



CLAYTON UTZ

IMPROVING THE OUTCOMES OF
PUBLIC PRIVATE PARTNERSHIPS

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Introduction

Public Private Partnerships, or PPPs, enjoy a good reputation for delivering projects on time and within budget. But there have been some high-profile failures, and they remain controversial.

The Australian PPP model is not without fault, and as we'll discover, there is room for improvement.

Nonetheless, there are many benefits associated with PPPs. Some, such as the transfer of risks to the private sector, the improved project scoping and risk assessment by government, and the whole-of-life benefits achieved by bundling maintenance services into the contract, are not unique to the PPP model. These benefits can also be achieved under publicly funded delivery models.

Unique to the PPP model, however, are benefits, most particularly those resulting from the additional rigour which the lenders apply to the due diligence assessment and monitoring of a project which is financed on a limited recourse basis. This is perhaps the single biggest factor that explains the superior cost and time performance of PPPs over traditional procurements, after contracts are signed.

There are of course some disadvantages associated with PPPs. While some are more perceived than real, the high transaction costs and the financing costs associated with the use of private sector finance are real issues with the PPP model.

Ultimately, the rationale for PPPs should be based on their value for money. For the PPP model to survive, it must continue to deliver better value for money for government than any alternative delivery model. This can only occur when the PPP model is used on the right projects. For most infrastructure projects, traditional procurement models will deliver better value for money than a PPP.

Finally, the PPP model must continually evolve in response to lessons learned and market conditions, and we will identify many steps that governments and industry can take to improve the outcomes of PPP projects.



What are PPPs?

The term PPP has been used to describe numerous arrangements in which the public and private sector work together to achieve an outcome. PPPs usually involve:

- private sector finance; and
- the bundling of design, construction, maintenance and sometimes other services into a single long-term “whole of life” contract.

We’ll be limiting the term PPP to contractual arrangements that have both of these features.

What sorts of PPPs are used in Australia?

There are two basic types of PPP in Australia.

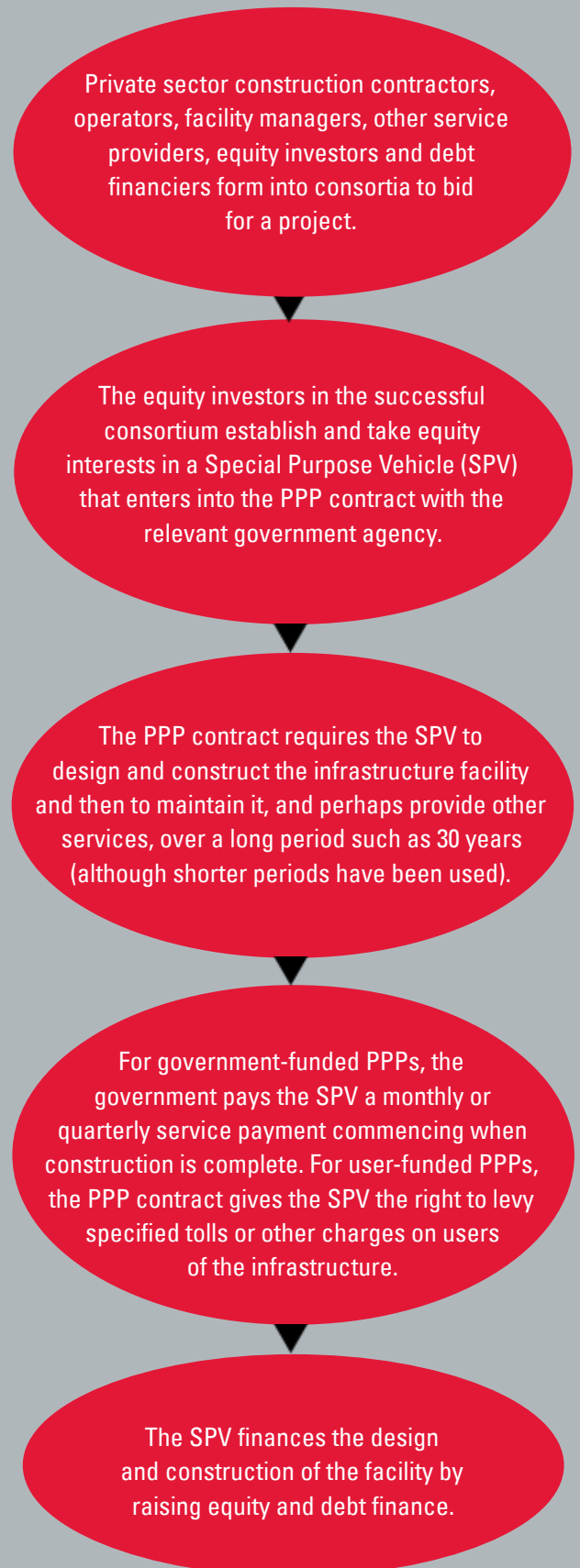
The **first** is where the primary revenue stream or source of funding that repays the private sector finance used to build the facility takes the form of a service (or availability) payment from government. The Australian policy guidance calls this a “social infrastructure PPP” because this model is typically used for schools, hospitals, prisons and other “social” (ie. non-income producing) infrastructure.

The **second** is where the primary source of funding takes the form of charges paid by the users of the infrastructure, such as tolls paid by the users of a toll road. This is called an “economic infrastructure PPP” because it is typically used for roads, railways and other “economic” (ie. income producing) infrastructure.

The terminology is confusing, however, as the first model has also been used to deliver the roads, railways and other economic infrastructure (such as the Peninsula Link road project in Victoria, the RailCorp Waratah Train project and the Gold Coast Rapid Transport project). It would be more apt to call the first model a government-funded PPP, and the second a user-funded PPP.

Both models share common features.

Unlike the UK PPP market, which is dominated by government-funded PPPs, the Australian PPP market has seen many user-pays PPPs. There are, of course, hybrids and other variants of these two basic models.



How common are PPPs?

PPPs represent less than 10% of total government infrastructure procurement in Australia. The use of PPPs is greatest in New South Wales and Victoria, at about 10%. In the UK, the percentage is slightly higher, at 10-15%. There has been limited use of PPPs outside the government sector.

This small proportion is appropriate, as better value for money can be achieved by using traditional procurement models for most infrastructure projects.

Traditional procurement

Most infrastructure is procured in Australia using contractual delivery models other than PPPs – often called “traditional procurement” or “traditional delivery models”.

There are many contractual delivery models which fall under the “traditional” banner. These are some of the more common types, but there are many more, including hybrids which combine features of two or more models.

Traditional Delivery Models

Construct only

Government produces a design (or engages a private sector design consultant to do so) and then calls for tenders from private sector constructors to build the facility to government’s design for a fixed price. Government is responsible for the maintenance of the facility.

Design & Construct (D&C)

Government produces a performance specification describing the outcomes that the facility must achieve and the requirements it must meet. It then calls for tenders from private sector D&C contractors to design and construct a facility that meets the performance specification for a fixed price. As with construct only, government is responsible for maintenance.

Design, Construct and Maintain (DCM)

As for D&C, except that the DCM contractor must also maintain the facility for a specified period – usually between 10 and 30 years – in return for a largely fixed monthly fee. The fixed monthly fee usually covers routine or planned maintenance activities. Unplanned maintenance, which arises for reasons unrelated to by fault by the contractor, is typically paid for on a cost reimbursement or schedule of rates basis. Maintenance payments can also be linked to performance (ie. abated if the facility is not available due to need to carry out maintenance work, or fails to perform at specified levels). This model motivates the contractor to design and build the facility in a manner that will minimise the combined design, construction and maintenance costs, which results in a lower whole-of-life cost for government. This model is also commonly referred to as Design, Build & Maintain (DBM). Another variant is the Design, Build & Operate (DBO) model, where the contractor design and builds a facility and then operates it for a specified period.

Managing contractor

Government appoints a managing contractor who engages subcontractors to deliver the work. The managing contractor is typically engaged early in the process to collaboratively assist government with scope definition and design development. The managing contractor is paid a fixed management fee, and is reimbursed for the amounts that it pays to subcontractors. The managing contractor may also receive incentive payments for achieving cost and time targets. Government is responsible for the maintenance of the facility.

Alliances

Government, the contractor and the designer agree to collectively share all risks associated with the design and construction of the facility. It is unusual, but not impossible, for alliance contracts to also cover the maintenance of the facility. The contract includes a sophisticated cost plus remuneration regime where government reimburses the direct costs of the contractor and designer, and pays them a fee on account of profit margin and contribution to overheads that is adjusted upwards or downwards depending upon the collective performance of the alliance members against agreed key performance indicators. The alliance participants agree to a “no blame” regime, under which they give up any entitlement to make claims against each other for poor performance or negligence. This is done to encourage the alliance participants to take risks and accept stretch targets in the pursuit of extraordinary outcomes. The model is particularly suited to risky projects, or projects with uncertain or changing scope, which are difficult to price on a fixed price basis.

What's good about PPPs?

Better value for money

The principal reason for using a PPP is that, for suitable projects, a PPP can deliver superior value for money for government than any alternative delivery model.

The rationale for PPPs was not always so. It is evident from early Australian government policies on PPPs that the initial focus was on overcoming fiscal constraints and Australian Loan Council restrictions on borrowings by state governments. Many countries continue to see PPPs as a means of delivering public infrastructure that the government cannot otherwise afford, rather than a means of achieving best value for money.

For the government-funded PPP model to survive, it must demonstrate the ability to provide superior value for money than alternative delivery models available to government. The PPP model can only provide superior value for money when used on suitable projects.

Superior cost and time outcomes, and greater budgetary certainty

PPPs enjoy a good reputation for delivering projects on time and within budget.

The most authoritative study of the relative performance of PPPs and traditional procurement in Australia is that released by the University of Melbourne in December 2008¹. This study compared the performance of 25 PPP projects and 42 traditionally procured projects throughout Australia since 2000. At 67 projects, this is the largest sample set of any comparable benchmark study worldwide. The study found that, from the time the relevant contract is signed:

- the PPPs experienced average construction cost over-runs of 4.3%, compared with 18% for the traditionally procured projects; and
- the average construction phase delay for the PPPs was 1.4%, compared with 25.9% for the traditionally procured projects.

Due diligence and monitoring by debt financiers


The higher contractual certainty of cost and time outcomes on PPPs is largely a result of the involvement of private sector debt financiers, and the rigour they apply to the due diligence assessment and monitoring of projects which they finance on a "limited recourse" basis (ie. on the basis that the debt financiers can only have recourse to the assets of the SPV to recover their debt, and cannot have recourse to the investors in the SPV).

Debt financiers will have technical consultants review the project's cost estimates and revenue projections. They will also closely monitor the performance of the project during the construction and operation phases, which assists with the timely identification and resolution of problems. For example, during the construction phase, the lenders will:

- engage a certifier to assess the value of the work completed and what it will cost to complete the construction of the project; and
- only allow further drawdowns of the debt facilities if the forecast cost to complete does not exceed the SPV's available funding.

Improved project scoping and risk assessment by government

The higher contractual certainty of cost and time outcomes on PPPs is also a result of the additional effort government agencies take when preparing PPP projects. There are many reasons for this, including the long-term nature of PPP contracts, their high value, and the involvement of treasury departments.



The level of risk assessment by government agencies prior to contract award is much greater on PPPs.

The end result is that governments' objectives, requirements and specifications for the project are better developed at the time when tenders are called. This, in turn, results in fewer government-initiated contract variations after the contract is awarded.

The level of risk assessment by government agencies prior to contract award is also much greater on PPPs for the same reasons. The risk analysis that underpins the Public Sector Comparator tends to far exceed the risk analysis performed by government for cost estimates for traditional procurements. This additional analysis makes the government agency a more informed purchaser, better able to interrogate the pricing and risk assumptions of bidders.

¹ Colin Duffield, Peter Raisbeck and Ming Xu, National PPP Forum – Benchmarking Study, Phase II – Report on the performance of PPP projects in Australia when compared with a representative sample of traditionally procured infrastructure projects, University of Melbourne, 2008.

However, there is no reason why government agencies cannot put a similar level of effort into to preparation of tender documents, and risk and cost assessments, for traditional procurements. Indeed, the best practices developed on PPPs are slowly being applied by Australian governments to traditional procurements.

Innovation

The long-term nature of PPP contracts makes governments think more carefully about the outcomes that a project should achieve. Why is the infrastructure required? What purpose is it to serve, and how will success be measured?

Consequently, the tender documents for PPP projects tend to be more output-focused – they specify the services that government wants delivered, rather than the means by which those services are delivered. This provides greater scope for the private sector to bid innovative solutions which can deliver the required services at a lower whole of life cost.

There is, however, no reason why government cannot achieve the same level of private sector innovation during the bidding process for a D&C or DCM contract.

Similarly, after contract award, the scope for private sector contractors to innovate in the delivery of design, construction, maintenance and other services is identical under PPPs and many traditional delivery models.

In fact, the risk transfer which PPP, D&C, DCM, FM and other fixed-price contracts seek to achieve can actually stifle innovation. Innovative solutions often involve more risk than tried and tested ones. Contractors will play it safe if the financial consequences of an innovative approach failing are disproportionate to the benefits they gain if the innovative approach succeeds. If risky innovation is critical to the success of a project, government should consider other delivery models, such as alliancing.

Planning and allowance for operation and maintenance costs

PPP contracts bundle the provision of maintenance and other operation phase services into the same contract as the design and construction services. The SPV is required to deliver maintenance and other services to the specified standard throughout the term of the contract.

The revenues received by the SPV in the form of user charges or service payments must therefore cover the cost of the maintenance and other services, in addition to the capital expenditure and financing costs. For a typical UK school PPP, about 30% of the

service payment is for the cost of maintenance and other operation phase services. The percentage is higher for hospital PPPs.

When infrastructure is built under a traditional short-term construction contract, the future funding required to operate and maintain the infrastructure is not always provided for. Indeed, when budget cuts are imposed on government agencies, facilities often end up being maintained according to the available budget, rather than to specified standards.

Funding source – if user pays

It is often said that PPPs expand the funding available for public infrastructure. But this is only true in the case of user-funded PPPs.

Government-funded PPPs, without user charges, simply substitute for government borrowings a different liability – a commitment to pay a service payment to the SPV. When assessing the credit rating of a government, ratings agencies consider all forward financial commitments of the government, including its commitments to pay service payments on PPPs.

However, where there is a significant contribution to the funding of a project from user charges, a PPP does expand the funding available to government.

Case study – Cross City, Lane Cove and M7 toll roads

The combined cost of constructing the Cross City Tunnel, Lane Cove Tunnel and M7 exceeded \$3 billion.

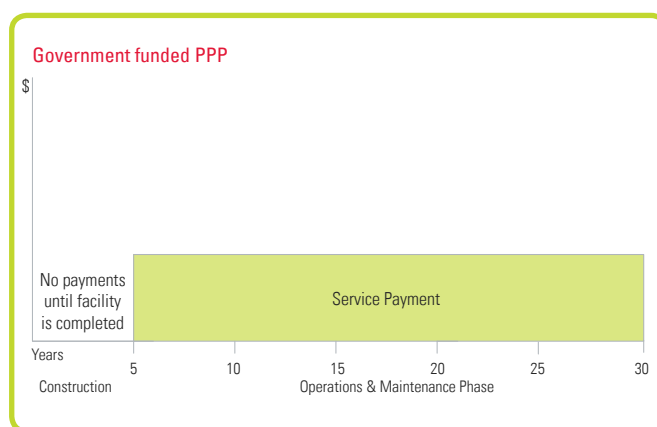
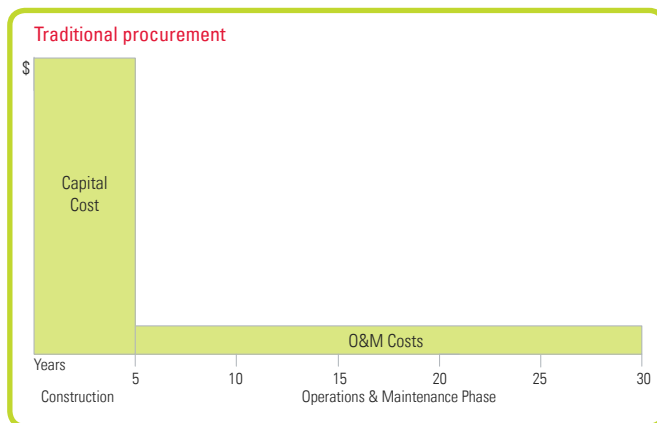
If that cost had been financed by State debt, annual interest costs would have been about \$200 million, excluding principal repayments. It would have also cost the State about \$120 million per annum to operate and maintain the three roads, which would have brought the total annual costs to the State to about \$320 million (plus principal repayments).

Over the 10-year period preceding the opening of the Cross City Tunnel, the total capital expenditure by the then Roads and Traffic Authority in the Sydney Metropolitan area (excluding toll roads) had been \$3.4 billion, or an average of \$340 million per year.

Accordingly, these three user-funded toll roads represented the equivalent of 10 years' spending from the public purse.

Source: Infrastructure Implementation Group, Review of Future Provision of Motorways in NSW

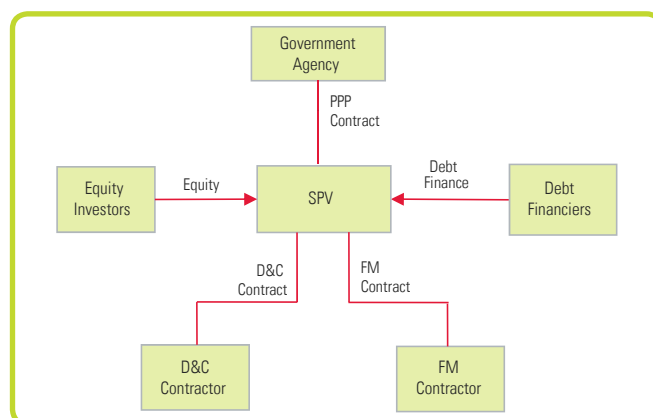
Although government-funded PPPs do not expand the funding available to government, they do allow government to spread its payment obligations over a long period of time. The diagrams below compare the payment obligations of government on a typical traditional procurement with those on a government-funded PPP.



Risk transfer

A key benefit attributed to PPPs is that they achieve significant risk transfer from the government to the private sector.

Australian PPPs seek to allocate project risks to the parties best able to manage them. Optimal risk allocation is the goal, where risks are allocated in a manner that minimises the aggregate cost of managing the risks on a whole of life basis. Only those risks that the private sector can manage at a lower cost than the government should be allocated to the private sector. The diagram below shows the basic contractual structure for a government-funded PPP.



The risk allocation is generally like this:

The SPV assumes most risks associated with the design and construction of the facility, including the risk that it will cost more than anticipated. The SPV then transfers these risks to a D&C contractor under a D&C contract.

The D&C contract will require the D&C contractor to design and construct the facility by a specified "date for completion", in return for a fixed price. The "date for completion" in the D&C contract will typically correspond with the date by which the facility is to commence operations under the PPP contract. If the D&C contractor fails to achieve completion by the specified date, it will be required to pay liquidated damages to the SPV. The daily rate for liquidated damages is typically set at a level which compensates the SPV for the service payment it would have received under the PPP contract if the facility had been completed on time, less any saving in the fee it pays to its facilities maintenance (FM) contractor on account of the FM services being deferred because of the late completion.

Government assumes the risk of its performance specifications for the facility being inadequate. If government ultimately requires service levels different to those specified in its performance specifications, it will need to direct a "variation" under the PPP contract and pay "variation costs" to the SPV to cover the additional costs and revenue impacts associated with the variation over the life of the contract. The SPV will, in turn, direct a corresponding variation under its D&C contract and/or FM contract and pay variation costs to the D&C contractor and/or FM contractor to cover the additional costs that they incur.

Government will accept certain risks associated with the construction of the facility. For example, government usually bears the risk of providing access to the agreed construction site, and the risk of legal challenges to the planning approval for the project that result in delays or additional costs.

The SPV assumes most of the risks associated with the maintenance of the facility and the provision of any other services that it must provide under the PPP contract, including the risk that it costs more than expected to provide these services. The SPV then transfers the maintenance risks to its FM contractor under the FM contract, which will require the FM contractor to maintain the facility in return for a fixed maintenance fee. The SPV may enter into similar contracts with other contractors for any other services that the SPV must provide.

For government-funded PPPs, government will pay the SPV a service payment (in monthly or quarterly instalments) once construction is completed and service provision commences. The service payment is abated (ie. reduced) if the services do not meet the full requirements of the specifications. These abatements are wholly or mostly passed through to the FM contractor, via a corresponding deduction the maintenance fee payable by the SPV to the FM contractor under the FM contract.

If the demographics of an area change such that the services provided by the facility are no longer required, government bears this risk in that it must continue to pay the service charge or bear the costs of terminating the PPP contract before its expiry.

The SPV bears the risk of loss or damage to the facility, and transfers this to D&C contractor during the construction phase, and to the FM contractor during the operations phase. The relevant contractor, in turn, obtains insurance for this risk. The government bears the risk of service discontinuity (or delay to completion of the facility, if the loss occurs during the construction phase) while the loss or damage is being reinstated.

The risk allocation for user-funded PPPs is much the same, except that there is no service payment. Instead, when construction is completed, the SPV's right to levy user charges commences. The SPV and its equity and debt financiers typically bear the risk of revenues from user charges being less than expected (although not always – for example, the NSW Government guaranteed minimum revenue levels from user charges on the Sydney Harbour Tunnel and Sydney Airport Link projects).

For user-funded PPPs, the SPV is usually given the right to operate the facility. Instead of engaging a FM contractor, the SPV engages an operation and maintenance (O&M) contractor to operate and maintain the infrastructure facility.

Is private finance needed to achieve this risk allocation?

Much of the above risk allocation can be achieved under traditional government-funded delivery models. In particular, government could directly engage the same D&C contractor and FM contractor under contracts identical to the D&C and FM contracts described above. Alternatively, the government could tender a single Design, Construct and Maintain (DCM) contract with a view to achieving an optimal “whole of life” approach to the design, construction and maintenance of the facility.

The key exception² is demand risk, which is usually transferred to the SPV and its equity and debt financiers under a user-pays PPP. This risk generally remains with government under government-funded delivery models, including government-funded PPPs.

Accordingly, and contrary to much PPP literature, it generally isn’t additional risk transfer that enables a government-funded PPP to deliver a superior value for money outcome to traditional procurement.

Financial incentives drive timely completion

The superior time performance of PPPs is often said to be due to financial incentives built into the PPP model. The service payment for government-funded PPPs does not commence until the facility is completed and services commence. Likewise, user charges can generally only be levied on a user-pays PPP once construction is completed.

Sometimes the SPV’s revenue earning period will be structured so that early completion results in a longer revenue-earning period for the SPV, and late completion results in a shorter revenue-earning period. The SPV will often agree to share any revenue it earns during the “additional” revenue-earning period with the D&C contractor. Most Australian toll road PPPs have included such a regime for the sharing with the D&C contractor of tolls collected by the SPV between the actual date of opening and the (later) contracted date for opening.

However, financial incentives for the timely completion of construction can also be built into traditional delivery models – for example, liquidated damages for late completion. Accordingly, the superior time performance of PPPs is more likely caused by the rigorous assessment by lenders of risks that could delay construction, and the careful management of the D&C contract to ensure that the liquidated damages regime remains enforceable.

² Another exception is the risk of the D&C or FM contractor becoming insolvent. This risk is transferred to the SPV and its equity and debt financiers under a PPP, with government instead bearing the risk of the SPV becoming insolvent.

Perceived problems with PPPs

PPPs remain controversial. Critics point to many problems – some perceived, others real. This section considers the perceived problems; real problems, and areas for improvement, are looked at in the next section.

Higher financing costs

The borrowing costs of a private sector owned SPV will always be higher than the borrowing costs of government, because lenders assume more risk when lending to a SPV than to government.

Most Australian governments have a AAA or AA+ credit rating, whereas most Australian PPP SPVs have an A- or BBB+ credit rating (or equivalent bank internal rating) at the time they raise debt. Lenders will charge a higher interest rate when lending to SPVs, on account of the higher credit risk.

The key difference, however, is the basis on which governments borrow.

Government borrowing costs less because it borrows on a full, not limited, recourse basis.

As mentioned above, Australian PPPs are typically financed by the SPV on a “limited recourse” basis (ie. on the basis the debt financiers can only have recourse to the assets of the SPV, and not to the investors in the SPV). When governments borrow money for traditional government-funded projects they don’t do so on a limited recourse basis; they agree to repay the loan regardless of whether or not the net revenues generated by the project are sufficient to repay the loan.

The lower cost of borrowing is therefore available to government because government borrows on a full recourse basis, rather than a limited recourse basis. If a government-owned SPV raised finance for a project on a limited recourse basis, it would incur the same borrowing costs as a private-sector owned SPV.

We look at some methods to minimise the higher financing costs later.

Failed (insolvent) PPPs

Most of the so-called “failed PPPs” in Australia have been user-funded PPPs, where the revenue generated by the project was well below that forecast by the consortium’s investors, leading to the insolvency of the SPV. Very few government-funded PPPs in Australia have resulted in an insolvent SPV.

But does the insolvency of the SPV really mean that the PPP has failed? The answer can depend on whose perspective one takes.

Consider, for example, the case of the Cross City Tunnel, where:

- the receiver appointed by the lenders was able to sell the project to new equity investors for a price which enabled the lenders to be repaid in full, and for a partial return of equity to the original equity investors;
- the government did not have to bail out the project via additional government funding;
- the road remained open to users at all times during the insolvency, for tolls no higher than those originally contemplated. In fact, there were periods when toll levels were reduced by the SPV below the maximum permitted under the contract, to entice more motorists to use the road;
- the insolvency did not affect any payments under the D&C or O&M contracts; and
- a significant piece of infrastructure was delivered at a cost to taxpayers far less than would have been the case had government procured it under a publicly funded delivery model.

Similar outcomes have been achieved on other so-called failed PPPs, such as the Lane Cove Tunnel and AustralAsia (Adelaide-Darwin) railway projects (although the sale proceeds on both were insufficient to fully repay the outstanding senior debt).

While these projects failed to achieve their revenue forecasts, the consequences of this risk were borne as intended, ie. firstly by the equity investors and then by the lenders. From their perspective, these projects failed. However, the objectives of government and the SPV’s contractors were achieved, and from their perspective these projects can be considered successes.

Risk transfer is illusory

Critics of PPPs say the risk transfer is illusory.

It is true there have been some Australian PPPs where the government has felt the need to:

- take control of a project; or
- provide additional financial support to a project,

because risks had occurred that the private sector had accepted but ultimately not been able to manage.

For example, in October 2000 the Victorian Government took control of the Metropolitan Women's Correctional Centre to overcome a failure by the private sector to provide adequate service levels. In the same month, it also bought back the Latrobe Public Hospital project for similar reasons. And in 2006 the NSW Government announced it would buy back the contract for the provision of health services at the Port Macquarie Base Hospital to address poor service levels. In each case, the private sector had underestimated the cost of meeting its service obligations and, in the case of the hospitals, had underestimated demand risk.

More recently, in February 2012 the NSW Government agreed to provide conditional deferred equity of A\$175 million to the Waratah train PPP project, to overcome concerns regarding the SPV's ability to refinance its debt in 2018.

So, there have been occasions where government has ended up sharing some of the risk that it thought it had transferred to the private sector under a PPP contract.

That said, there are many more PPPs where the private sector has paid dearly for miscalculating or mispricing the risks involved. Examples include:

- the toll road projects where traffic has been overestimated: those holding equity in the Cross City Tunnel project were expected to lose between 80 and 90 cents for every dollar they invested, when the project was sold by the receiver in June 2007. But they fared better than those who held equity in the Lane Cove Tunnel, who lost all of their equity when that project was sold by the receiver. Indeed, the lenders also took a haircut on that project, as the sale proceeds were insufficient to fully repay the debt. Those who bought ConnectEast shares for \$1 in 2004 received just 55c for their securities when the road was sold in September 2011. Similar outcomes are expected on the Clem7 and Brisbane Airport Link projects;
- the AustralAsia (Adelaide-Darwin) railway: demand for rail freight services was over-estimated resulting in the SPV becoming insolvent, and the project being sold by the receivers for an amount less than the senior debt

then outstanding, such that the other creditors and the equity investors lost all their money;

- the Brisbane Airtrain: initial predictions of passenger numbers went unrealised, resulting in a financial restructure which saw debt swapped into equity, and the interests of existing equity investors reduced by about half;
- Southern Cross Railway Station: Leighton Holdings announced forecast losses of \$122.6 million as a result of cost overruns under the D&C contract;
- the RailCorp Waratah Train: Downer EDI has announced losses totalling A\$440 million on the D&C contract;
- the Victorian Desalination Plant: in March 2012, Leighton Holdings announced that it expected to make a loss of A\$602 million on the D&C contract, after originally forecasting a profit of almost A\$300 million;
- the Brisbane Airport Link: at the same time, Leighton Holdings announced that it expected to make a loss of A\$668 million on the D&C contract, after originally expecting to make a profit of A\$407 million; and
- Ararat prison, where the lenders have had to step in and appoint a new builder following the insolvency of the original D&C contractor.

Clearly, risk transfer was not illusory on these PPPs.

Insufficient flexibility

PPPs involve long-term commitments, often in the order of 30+ years. Breaking a PPP contract early can be expensive, as counterparties will be entitled to be compensated for the return they would have derived from the contract. Accordingly, government should not contract for a term longer than it can sensibly commit to.

PPP contracts should allow government to direct the SPV to vary the infrastructure, or the associated services, if its requirements change or it wishes to reduce its spending.

That said, infrastructure investments are inherently long-term in nature. If government decides that a hospital that is only 10 years old is no longer required, it will be expensive to abandon it, having regard to sunk capital costs, even if it was built using traditional short-term construction contracts. Accordingly, for infrastructure having a long useful life, it can be sensible to make long-term contractual commitments.

What is important is that PPP contracts include provisions which enable government to direct the SPV to vary the infrastructure, or the associated services provided by the SPV, if government's requirements change during the contract term or it wishes to reduce its spending. Government should, of course, reimburse the SPV for all additional net costs, or loss of revenue, reasonably incurred by the SPV as a result of a government-initiated variation.³ Most Australian PPP contracts give government the flexibility to direct such variations on this basis.

Variations are said to be expensive under PPP contracts. But are they really more expensive than the cost of variations to traditionally procured infrastructure? Or are the true whole-of-life costs of a variation simply more transparent under a PPP contract?

For example, variation costs payable under a traditional construction contract will only cover the additional costs incurred by the construction contractor during the construction phase. If the variation will also increase the cost of operating or maintaining the facility, these further costs will be incurred by government in the future. With a PPP, all additional operating or maintenance costs that will be reasonably incurred by the SPV are assessed and included in the variation costs payable to the SPV.

The SPV's contractors will expect to be paid a margin on top of the costs which they incur as a result of a government-initiated variation, which is appropriate if the contractor bears risk in relation to the variation (such as the actual cost of the variation exceeding the estimated cost). The SPV may also seek a margin on top of the amounts that it must pay to its contractors. Government should seek to pre-agree the variation margin entitlements of the SPV and its contractors during the competitive bidding phase of the project. Government should also ensure that any entitlement of the SPV to charge a margin on top of those charged by its contractors is appropriate, having regard to the allocation of risks associated with the variation as between the SPV and its contractors.

Finally, government should consider "pre-priced variations" for those variations that are likely and that can be priced by bidders during the bidding process, subject to also considering the impact that this will have on bidding costs.

Accordingly, significant flexibility can be obtained on a value for money basis with an appropriately structured variation mechanism.

Challenges can arise when government wishes to vary a PPP project in a fundamental way that can't be accommodated within a normal variations clause. A recent example is the Sydney light rail project. The current light rail system from Central to Lilyfield was procured under Build, Own, Operate and Transfer PPP contract signed in 1994. The NSW Government made unsuccessful attempts to negotiate amendments to the contract to enable the extension of the light rail network; it addressed the impasse by agreeing to buy the SPV from the equity investors in 2012.

More modern PPP contracts address this issue by giving the government the right to terminate the contract for convenience, subject to paying an early termination amount, so that it can call for tenders for a new contract which combines the construction and operation of the original and extended networks.

Fetter on future decision-making

PPPs can constrain flexibility of future public policy decision-making. This is particularly so with user-funded PPPs.

For example, the existing Sydney toll road concessions are an impediment to the implementation of a consistent network wide tolling policy across the Sydney orbital network, as any changes to the tolling arrangements for those parts of the network operated by existing concessionaires require their agreement. Those existing concession agreements also contain provisions which can require the government to compensate the concessionaire for the loss of toll revenue associated with certain transport policy decisions, such as the development of alternative roads or transport options.

Governments should avoid making contractual promises that fetter the ability of future governments to implement their policies. Indeed, such promises are unenforceable under Australian law in any event. Rather, PPP contracts should expressly state that they do not affect the ability of the government of the day to implement its policies. It is, however, appropriate for a PPP contract to:

- record any agreed assumptions as to future government actions which underpin the private sector's investment in the project; and
- require government to compensate the SPV if future government actions depart from the agreed assumptions and this adversely affects the SPV.

³ This reimbursement should also occur in a timely manner, which avoids the need for the SPV to raise additional debt or equity to finance the variation costs.

Accounting treatment

Opponents say governments favour PPPs because they shift the project off the government's balance sheet. While this may have been true in Australia in the late 1990s, balance sheet treatment is no longer a driver of Australian PPPs.

Currently, most Australian governments will only commit to a project following the allocation of its full capital costs within the relevant government's budgetary cycle. If the government chooses to proceed with a government-funded PPP model, it reallocates that capital allocation to cover its future service payment obligations, which are shown in its balance sheet as a liability.

It remains true that wholly user-funded PPPs are not shown in the government's balance sheet, but this is because the government doesn't pay for the infrastructure – users do.

Transparency

Critics have complained about the lack of transparency over returns made by investors and future liabilities of taxpayers. Much of this criticism has been directed at UK PPPs, rather than Australian PPPs.

"Excessive profits" and "windfall gains" to equity investors on Australian PPPs are rare. Unscheduled refinancing gains are typically shared. And user-pays PPPs typically require revenues in excess of those forecast in the base case financial model to be shared with government. Windfall gains from unused major maintenance reserves are also uncommon in Australia.

The UK Government has recently announced a number of changes to its PPP policy aimed at improving transparency, including:

- government taking a minority equity interest in the SPV and thereby getting a seat on the SPV's board of directors;
- requiring the private sector equity investors to provide forecast and actual equity return information, for publication;
- government having the right to attend SPV board meetings as "an observer"; and
- an open book approach to major maintenance reserves.

Whether these approaches will have the desired effect, or create other problems, remains to be seen. By investing equity in the SPV, the government will assume those risks borne by equity. This will adversely affect the value for money which government presently obtains from transferring such risks to the equity investors. It also creates conflicts of interest. For example, the termination of the PPP contract by procuring agency because of poor performance of the SPV would be contrary to the government's interest as an equity investor.

Further, requiring private sector investors to disclose their forecast and actual equity returns is contrary to laws in Australia which require the full publication of PPP contracts, other than provisions which disclose the profit margins of the private sector participants (or other "commercial-in-confidence provisions").



Excessive profits and windfall gains to equity investors on Australian PPPs are rare.

How can PPPs be improved?

Only use PPPs for suitable projects

As already mentioned, PPPs should only be used on suitable projects, where the PPP model is likely to deliver a superior value for money outcome to any alternative delivery model. The below table identifies characteristics which make a project suitable or unsuitable for a PPP.

Is a PPP the right model for my project?	
Yes, if ...	No, if ...
<ul style="list-style-type: none"> it involves infrastructure and services which are likely to be required for the duration of the contract 	<ul style="list-style-type: none"> the project involves the development of infrastructure which is constantly changing, such as information technology and telecommunications projects, or defence projects involving weapon systems
<ul style="list-style-type: none"> the infrastructure and services are unlikely to change significantly during the term of the contract, or any changes can be predicted and priced up front 	<ul style="list-style-type: none"> the project outcomes government desires are not sufficiently certain to enable the private sector to devise and price an infrastructure and service solution
<ul style="list-style-type: none"> the project involves risks which cannot be transferred to the private sector under alternative delivery models (eg. demand risk), but which the private sector is prepared to take at a price lower than it would cost government to manage the risk itself 	<ul style="list-style-type: none"> the project involves many significant risks which are most efficiently managed collectively (ie. by government embracing and sharing the risks with the designer, the constructor and the operator/maintainer), rather than by allocating them to a particular party
<ul style="list-style-type: none"> the project is complex or unique, and therefore likely to benefit from the additional due diligence which private sector financiers will perform 	<ul style="list-style-type: none"> the government wants a high degree of control over service delivery
<ul style="list-style-type: none"> the project is of sufficient size (eg. the capital cost exceeds \$100 million) to justify the transaction costs associated with a PPP 	<ul style="list-style-type: none"> the project involves public interest issues best managed by traditional procurement approaches which give government greater control

More risk sharing

Some private sector participants have suffered significant losses on Australian PPP projects from the risks they have accepted. This has been most evident in the case of demand risk on toll road projects, as discussed above.

The poor financial performance of most recent Australian toll road projects has significantly reduced the appetite of equity investors and debt financiers to take demand risk in greenfield projects. The last greenfield toll road project which sought to transfer demand risk to the private sector was the Legacy Way project in Brisbane, but government abandoned its plans to deliver this project under a user-pays PPP model when only one bidder was able to attract the necessary finance.

Consequently, recent Australian PPPs involving economic (ie. income producing) infrastructure have not sought to transfer demand risk to the private sector. For example, government bears demand risk on the Gold Coast Rapid Transit project, and the same is proposed for the PPP component of the North West Rail Link project. It has also been recently announced that government will bear demand risk on the initial section of the WestConnex Motorway in Sydney, and on stage one of the East West Link in Melbourne.

But it is not just demand risk that has caused heavy losses on PPPs. D&C contractors have also incurred significant losses as a result of construction risks on PPPs. As a result, contractors are more fully pricing, or refusing to accept, some construction risks (such as site condition risks, contamination risks, and change in law risks). In response, government takes more construction-related risks in order to achieve the optimal value for money risk allocation.

Contractors are more fully pricing, or refusing to accept, some construction risks.

But this diminished private sector appetite for risk can reduce the case for doing a project as a PPP, as an alternative delivery model may achieve equivalent risk transfer without the higher financing costs. For example, on a road project where government takes demand risk, a publicly funded design, build and maintain (DBM) contract can achieve similar risk transfer as a privately financed "availability payment" PPP, but without the higher cost of private sector finance. Although the benefit of additional due diligence and monitoring by the lenders and equity investors is lost under a DBM model (as there is no debt or equity capital at risk during the maintenance phase), it's still possible to create sufficient incentive for the contractor to optimise whole of life costs and perform the maintenance tasks well by ensuring an adequate portion of the DBM contractor's maintenance fee is fixed and at risk for performance.

There are, of course, other delivery models for infrastructure projects that involve significant risk sharing between government and the private sector, such as alliancing and other forms of collaborative contracting. Properly applied to the right projects, these delivery models can deliver better value for money outcomes for government than privately financed PPPs.

The flip side of greater risk sharing is less cost certainty for government, as government shares the cost of dealing with shared risks that materialise after the contract is awarded. Other PPP benefits which can be lost or reduced by adopting alliances and other models involving greater risk sharing include:

- the benefits which the rigour of limited recourse financing brings to a project (because the sharing of significant risks by the SPV, where those risks are not then transferred by the SPV to contractors with large balance sheets, is incompatible with the raising of limited recourse project finance by the SPV); and
- the optimised whole-of-life costs, and upfront commitment of funding for maintenance to specified standards, derived from bundling maintenance services with design and construction services into a single fixed price contract.

More robust financing structures

A number of Australian PPPs have failed because, amongst other reasons such as over-optimistic revenue forecasts, the SPV's financing structure was too aggressive (ie. too highly leveraged) and consequently could not absorb unexpected costs or revenue shortfalls.

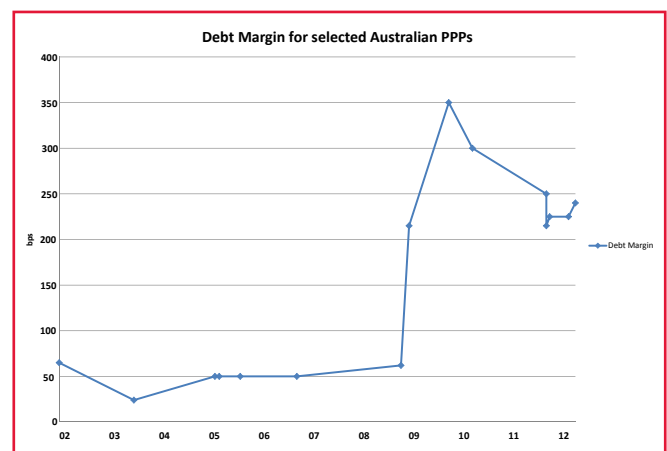
Although the financial consequences of these failures have generally been borne by the equity investors and, in some cases, the debt financiers, government has suffered political damage from being associated with the failure.

The risk of such failures can be reduced by government encouraging bidders to adopt less aggressive financing structures. This can be done by making "the robustness of the financing structure" one of the evaluation criteria against which bids are assessed, and by giving more weight to this criterion. Government would, however, need to be prepared to pay for the additional financing costs associated with a more robust financing structure, which would manifest in a higher service payment or government capital contribution.

More robust financing structures will also improve the credit rating of PPP projects and, consequently, their attractiveness as an equity investment opportunity.

Minimise financing costs

As already discussed, the due diligence and project monitoring undertaken by private sector financiers are significant drivers of the superior cost and time certainty outcomes achieved by PPPs. However, as the below graph demonstrates, the cost of private finance for PPPs in the current market is high, compared with pre-global financial crisis financing costs. This has made it harder for PPPs to provide better value for money than traditional delivery models.



Australian governments are responding by exploring and adopting funding models which minimise the amount of private finance needed to maintain the risk management disciplines which private finance brings.

This can be achieved by government providing a portion of its funding earlier, thereby reducing the amount of private finance required, or the period for which it is required. The additional or accelerated government funding can take many forms, including progress/milestone payments during the construction phase, a capital contribution at or shortly after the facility commences operations, or a service payment structure which is front ended (rather than flat). Recent projects which have adopted such funding models include Sydney International Convention, Exhibition and Entertainment Precinct, Sunshine Coast University Hospital, Gold Coast Rapid Transit and the Victorian Comprehensive Cancer Centre. A similar model is proposed for the North West Rail Link.

The impact that the form, amount and timing of any government funding will have on the risk borne by government must be carefully considered. For example, the amount of private debt carried by the SPV and the associated financing costs could also be reduced by government investing equity in the SPV, or by government becoming a lender to the SPV.

However, these approaches involve government assuming the risks borne by equity investors or lenders, which adversely affects the value for money of a PPP compared to traditional models. Government guaranteeing the repayment of the SPV's debt raises similar issues. The participation of government in PPPs as both the procuring agency and as an equity investor or debt financier also creates conflicts of interest, as previously mentioned.

For large projects, where lack of liquidity could force financing costs to be too high to provide value for money, deferring the requirement for underwritten debt finance until later in the bidding process can also reduce the cost of finance.

Reduce transaction and bid costs

PPP procurement processes take longer than many traditional types of procurement. There are many reasons for this, including:

- the need for government to determine and articulate not only its short-term requirements, but also its long-term requirements, before calling for tenders;
- the need to short-list bidders before requesting detailed proposals – most bidders won't invest in the significant cost of preparing a detailed proposal unless the field of potential bidders has been narrowed;

- the due diligence undertaken by debt and equity financiers; and
- the need to finalise contracts with a larger number of counterparties.

Consequently, the cost of bidding PPPs is significant. Some private sector participants say it is excessive.

In response to industry concerns about the high cost of bidding PPP projects, Infrastructure Australia commissioned a detailed review bid costs for PPPs by KPMG.⁴

Key findings from the KPMG Review

- Australian PPPs are generally more complex than those in other countries, because of Australia's focus on value for money; Australia's federal government system, with different laws and policies at the federal level and in each State and Territory; and Australia's complex tax system.
- The average value of Australian PPP projects is also considerably higher than those in the UK and Canada.
- These factors make like-for-like comparisons with procurement processes of other countries difficult.
- That said, the average procurement time for government-funded PPPs in Australia of 17 months is close to world's best practice (Canada – 16 months), and is considerably shorter than the UK (34 months).
- Australian PPP bid costs have been 0.5-1.2% of project capital value, which is higher than Canada (0.35 – 1% of capital value), but considerably lower than the UK (2-3% of capital value).
- For smaller projects, where a like-for-like comparison is possible, Australian bid costs are perhaps 25-45% higher than those in Canada.
- The largest component of Australian bid costs is usually design costs (50-60%, up from approximately 40% in 2005). Legal fees have dropped significantly from 40% in 2005 to 10-12% in 2010.

Are bidding costs excessive, and is competition being affected?

According to KPMG, bidders typically spend about A\$2.5 million on bids for projects with a capital value between A\$250-300 million, rising to A\$5-6 million for a A\$1 billion hospital, and A\$30 million or more for a large A\$2 billion plus economic infrastructure project. It is possible that costs have been exaggerated, as KPMG appears to have relied on information provided by market participants without verifying it.

⁴ KPMG, PPP Procurement – Review of Barriers to Competition and Efficiency in the Procurement of PPP Projects, May 2010 .

The costs also include success fees paid to consortium members in the winning consortium.

While these costs may be significant in absolute terms, they equate to between 0.5-1.2% of project capital value (with the larger projects costing proportionately less), which is close to world's best practice, so they are certainly not excessive.

There is also little, if any, evidence that these bid costs are discouraging potential bidders from bidding to an extent which is materially affecting competition and, consequently, the value for money which government is obtaining from PPP bidding processes.⁵

Value for money drives higher bidding costs

The higher bidding costs of Australian PPPs, compared to those in Canada (best practice), are partly caused by Australian government agencies' preference for a high level of certainty on commercial terms before a sole preferred bidder is appointed. Canadian procuring agencies, on the other hand, are prepared to leave more for negotiation after a sole preferred bidder has been selected. Consequently, further bidding stages involving requests for "best and final offers" are more common in Australia.

This driver of higher bidding costs is a consequence of the strong emphasis in Australia on achieving best value for money for government. The adoption of certain strategies used in Canada that have reduced procurement periods and bid costs – such as deferring the negotiation of commercial terms, and the development of concept designs, until after the appointment of a sole preferred bidder – would undoubtedly reduce the value for money outcomes which have been achieved on Australian PPPs by completing these tasks within a competitive environment.

Even though the additional bidding costs, including losing bidder costs, are ultimately borne by government in the form of higher contract prices, the additional value which government achieves by finalising the key drivers of value for money in a competitive environment would almost certainly exceed the additional bidding costs.

Indeed, there is a strong case for government to return some of this value to the losing bidders that generate it, by reimbursing a portion of their bid costs.

Of course, there is no case for continuing parallel negotiations with multiple bidders once it becomes certain that a clear leader has emerged. Stalking horses are neither appropriate nor fair.

Strategies for reducing bidding costs

There are a number of strategies which governments can adopt to reduce bidding costs of which would not affect value for money. These include:

- avoiding premature project announcements, and allowing sufficient time for pre-tender phase preparation;
- adopting a sensible procurement timetable, and sticking to it;⁶
- only issuing the request for detailed proposals once all necessary preparatory work has been completed, thereby minimising the need for addenda and re-bids;
- ensuring the government project team is resourced with highly capable people;
- adopting a clear and effective governance structure to facilitate quick decision-making on the government side;
- interacting effectively with bidders during the tender process, consistent with appropriate probity arrangements;
- not asking bidders to provide information which isn't needed to evaluate their capability, or to achieve certainty on commercial terms prior to the appointment of a sole preferred bidder;
- reducing the amount of bid phase design work required from bidders, and instead placing greater reliance on the project contract requirements, including fitness for purpose warranties, the requirements of the performance specification (including minimum architectural outcomes) and the payment and abatement mechanism; and
- conducting due diligence investigations (eg. geotechnical, contamination, heritage) for the benefit of all bidders, where this is more efficient.

While bid costs may be significant,
they are certainly not excessive.

⁵ National PPP Working Group, Statement of Response to the Infrastructure Australia & KPMG Report, August 2010.

⁶ For benchmarks for best practice procurement timetables see Infrastructure Australia, Efficiencies in Major Project Procurement, Volume 1: Benchmarks for Efficient Procurement of Major Infrastructure, June 2012

Improve pipeline

According to the Infrastructure Australia/KPMG review, the most significant barrier to increased participation in the Australian PPP market is not bid costs but the stop/start nature of the project pipeline and existing and potential market participants' inability to undertake an informed assessment of likely PPP projects. Participants are then reluctant to expand their teams to meet surges in demand for PPP bids because they might not be able to continue to carry the cost of an expanded team.

Overcoming the infrastructure funding challenge is the key to unlocking an improved PPP pipeline.

Australian politicians would love to announce an extensive pipeline of projects. However, funding capacity is the constraining factor, as most Australian governments will only commit to a project following the allocation of its full capital costs within the relevant government's budgetary cycle. Accordingly, overcoming the infrastructure funding challenge is the key to unlocking an improved PPP pipeline.

Within the overall pipeline of projects that governments can afford, the PPP pipeline could be improved by ensuring, when the procurement method decision occurs, that the PPP model is adopted for those projects that are best suited to the PPP model.

There is, however, no case for giving preference to PPPs over alternative delivery models, as the recent change of UK policy demonstrates. The determination of the optimal delivery model should be unbiased.

Sensible management of probity

All participants in PPP bidding processes want a process that is fair. Potential bidders will be reluctant to invest in a bid if they are not confident that the process will be fair. Reduced participation in bidding processes will adversely affect government's ability to achieve the best value for money outcomes.

Consortium members also wish to ensure that the participation of other members of their consortium, or related companies of those other members, in a competing consortium will not result in their confidential bid information being shared with the competing consortium or otherwise adversely affect their own competitiveness.

Finally, both the successful bidder and government wish to avoid

situations that could result in a disgruntled losing bidder seeking a court order stopping the award of the contract based on the unfairness of the bidding process.

Accordingly, all parties have an interest in having adequate processes governing interactions between government and bidders, access to information and the participation of companies within competing consortia, to ensure the fairness and competitiveness of the bidding process.

That said, government also wishes to obtain the best possible bids. Workshops at which bidders can seek clarification of government's requirements and preferences, and road test potential solutions without their ideas being shared with other bidders, can greatly assist bidders in developing better proposals. These workshops can be conducted on a confidential basis with individual bidders, without being unfair to other bidders.

There have been occasions, however, where such interactions have been unnecessarily restricted out of concerns they could be unfair. But fairness can be maintained by giving all bidders equal opportunity to have such interactions. Relevant information which government volunteers to one bidder should be given to all bidders, but information given to one bidder in response to a confidential question need not (unless another bidder asks a similar question, in which event it should receive an equivalent response). If meetings or workshops are held, and each bidder gets as much time with the government's project team as the bidder wants, there is no need for each bidder get the same amount of time.

Governments need to better educate their bid managers and PPP project directors on how fruitful interactions can be managed without prejudicing the fairness of the bidding process. The guidance issued by Partnerships Victoria, and subsequently by Infrastructure Australia, on this topic is a good start.⁷

Cease using PSC as a pass/fail test of value for money

Australian PPP policy presently requires a Public Sector Comparator (PSC) to be developed for all PPPs as a way of testing whether the PPP provides better value for money than traditional procurement methods.

The PSC is an estimate of the whole-of-life risk adjusted cost of a project if delivered by government. Under most Australian PPP policies, a PPP can only proceed if the winning bid is priced below the PSC.

PSCs have been strongly criticised as a pass/fail test of value for money. They are inherently uncertain and can be easily manipulated to get the desired result.⁸ Indeed, the Australian experience has been that the PSC never wins. While there

⁷ Partnerships Victoria, Interactive Tender Process, Advisory Note, 2005; Infrastructure Australia, National Public Private Partnership Guidelines – Volume 2: Practitioners' Guide, pp70 – 71 and 109 – 122.

⁸ See Peter Fitzgerald, Review of Partnerships Victoria Provided Infrastructure – Final Report to the Treasurer, Growth Solutions Group, 2004, p30. See also Delivering better value for money from the Private Finance Initiative, House of Commons Public Accounts, 28th Report, June 2003.

have been some PPP projects which have stalled during the procurement process when no bid has beaten the PSC, the PSC has been adjusted on account of errors and new information, with the result that the project has been able to proceed as a PPP. Examples include the Victorian Comprehensive Cancer Centre and the Southbank Education and Training Precinct Development Project.

The concept of public provision of the project as the alternative can also be a fiction. The days of public works departments building large infrastructure projects are largely gone. If government doesn't engage a consortium SPV to design, construct and maintain a project under a PPP, then the most likely alternative is to engage a private sector contractor to do so under a DCM contract, or separate D&C and FM contracts. In this context, the government's PSC estimate of what it would cost to deliver the works and services under such contracts is unlikely to be more accurate than the prices obtained by the PPP bidders from their proposed D&C and FM contractors. The PSC estimate would need to include an allowance for government-initiated variations and other events that would entitle the contractor to payments additional to the original contract price.

The use of the PSC as a pass/fail test of value for money was abandoned in the UK in 2003. Presently, Australia is the only country which uses the PSC in this way.

Further, no other delivery model needs to justify its use by having competitively tendered bids beat a theoretical cost estimate for an alternative delivery model. Rather, theoretical cost estimates for various delivery models are used at the business case stage to determine which delivery model is likely to deliver the best value for money outcome. Having made that decision before calling for tenders, it is not revisited once competitively tendered prices have been received.

It is therefore a welcome development that the Victorian Government has now abandoned the pass/fail test. We expect other Australian governments will follow suit.

Of course, government should still do a detailed cost forecast to ensure that the performance outcomes it has specified are affordable. Government should also advise its affordability limit in the tender documentation. If government wants the best facility possible within its affordability limit then it should also consider providing bidders with "scope ladders" that indicate items that could be removed from the scope in priority order if bidders have difficulty in providing the full scope within the affordability limit, and additional scope items which could be added.

Encourage "owner-led" bids

Historically, consortia bidding for Australian PPPs have been dominated by investment banks and/or contractors who are more interested in the income they can generate out of doing the deal or the construction work, than being a long-term "owner" of the project. And when investment banks and contractors have taken equity interests in PPP projects, it has not been uncommon for them to sell their equity interests shortly after financial close or before the completion of construction.



Government should encourage
"owner-led" bids.

Governments at various times have responded by expressing a desire for more "operator-led" consortia. It should be remembered that limited recourse financing will require the SPV to transfer most risks associated with the operation of the infrastructure facility to an operator with the expertise and balance sheet strength to manage such risks. Further, having accepted such risks, the interests of the operator will conflict with the interests of the equity investors from time to time. If the operator is performing poorly and is unable to lift its performance to an adequate level, the equity investors may wish to appoint a replacement operator.

Accordingly, government should instead be structuring its tender processes and evaluation criteria to encourage consortia that are led by those who will be the long-term "owners" of the project. Of all the private sector participants in PPP, it is the long-term owners whose interests will be most aligned with those of government.

Unbundling

Australian governments have encouraged PPP bids from consortia that can provide the complete package of services required for the project, including financing, construction, maintenance and operations or service provision. In doing so, governments are not able to cherry pick the best components from competing bids. The bidder that offers the best service solution may be rejected in favour of another bidder who offers the best overall value for money because it has a cheaper financing solution.

Government may be able to achieve better value for money by unbundling the PPP, and separately tendering one or more of the construction, maintenance or debt financing packages after it has appointed its preferred private sector partner for the project. Indeed, a portion of the equity package could also be separately tendered, as recently proposed by the UK Government.

However, unbundling a PPP would not be without its own difficulties. For example, if the owners and service providers are appointed ahead of the lenders, the rigour which the lenders bring to the assessment of project risks will not occur until after the owners and service providers have been appointed. The lenders may identify risks which have been inadequately assessed or allocated, resulting in the reopening of proposed commercial terms.

Perhaps this risk could be addressed by requiring a portion of the debt to be fully underwritten at the time the owners are appointed, with a separate debt funding competition for the balance of the debt to follow. But the underwriting financiers would need to be recompensed for their additional effort. Lack of debt financier engagement during the bid development phase has been one downside of separate debt funding competitions in the UK.

Similarly, the UK Government's proposal to have an equity funding competition after the appointment of a preferred bidder may discourage equity investors from incurring the expense of developing a proposal to that point, as the return they receive through a forced sale of a portion of the equity may not adequately compensate them for the bid development costs which they have risked.

Expand scope of services

Australian PPP policy guidance presently draws a distinction between "core services", such as the clinical services provided at hospitals, and "non-core services" (otherwise known as "ancillary" or "soft" services) such as laundry, cleaning, and catering. The policy says that non-core services can be delivered by the private sector, but that responsibility for the delivery of the core services must remain with government.

But does this approach deliver best value for money for taxpayers?

For example why shouldn't school PPPs require the private sector to also provide teaching services? The Australian private school sector has a strong track record in delivering high-quality teaching services. Why don't State governments measure the quality of the teaching services delivered, rather than the quality of the building environment in which the services are delivered?

Similar questions can be asked of Australian hospital and prison PPPs where government is providing the clinical and custodial services.

We expect other governments will follow the lead of the Victorian Government, and consider including services previously considered core in PPPs.

Project governance

Australia has seen many different governance arrangements for PPP projects. Some have been procured by the government agency that will be the customer (examples include the Waratah Train PPP procured by RailCorp, and the Sydney toll road PPPs procured by the Roads and Traffic Authority).

Others have been procured by project specific authorities established for the sole purpose of delivering the project (for example the Melbourne City Link Project, procured by the Melbourne City Link Authority).

Some of these authorities continue to manage the project contracts during the operations phase (for example, the AustralAsia Railway Project between Adelaide and Darwin, which continues to be administered by the AustralAsia Railway Corporation established by the South Australian and Northern Territory Governments).

Others have transferred the contract management function to the customer agency following completion of construction and become responsible for the procurement and delivery of further projects. For example, the contracts for Eastlink are now administered by VicRoads, after having been awarded and managed during the delivery phase by the Linking Melbourne Authority, which is presently responsible for the management of the contracts for the Peninsula Link road project that recently opened to traffic).

State Treasury Departments have controlled the development of PPP policy, and developed specialist expertise in the structuring, negotiation and administration of PPP contracts. More recently, Infrastructure NSW has developed centralised expertise in the structuring and negotiation of PPPs.

There presently seems to be a preference for more centralised PPP procurement authorities. This approach facilitates the development of public sector expertise in the procurement of PPPs, as it provides opportunities for public sector procurement specialists to apply lessons learned to subsequent projects and to further develop their skills. A downside, however, is that customer agencies that take over the administration of the contracts once the procurement and

construction phases have been completed find it difficult to understand and master the complex contractual arrangements which they inherit. There is considerable value in government achieving continuity of expertise across the procurement, deliver and operation phases of a project. The Waratah Train PPP is a rare example of a project where the government's project director has been critically involved in each of the procurement, delivery and operation phases.

Contract management plans and contract administration manuals should be developed for all PPP projects. The contract administration manual should evolve as the project moves through the design, construction and operation phases.

Disclose weightings for evaluation criteria

Australian governments advise bidders of the evaluation criteria against which PPP bids will be assessed, but they do not disclose the relative importance (or weightings) of the non-price evaluation criteria.

Why Australian governments do not want bidders to know the relative importance of the non-price evaluation criteria is puzzling, as government is more likely to get better proposals if it tells bidders what it prefers.

Dispute Resolution Boards

Dispute Resolution Boards (DRBs), which are also referred to in Australia as Dispute Avoidance Boards, have established themselves as very effective mechanisms for the avoidance and resolution of disputes on major infrastructure projects.

DRBs have not yet, however, been used on an Australian PPP project, and perhaps not on any PPP project worldwide. An opportunity therefore exists to improve dispute avoidance and resolution practices on PPP projects.

What are DRBs and why do they work?

Australian DRBs usually comprise independent three people, appointed by the owner and the contractor at the commencement of a project to assist with the resolution of issues which arise during the construction of the project. The DRB members will typically have between them significant experience in the delivery of similar projects, and the resolution of disputes arising out of such projects. The combined expertise of the DRB members is typically a blend of engineering, project management and legal expertise. They are typically "grey hairs" that are well respected by the parties and thus able to ask questions and express views which will be listened to, carefully considered and actioned.

The DRB will typically conduct regular (eg. monthly) site visits and joint meetings with the owner and contractor during the construction of the project, at which either party can raise issues requiring resolution. The DRB will ask questions and make suggestions in an effort to assist the parties to address and resolve

these issues before they escalate into full-blown disputes. This **dispute avoidance function** is akin to proactive mediation, in that it occurs before issues become disputes, with the DRB helping the parties to resolve their issues through consensual agreement at the job level.

Most DRBs also have a **dispute resolution function**, whereby either party can formally refer a dispute to the DRB for a written determination. These determinations can be binding or non-binding, depending on what the parties agree in their DRB agreement. Either way, the parties will usually agree that these determinations are to be "with prejudice", ie. they can be submitted in any subsequent court or arbitral proceedings. Doing so is thought to reduce the likelihood of subsequent proceedings, as a court or arbitrator will likely pause for thought before departing from the determination of a wise group of people with detailed knowledge of a project's history and the matters in dispute.

What does it cost?

While there is a cost associated with regular DRB meetings throughout the construction process, the cost is low compared to the value that Australian DRBs are delivering. The base cost of a DRB in Australia is between 0.1 and 0.2% of the total project cost on a project over A\$100 million. That equates to between A\$100,000 and A\$200,000 for a A\$100 million plus project. The base cost doesn't increase much as the project value increases.

On the value side, it was reported at the Dispute Resolution Board Foundation's 2012 International Conference in Sydney that DRBs have been used on more than 30 projects in Australia, with not one having had a dispute proceed beyond the DRB. Further, the value of the dispute avoidance role of Australian DRBs was evidenced by there having been a total of just six disputes referred to the DRB for a formal determination across those 30 projects, which range in value from A\$22 million to A\$1.8 billion. For each of those six disputes, there would be literally dozens upon dozens of issues that if left unattended would undoubtedly have become a source of conflict.

Can the model be used on PPPs?

As already mentioned, PPPs differ from traditional construction contracts in several key respects. In the DRB context, relevant differences include:

- the owner, in this case the relevant government agency, enters into a PPP contract with the SPV, who in turn enters into a traditional D&C contract with a D&C contractor, and an FM contract with an FM contractor;
- the D&C and FM contracts will typically reflect the risk allocation in the PPP contract, and will state that the relevant contractor is only entitled to additional money from the SPV if the SPV can recover such additional money from the government agency under the PPP contract. The D&C and FM

contracts will also typically allow the relevant contractor to control how the SPV conducts “pass through” claims, ie. claims under the PPP contract which concern corresponding claims under the D&C or FM contract; and

- the loan agreement between the SPV and its debt financiers will typically require the SPV to notify the debt financiers of any claims made by the D&C or FM contractor for extra time and/or money, and will prohibit the SPV from settling such claims without the consent of the debt financiers.

There is no reason why the success of DRBs on Australian infrastructure projects cannot be replicated on PPP projects.

A DRB on a PPP project would need to reflect this contractual structure. Each of the government agency, the SPV, the D&C contractor and the FM contractor would need to agree to the establishment of the DRB. The consent of the debt financiers to the establishment of the DRB may also be necessary.

The DRB could be empowered to deal with all issues arising under the PPP contract including those involving the D&C or FM contractor. Regular DRB meetings involving pass-through issues would be attended by each of the government agency, the SPV and the D&C and/or FM contractors (and perhaps also the debt financiers). The relevant contractor would also be entitled to take over the running from the SPV of any pass-through claims referred to the DRB for a formal determination. Agreements to settle disputes and/or depart from the requirements of the PPP contract, the D&C contract and/or the FM contract would require any necessary consent from the debt financiers.

The same DRB could also be utilised by the SPV and each contractor to deal with issues arising under the D&C contract or the FM contract which don't involve a corresponding claim under the PPP contract.

There is no reason why the success of DRBs on Australian infrastructure projects cannot be replicated on PPP projects.

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