms SMITH** — Government is responsible for implementing community service, I guess that is the issue.

**The CHAIRMAN** — If you ascertained from the government that, for example, the correct community service obligation in transport is such and such, then that would surely apply to any private-public partnership pursued after that. Would that not be the correct level at which it should be done?

**Ms SMITH** — There are a number of different levels, aren't there? There is one level that is the broad, whole-of-government approach to meeting CSOs, and that is not just a role for the Community Support Fund or concessions but for the whole of government. There is that level. I submit that the community sector seeks to have some involvement and consultation at that level.

Then there is the level within transport or health, a level of consultation and involvement, and then there would be the practicalities of implementing out any particular partnership with key community stakeholders that were impacted on by that particular partnership. I am not saying it would be VCOSS at all those levels, but I am saying there should be ways built in at all three levels to provide for community involvement and consultation.

**The CHAIRMAN** — Thank you for your attendance and for following up your submission in this session.

**Ms SMITH** — Would you like further information about Mildura?

**The CHAIRMAN** — Yes, you might like to follow that up with us in writing. We would appreciate that.

**Committee adjourned.**