Review of *Partnerships Victoria* Provided Infrastructure

Final Report to the Treasurer

January 2004

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Partnerships Victoria - Review

The Hon. John Brumby MP
Treasurer
1 Treasury Place
Melbourne VIC 3002

28 January 2004

Dear Treasurer

Report of the Review of *Partnerships Victoria* Provided Infrastructure

I have now completed the task you assigned to me in August 2003 and herewith transmit my final report to you for consideration by the Government. Twenty-two specific recommendations of the review are listed in Appendix A of this report.

The recommendations included in the report would result in a significant strategic realignment of the policy. The recommendations enjoy broad support with the exceptions being a concern about deal flow and concern about when and how market risk should be priced. I believe that both should be resolved with a view to maximising value for money; which means a more selective approach to paying market premia, and a deal flow driven by evidence of savings.

One area in which I have been unable to do justice to the task is a comprehensive review of processes and documentation towards streamlining and standardisation. I suggest that this is an area in which more work might be done by the proposed National PPP Council and its working party; an initiative by the way, that I commend yourself and the Premier for initiating.

I would be happy to elaborate on the findings and recommendations, or on any other aspects of the review.

Yours faithfully

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Reviewer

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ACKNOWLEDGEMENTS

Although this review has been structured as being the work of a single-person reviewer, it has been ably supported by a review team and a Reference Panel.

The review team has included almost full-time support from Bernard Moylan, a former officer of the Department of Treasury and Finance, and now a consultant. His encyclopaedic knowledge of public administration in Victoria has been invaluable. The evaluation of the eight case studies has been undertaken with great rigour under the leadership of Fiona Thiele, a PhD researcher from Melbourne University. The development of findings and recommendations has also been assisted by the sage advice and steerage of Dr Colin Duffield of Melbourne University Private's Australian Centre for Public Infrastructure and Professor Bill Russell of Monash University.

Also assisting the review team has been a Reference Panel of senior officers involved in the procurement of projects via *Partnerships Victoria*. It has included representation from the Departments of Treasury and Finance, Premier and Cabinet, Infrastructure, Justice and Human Services.

The writing and editing of the Draft Report has also been assisted by Liz Sharman and by Leah Schuter, who also managed the logistics and scheduling for the review team.

Peter Fitzgerald

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EXECUTIVE SUMMARY

The Review of *Partnerships Victoria* Provided Infrastructure has been undertaken over the five months to January 2004 and involved a review of eight projects and the processes involved in their evaluation.

The review has examined project economics and contract documentation and has been briefed on the details and progress of the projects, of which two are operational and one is presently being commissioned. Briefings and discussions have taken place with over 30 organisations and government agencies involved in the projects. Also, a public submission process was undertaken with the release of a Draft Report – emailed to over 150 people and downloaded from a website by a further 300.

A total of 38 written submissions were received in response to the Draft Report. Of the 20 draft recommendations, all except four received broad support.

The recommendations that enticed most disagreement relate to the proposed changes to the risk premium imbedded in the State's discount rate used in the evaluation processes. From the financial experts responding, the disagreement related to the practicality of estimating the value of transferred market risk, rather than its technical correctness. The other contentious recommendation related to the proposal to limit the application of the policy to projects over $100 million in size, where concerns were expressed for the impact on deal-flow.

The Final Report largely reiterates the findings and recommendations of the Draft Report. It argues for a significant realignment of the policy and the processes and projects involved. The Final Report provides further elaboration and evaluation of the key issues raised in the submissions. The major findings and recommendations are as follows:

- The first eight projects provide credible evidence of the benefits that may flow from the *Partnerships Victoria* channel of procurement, including innovation of design, timeliness of delivery, certainty of price and a whole-of-life approach to maintenance.

- The report recommends that the policy be strategically realigned towards infrastructure segments where the private sector can best add value. This might realign the policy towards large (e.g. more than $100m), complex, one-off or non-standard projects, or towards standard government buildings in circumstances where there are challenges of a technical, innovation or design nature.

- Based on the potential benefits and the niche role assigned, the report recommends that the State has an interest in ensuring that there is a critical mass of potential PPP participants capable of delivering up to 10 per cent of Victoria's annual investment in public infrastructure.

- The report also proposes that the processes of risk evaluation undertaken under the policy need to be further improved. Specifically they need to be based on better evidence of the frequency and quantum of risk events and to that end a Review of Major Projects is recommended. Further, the pricing of transferred market risks needs to be done more selectively; and where no market risk is transferred (the norm), the State should use a discount rate that does not incorporate a premium for risk.

- The other recommendations include the need for a concerted effort to improve the skills and capabilities within the government, to reduce transaction costs through streamlined processes and contractual material, a need for improved transparency and the piloting of new partnership and financial structures.

It should be noted that for a number of the recommendations, the *Partnerships Victoria* policy and practices have already been in a state of revision. To the extent that this review focuses on the eight initial projects, some comment necessarily relates to policy and practices that may have already been substantially realigned. Where this has occurred the report has noted the change.

CHAPTER 1

INTRODUCTION

1.1 THE REVIEW

The purpose of this review is to provide independent advice to enhance the future achievement of value for money in the public interest in projects undertaken under the *Partnerships Victoria* policy.

The task, allocated in mid-August 2003, was to produce a draft report and, following public comment, this final report to the Treasurer.

This review of the application of a three and a half year old policy services a commitment of the Government's 2002 election policy. The Terms of Reference of the review are in Appendix F.

It has been a very focused review, with some very specific terms of reference and a limited, but adequate, time for its execution. It should be complemented by the pending report of the broader Inquiry into Private Sector Investment in Public Infrastructure being undertaken by the Public Accounts and Estimates Committee of the Victorian Parliament.

When the Victorian Premier, on 10 November 2003, announced a proposed National PPP Council, the review observed that its emerging findings dovetailed very well with the intended agenda of the proposed Council. Hopefully, this report will be a useful input to the deliberations of the proposed Council.

A review team has evaluated the operation of the *Partnerships Victoria* policy by looking in detail at published guidance materials, the literature of PPPs, the contract and evaluation documents of the first eight projects, as well as scanning the project details of the next five projects under delivery. Before releasing a draft report, discussions were held with various government departments and agencies involved with *Partnerships Victoria* projects, members of parliament, industry groups, project advisors, financiers, constructors, operators of infrastructure and consumer groups.

Submissions, based on the Draft Report, were invited by newspaper advertisements. The Draft Report was provided by email to over 150 people and a further 300 downloaded it from the *Partnerships Victoria* website. A further round of briefings and consultations involved meetings with more than 50 people, including members of parliament, government officials, statutory officers, industry groups, project advisors, financiers, unions, academics, and constructors and operators of infrastructure.

The review received a total of 37 submissions, from a range of service providers, constructors, active citizens, financiers, academics, project advisors, industry associations, water authorities and interstate government organisations. Providers of these submissions are acknowledged in Appendix G.

1.2 PUBLIC PRIVATE PARTNERSHIPS

This report uses public private partnership (PPP) to designate a relationship between a government party and a private party to deliver public infrastructure or facilities and any related ancillary services. The relationship is regulated by a contract that allocates responsibilities, rights, risks and rewards between the parties.

Motivation, on the government side, typically includes the potential for:

- an improved focus on service delivery, by reducing the time and effort that an agency will spend on property-related matters;
- a requirement to pay only for defined infrastructure or facility-related services and to pay only when those services are delivered;
- a very high level of confidence that infrastructure will be available on time and without cost blowout;
- an ability to hold a provider financially accountable for the performance of particular infrastructure throughout its lifetime;
- access to the best technical and management skills, from whatever source;
- improved outcomes, by using competitive forces to stimulate creativity, pricing and delivery;
- access to infrastructure financing without additional government borrowing.

Governments adopt a somewhat common set of principles to be observed in their PPPs. Typically these include:

- specifying only (to the extent possible) the service outputs required, thus allowing scope for flexibility and creativity;
- tying payments to the achievement of specified performance standards and structuring the payments to provide incentives;
- including mechanisms to allow for government-initiated variations to meet changing service needs.

CHAPTER 2

PARTNERSHIPS VICTORIA

2.1 THE POLICY

Although private investment in infrastructure has a long history in Victoria, it is particularly relevant for this review to consider the nature of developments over recent years.

Published policies of previous Victorian governments include *Infrastructure Investment Guidelines for Victoria – "Public/Private Sector Partnership"* (issued by Treasurer Tom Roper in May 1991) and *Infrastructure Investment Policy for Victoria* (issued by Treasurer Alan Stockdale in June 1994). It seems that private financing arrangements before the Roper document were not directed by formal government policies. Hints at the motivation behind these two publications and the current policy appear in the foreword of each publication.

The *Infrastructure Investment Guidelines for Victoria (1991)* reflect a strong financial need and national restrictions on borrowings: 'The challenge of difficult economic times and national economic policies, which have reduced infrastructure spending to its lowest level since the end of World War II, mean that these vital investments cannot be met by Government alone.';

Infrastructure Investment Policy for Victoria (1994) suggests that increased private involvement can drive growth and efficiency: 'The Victorian Government is committed to the pursuit of growth and efficiency. It believes that this will be facilitated if the private sector participates to a greater extent in the provision of infrastructure and related services.'; and

Partnerships Victoria also seeks to harness benefits that may be gained by involving private parties in competitive bidding, but is more discriminating: 'Choices between public and private provision of infrastructure and related ancillary services will be made on practical grounds. Such choices will be based on consideration of the needs of each project and will be assessed against a rigorous public interest test which will examine the potential impact on privacy, security, consumer rights, public access and equity'.

Thus, the policy focus in recent times is represented as moving from a focus on overcoming fiscal restraints and Australian Loan Council limitations, through a focus on increasing the extent of private participation to stimulate growth and efficiency, to one of achieving value for money in the public interest.

This history is relevant in that it suggests that the rationale for private investment in infrastructure takes many forms and tends to change over time. It is expected to evolve further as experience is gained and results are reviewed.

The *Partnerships Victoria* policy has been published by the Victorian Department of Treasury and Finance in a twelve page document, with chapters headed: Scope and Application, Nature of Partnership Projects, Objectives, Principles, Protecting the Public Interest, Value for Money, Risk Identification, Allocation and Management, Engaging the Market, and Government Accountability and Support Structures.

The apparent purpose of this policy is to ensure that particular measures are adopted where private investment in public infrastructure is planned. That is, it seems concerned primarily with ensuring that various principles and practices are observed, to achieve optimum outcomes when private parties are invited to invest in infrastructure.

Notable reforms introduced by the *Partnerships Victoria* policy include:

- restriction of the role of the private sector to the provision of infrastructure and related ancillary services – that is, Government retains direct control over the delivery of core services;
- a formal public interest test; and
- a Public Sector Comparator.

2.2 PROCESSES

Operation of the policy is supported by a number of volumes of guidance material, including: *Practitioners' Guide* (June 2001); *Risk Allocation and Contractual Issues* (June 2001); *Public Sector Comparator – a technical note* (June 2001); *Overview* (June 2001); *Non-Metropolitan Urban Water Authority Approval Process* (June 2001); *Contract Management Policy* (June 2003); *Contract Management Guide* (June 2003); *Public Sector Comparator Supplementary Technical Note* (July 2003); and *Use of Discount Rates in the Partnerships Victoria Process Technical Note (July 2003)*. These publications are sold by Information Victoria, 356 Collins Street, Melbourne, or may be downloaded from www.partnerships.vic.gov.au.

The overall Victorian process, as it existed for most of the eight projects reviewed, is set out in the flow chart at Appendix E.[1] The review and some participants in the review, have identified a number of areas where the process may be enhanced. These are identified in the recommendations of the review and, at Appendix C, in a list of suggestions received relating to bidding and transaction costs.

[1] *Partnerships Victoria Guidance Material*, *Practitioners' Guide*, Department of Treasury and Finance, June 2001, p.14.

CHAPTER 3

PROJECTS REVIEWED

The review investigated eight projects for which contracts had been entered into at the time of the review. For this purpose, the review was able to draw upon contracts and other project documents and also the knowledge of officers and practitioners who had been involved closely with project development and delivery.

Four other projects which had been developed or partially developed as *Partnerships Victoria* projects did not result in *Partnerships Victoria* contracts. A proposed Westgate International Container Terminal did not go ahead, due to a low level of market interest. (Government had advised, when inviting private participation, that the project would not go ahead in the absence of acceptable bids.) A regional fibre optic initiative has gone ahead as publicly owned infrastructure, due to the absence of an acceptable private bid. A new multi-storey car park at Box Hill Hospital has gone ahead with public ownership and operation, also due to the absence of an acceptable private bid. A proposed rapid transit link between Melbourne and Melbourne Airport was found not to be viable at the time and was not put to the market.

Project information and some observations regarding the eight projects for which contracts have been entered into follows. This information and the observations are necessarily selective, being directed to the various matters raised by the terms of reference of the review. They do not portray or recognise the immense and highly skilled contributions of a range of officers to these complex and often very urgently needed projects. Delivery of these projects normally is very demanding of time, intellect and energy.

Some discretion has been used where commercial issues necessitate it, but the general objective has been to build on information already in the public domain.

3.1 VICTORIAN COUNTY COURT

The new Victorian County Court building is seen as a case study of the timeliness of delivery and the quality of finish that can be obtained from a PPP.

The building was built in under two years from the date of contract finalisation. The quality of the building and the services provided have been commended by the judiciary, the legal profession and by the public.

The contract was signed in June 2000. It was signed with The Liberty Group, a consortium including ABN AMRO Australia Limited, NM Rothschild & Sons (Australia) Limited, Multiplex Construction Pty Ltd and Honeywell Limited.

The project seeks to address case backlog, to meet foreseen demand, to improve service quality and to enhance court productivity.

Under the contract, The Liberty Group is required to provide a maintained court building, building management services, security and information technology systems. The Government's contractual arrangements involve commitments to make payments over the 20-year contract life of an estimated $519 million (*State Financial Report*, 2002-03)[2], including adjustments for forecast inflation. This payment stream was equivalent to a net present cost of $195 million (discounted at 8.65 per cent, nominal pre-tax) at June 2000.

The Liberty Group has a 99-year lease of the crown land on which the court is situated, for a peppercorn rent. The term of the accommodation contract is 20 years, with building management, security and IT services initially contracted for a five-year period and the State having options for five extensions of three years each for these services. Unlike other Partnerships Victoria accommodation contracts, the court building remains the property of The Liberty Group at the end of the contract period.

This project has been reviewed by the Victorian Auditor-General, who reported that in his opinion and despite retention by the State of a number of obligations, The Liberty Group bears substantial risks associated with the construction, financing and operation of the court facility.[3]

Because the project commenced under the Infrastructure Investment Policy for Victoria of the previous Government, it did not undergo the early processes and evaluation techniques of Partnerships Victoria, including the public interest test and construction of a Public Sector Comparator. A cost estimate based on a reference case was used for the sake of evaluating value for money. This estimate was subsequently revised and when bidders still did not better the revised estimate, best and final offers were invited.

This early *Partnerships Victoria* project gives rise to issues including:

- the absence of real-life benchmarks as the foundation of cost estimates and risk adjustments (a recently constructed nearby Federal court building could have assisted);
- the appropriate discount rate for evaluating the State's contractual commitments;

[2] *Financial Report of the State of Victoria 2002-03*, Department of Treasury and Finance, October 2003.
[3] Report on the *Finances of the State of Victoria 1999-2000,* Auditor-General of Victoria

- the treatment of residual value where the contract does not transfer the asset at the end of the contract term;
- the status of demand risk, for the purposes of determining the applicability of any risk premium in the discount rate, where the private party overcaters for the demand incorporated into the reference case.

These issues are considered in Chapter 4 of this report.

3.2 MOBILE DATA NETWORK

Motorola, in June 2003, contracted with the State to provide a Mobile Data Network for Victoria Police and Ambulance Service vehicles in the greater Melbourne and Geelong areas.

The Mobile Data Network was to meet an identified need to coordinate emergency communications and to allow more efficient communications by providing in-vehicle and out-of-car access to various databases, display maps and emergency dispatch information and to provide an automatic vehicle location function. The service was to provide a guaranteed operational availability of 99.9 per cent.

The project forms part of the Statewide Integrated Public Safety and Communications Strategy (SIPSaCS).

The contract, for a period of five years, has two optional extensions of two years each. The commitments under the contract involve estimated payments of $138 million (*State Financial Report*, 2002-03). This payment stream is equivalent to a net present cost of $85 million (discounted at 8.65 per cent, nominal pre-tax), and involves an 11 per cent saving against the risk-adjusted cost of the Public Sector Comparator.

A striking aspect of this project is the elapsing of three years between the receipt of bids and execution of a contract – a period occupied with alterations to the project scope, calculation of risk adjustments to the Public Sector Comparator and intensive negotiations to bring the preferred bid within State approved funding and client technical requirements. Some difficulties resulted from the industry's lack of experience with PPPs.

Issues of relevance to this review include:

- the adaptability and appropriateness of PPP methodologies to fast-moving areas of technology procurement;
- the applicability of the Public Sector Comparator to one-off projects where public sector provision is not a real option;

- the absence of benchmarks, both cost and functional, using existing off-the-shelf technology.

The design and development of the Network has begun.

3.3 DOCKLANDS FILM AND TELEVISION STUDIO COMPLEX

In September 2002, the State entered into a 20-year contract with Central City Studios for the construction of six studios and a complementary industry cluster suitable for local and international film and television production at a Docklands location. The State has committed a loan of $31.5 million and land (including some infrastructure contributions) valued at $8.7 million, plus other sundry commitments and contingencies.

This is an industry development initiative undertaken by Government to increase local and offshore film and television production in Victoria. It promotes an accessible and competitive environment for Australian film and television productions in Victoria to maintain a local industry with an internationally competitive capability, through development of a film and television industry cluster in and around a studio.

Various issues relating to this complex and drawn-out project are raised in a report by the Auditor-General and a response to that report by the Secretary, Department of Innovation, Industry and Regional Development.[4]

The project raises some issues of relevance to this review:
- the applicability of the *Partnerships Victoria* process to industry-development objectives;
- the applicability of the Public Sector Comparator to one-off projects where public sector provision is not a real option;
- the use of the Business Case for Industry-Development as a substitute for the development of a complete Business Plan for operation of the facility;
- the enforceability of performance covenants during the startup phase of the business.

Construction commenced in November 2002 and the expected completion date is March 2004.

[4] Report on *Public Sector Agencies Results of Special Reviews* and *30 June 2002 Financial Statement Audits,* Auditor-General of Victoria, February 2003, p. 168.

3.4 BERWICK COMMUNITY HOSPITAL

In October 2002, the State contracted with the Progress Health consortium for the provision of a new 'greenfields' hospital to service the fast growing Casey and Cardinia local Government areas. Progress Health is a special purpose consortium formed for this project. Its members include ABN AMRO, Multiplex Constructions Pty Ltd, Multiplex Asset Management, Silver Thomas Hanley Daryl Jackson Pty Ltd and Blake Dawson Waldron.

The hospital development project commenced under the *Infrastructure Investment Policy for Victoria* and had a difficult development period, including the withdrawal of a preferred bidder late in 1999. However, on recommencement, the project moved from invitation of expressions of interest to contract execution in a little under twelve months.

This project, at least in the second go-round, has been described by participants as a 'plain vanilla' project.

What appears to be a sound level of community consultation has been undertaken. Various rights are recognised in a public interest test and protected through provisions of the contract. The State is entitled to require (and pay for) modifications or extensions to the facility or, alternatively, may engage third parties to perform modifications or extensions.

The contract provides for design, construction and maintenance of a hospital building, provision of nominated primary medical equipment and provision of various support services. Operation of the hospital and provision of core clinical services is to be undertaken by Southern Health. The contract is for a period of 25 years, after which ownership of the hospital passes to the State.

The Government's contractual arrangements involve commitments to make payments over the 25-year contract life of an estimated $378 million (*State Financial Report*, 2002-03), including adjustments for forecast inflation. This payment stream is equivalent to a net present cost of $115 million (discounted at 8.65 per cent, nominal pre-tax) at June 2002. The cost was calculated as being a 9 per cent saving against the net present risk-adjusted cost of the Public Sector Comparator.

The Auditor-General's Report on the Finances of the State of Victoria 2002-2003 noted that: *'based on our assessment of the risk profile of the contractual arrangements ... we conclude that the key risks associated with the project remain with the State... Accordingly, we concur with the proposed accounting and financial disclosure for this project, which will entail its future recognition as a financing* *arrangement. On this basis, upon its completion in 2004, the hospital is to be recorded as an asset of the State with a corresponding liability to be recognised reflecting the State's obligations to finance the capital cost of the facility. In the interim, the nominal commitments associated with the project are disclosed as part of commitments in the Annual Financial Report.'* (para 7.56).

It should be noted that according to the Department of Treasury and Finance, the purpose of the transaction was not to access off-balance sheet financing. Prior to the Auditor-General's Report, the department had proposed that the liability for funding the project would be on the State's balance sheet.

Among the issues raised were:

- the appropriate discount rate for evaluating the State's contractual commitments and for calculating the savings, if any, against the Public Sector Comparator;
- the issue of whether the adjustments to the forecast cost of the tenders should include the possibility and cost of default or revision to the contract in the long term, having regard to case studies such as the Latrobe Regional Hospital;
- whether there should be specific accounting standards for the disclosure of commitments under PPP contracts, including whether and in what circumstances financial obligations under such arrangements should be considered as balance sheet liabilities.

Construction commenced in November 2002, and is expected to be completed by mid 2004.

3.5 WODONGA WASTEWATER TREATMENT PLANT

The Wodonga Wastewater Treatment Plant is a contract for the upgrade, expansion and operation of existing wastewater treatment facilities to meet State environment protection policy objectives for effluent quality, while accommodating the needs of future growth in the region.

A contract between the North East Region Water Authority and PURAC Pty Ltd, signed in December 2000, provides that the Authority takes over ownership of the upgraded plant following successful commissioning, while PURAC remains responsible for operating and maintaining the plant for an additional period of ten years with two five-year options.

This design-build-operate contract makes the private party's operating income reliant on the effectiveness and efficiency of the plant designed and constructed by the same private party.

Customers continue to deal only with the Authority and their rights are relatively unaffected, except to any extent that the costs of water treatment will be influenced by the payments committed under the contract. This is the case with each of the water projects examined.

The net present cost of the capital and operating costs of this contract has been calculated at $32.5 million (discounted at 8.65 per cent, nominal pre-tax). Of this, the capital component of $15.6 million was payable on successful commissioning. The plant has now been commissioned, ahead of the contracted date.

Some observations on the potential of these relatively smaller specialised projects to offer value for money is included later in this report in Chapter 4.

3.6 ECHUCA/ROCHESTER WASTEWATER TREATMENT PLANT

This is a November 2002 build-own-operate-transfer project with a 25-year term, between Earth Tech Pty Ltd and Coliban Region Water Authority, to treat wastewater from Rochester and Echuca, with all treated effluent to be recycled for farmland irrigation. Construction commenced in early 2003.

The net present cost of projected payments by the Authority is $51.3 million (discounted at 8.65 per cent, nominal pre-tax). This cost has been calculated by the Authority as a 28 per cent saving over the risk-adjusted cost of the Public Sector Comparator. At the end of the 25-year contract period, ownership of the plant is available to the Authority for a nominal sum. The Authority attributes the substantial savings to a range of innovations introduced by Earth Tech Pty Ltd.

The Authority has an active program to maintain and upgrade an extensive network of pipes, treatment plants and dams. This latest contract increases the commitments that the Authority has made for future payments from $324 million in 2002 to $500 million as at June 2003 (*Financial Report for the State of Victoria,* 2002-2003). This level of forward commitment is backed by annual operating revenues of over $40 million per annum and a forecast 25-year revenue stream, according to the Authority, of over $1600 million.

Two key issues were raised:

- whether there should be guidelines for small authorities and agencies as to the appropriate relativities between forward contractual commitments, existing levels of revenues and free cashflows;
- whether there should be specific accounting standards for the disclosure of commitments under PPP contracts, including whether and in what circumstances obligations under such arrangements should be considered as balance sheet liabilities.

3.7 ENVIRO ALTONA

On 23 June 2003, Simon Engineering entered a 10-year contract (with a 5-year option at the discretion of City West Water Limited) for the upgrading and operation of wastewater treatment facilities in Altona. The obligations of Simon Engineering are to build and operate a facility that will meet Environment Protection Authority licence requirements and will allow the sale of recycled water.

Projected payments by City West Water have been calculated at a net present cost of $20.3 million (discounted at 8.65 per cent, nominal pre-tax), a saving of 6 per cent against the risk-adjusted cost of the Public Sector Comparator.

The project was originally proposed (on a larger scale) as a build-own-operate-transfer project, but attracted almost no private sector interest in that form, perhaps as a result of unknown issues relating to a high level of salt infiltration in the reticulation system.

The design solution of Simon Engineering is considered by City West Water to provide an innovative and cost-saving means of dealing with the salt infiltration.

Construction of the new facility will commence shortly.

3.8 SPENCER STREET STATION REDEVELOPMENT

In August 2002, the State entered into a contract with the Civic Nexus consortium for the redevelopment of Spencer Street Station and its precinct. Members of the consortium are ABN AMRO, Leightons Contractors, Daryl Jackson Architecture, Nicholas Grimshaw & Partners, Honeywell Limited and Delaware North Australia.

The contract provides for Civic Nexus to redevelop the Spencer Street Station to an agreed standard and to operate the station for a period of 30 years, after which ownership passes to the State. Civic Nexus will also develop catering and retail services within the Station. Additionally, Civic Nexus has paid the State $66 million for commercial development rights in neighbouring properties over which they have a 99-year lease for a nominal figure.

The Government's commitments in relation to this project, including projected contractual payments over the 30-year contract life, amount to $1762 million (*State Financial Report*, 2002-03), including adjustments for forecast inflation. Excluding inflation, the total payments have been estimated at just over one billion dollars. This payment stream was equivalent to a net present cost of $309 million (discounted at 8.65 per cent, nominal pre-tax) and involved a saving against the risk-adjusted cost of the Public Sector Comparator of 5 per cent.

The Auditor-General's Report on the *Finances of the State of Victoria 2001-2002* noted that commercial arrangements for the Spencer Street Station redevelopment *'will need to be reported in future statements of financial position as a liability of the State, with the corresponding asset also reported*'. (para 7.125).

This is a complex construction project, particularly given the need to continue operation of the station during its reconstruction. A range of stakeholders – travellers, retail tenants, bus, taxi and train operators, the operator of the rail track and others – have rights that must be respected. The duration of the contract and structure of the payment schedule are designed to provide an incentive for constructing an effective and enduring building and efficiently operating the station with all its related services. Additionally, the redeveloped station is required to have iconic architectural qualities that will help integrate the Docklands development into the City of Melbourne and will be a suitable structure to occupy a central position in an expanded central activities district of Melbourne. One further complexity is a requirement that the redeveloped station be fully operational for the Melbourne 2006 Commonwealth Games.

Consideration of the one-off nature of this project, its commercial dimensions and other complexities support a review recommendation that the policy be strategically focused on infrastructure segments where the private sector can best add value. This might be one such project. For a project of this nature, it would be remiss of the State not to seek to engage the best resources, from whatever source.

The project raises some other issues of relevance to this review:

- the appropriate discount rate for evaluating the State's contractual commitments and for calculating the savings, if any, against the Public Sector Comparator;
- the issue of whether the State should have a policy on the maximum term for the financing component of a PPP, and specifically whether 30 years is too long;
- the transparency of the contractual arrangements and whether the State should publish, at the time of entering the agreement, the full forecast payment schedule;
- whether there should be specific accounting standards for the disclosure of commitments under PPP contracts, including whether and in what circumstances financial obligations under such arrangements should be considered as balance sheet liabilities.

Construction commenced in August 2002, and the expected completion date is 30 June 2005

CHAPTER 4

OBSERVATIONS AND RECOMMENDATIONS

The review of the projects so far delivered under the *Partnerships Victoria* policy – in the period between mid-2000 and 2003 – has found credible evidence of the benefits of PPPs. It has also found a case for realignment in the scope and operation of the policy.

4.1 PUBLIC PRIVATE PARTNERSHIPS IN THE CONTEXT OF STATE INFRASTRUCTURE INVESTMENT

The financial resources of the State and its agencies, as well as the State's capabilities to initiate and project manage major infrastructure projects, have their limits.

In the past few years, in an environment in which the Government has endeavoured to reduce government debt, the State's net infrastructure investment has risen, according to the *Financial Report for the State of Victoria* 2002-03, from $1.1 billion per annum to average around $1.8 billion per annum in the three years to 2002-03.

As at 30 June 2003, the State of Victoria's investment in all capital stock (including roads, schools, hospitals, land, buildings and equipment) is over $69 billion, or more than $30,000 per household.

In addition to State-owned infrastructure, the private sector has invested in Victorian road, water and energy infrastructure to the extent of over $30 billion. The annual new capital investment by privately-owned energy distribution companies now exceeds $500 million per year.

In contrast, the PPP investments undertaken over the past three years are still less than $500 million in total.

Around $7.5 billion has been invested over the past three years in Victoria in public infrastructure by the State and by private operators (excluding Federal jurisdictional areas such as telecommunications and electricity transmission). That $7.5 billion investment amounts to over $3000 for each Victorian household. The contribution of PPP projects to that total has been less than 7 per cent.

If all the present projects mooted as potential PPP projects were undertaken, the PPP contribution to total infrastructure investment in the State might be equivalent to around 10 per cent over the decade 2000-2010. As explained later in this chapter, that 'niche' role is an appropriate one.

4.2 THE BENEFITS OF PUBLIC PRIVATE PARTNERSHIPS

The objectives of having a PPP channel for infrastructure procurement is largely common among western governments. They might best be described as follows:

> 'The aim is to deliver improved services and better value for money, primarily through appropriate risk transfer, encouraging innovation, greater asset utilisation and integrated whole-of-life management'.[5]

Against that list it can be said that the eight projects evaluated during this review, although only two are presently operational, have provided evidence of the potential benefits from PPPs.

The County Court was delivered on time and without cost variation for the State. The quality of the facilities and the operations has been commended by its users. The innovation sought in the design of an iconic roof and other aspects of the Spencer Street Station Redevelopment appears to have been achieved. The technical innovation put forward for the Altona wastewater treatment plant has also been commended. Likewise the Wodonga Wastewater Treatment Plant was commissioned ahead of schedule and without contract revision in terms of cost.

These eight projects have the potential to demonstrate innovation of design, certainty of timing and cost, and the delivery of a whole-of-life approach to facility maintenance.

It should also be added that, using the methodology of comparing their cost to a Public Sector Comparator, each of the eight projects has been declared, at the time the contracts were entered into, as being equal to or better value than the option of public sector provision. The weighted average savings was 9 per cent against the risk-adjusted PSC using the then prevailing discount rate.

4.3 STRATEGIC ROLE AND SCOPE OF PUBLIC PRIVATE PARTNERSHIPS

The 'niche role' assigned to PPPs is appropriate, particularly as most enterprises involved in PPPs are special purpose one-off vehicles, unlike, say, the privatised energy utilities that have an ongoing mandate and segment focussed capability.

The overwhelming case for having a PPP channel of public infrastructure procurement particularly recognises the need of the State to selectively draw on private sector capital and capabilities.

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[5] *Working with Government – Guidelines for Privately Financed Projects,* NSW Government, November 2001, p. iii.

The State should be ‘strategic’ in its choice of PPP projects based on factors such as:

- the size and complexity of the project;
- the technical challenges or requirements for innovation;
- the relative expense of private finance and PPP transaction costs;
- the relative capabilities inside government to fully project manage the project;
- an assessment of where the private sector can best add value; and
- what stakeholder and other public interest issues might there be that suggest that contractual obligations and safeguards might be less appropriate than ‘routine’ public delivery approaches.

In the context of where the private sector might best add value, the UK Government in the past two years has undertaken a set of studies on major project performance compared to initial estimates of timing and cost.

Two UK reports, the Mott MacDonald Report, entitled *Review of Large Public Procurement in the UK*, July 2002 (*Table 1*) and a National Audit Office’s report, *PFI: Construction Performance*, February 2003 (*Table 2*) looked at the performance of ‘traditionally procured projects’ as well as projects procured through the Private Finance Initiative (PFI).

TABLE 1 MOTT MACDONALD REPORT

Mott MacDonald	Optimism Bias	
Project Type **Government Procurement**	Capex	Duration
Standard Buildings	24%	4%
Standard Civil Engineering	44%	34%
Non-Standard Buildings	51%	39%
Non-Standard Civil Engineering	66%	15%

Source: Review of Large Public Procurement in the UK
July 2002, Mott MacDonald, p. 14.

TABLE 2 UK AUDIT OFFICE

	PFI Projects 2002 NAO census	Government Procurement 1999 Survey
Per cent of Projects **- On Time** **- On Budget**	76 78	30 27
Per cent of Projects **- Not on time** **- Not on Budget**	24 22	70 73

Source: PFI: Construction Performance
Report by the Comptroller and Auditor General, UK
Audit Office, HC 371 Session 2002 – 2003: 5 February 2003.

These reviews examined a total of 50 projects each with a value exceeding £40 million. The findings included the observation that traditional procurement has a better performance for standard buildings and standard civil engineering than for non-standard. Non-standard buildings were defined for example as those with ‘special design considerations and may include specialist hospitals, innovative prisons, high technology facilities, other unique buildings or refurbishment projects’.

The Mott MacDonald Report evaluated the factors that contributed to an ‘optimism’ bias which it defined as being the difference between the metrics used at the Business Case stage versus final outcome. The metrics examined were operating costs (opex), capital expenditure estimates (capex), and the estimate of project duration (the time required to design, construct and commission a facility prior to commencement). Across these metrics the report found that for the public procurement of standard buildings, the average optimism bias for duration was a negligible 4 per cent; whereas for capex it was significant at 24 per cent (Table 1). For public procurement of non-standard civil engineering projects, the optimism bias for capex forecasts was a substantial 66 per cent.

The NAO found that in contrast to traditionally procured projects, the PFI projects were largely being delivered on time (76 per cent versus 30 per cent) and on budget (78 per cent versus 27 per cent) – see Table 2.

One potential implication of these findings is that it creates an empirical basis upon which strategic decisions can be made. If the private sector is better at project managing one-off, highly complex or unique projects, then that may become a basis for decisions on which projects are most logically put forward under the *Partnerships Victoria* ambit. It is also the case that for a number of the one-off projects (Table 3) there are not the same stakeholder and public interest considerations that might attach to the private provision of 'standard specification buildings' such as schools, hospitals, prisons or courts.

A further UK development of relevance in this context is a decision to limit the scope of their PFI policy to projects over £20 million. This is equivalent to around A$50 million. This number is intended to be flexible and subject to exceptions, including bundling of a number of projects. This decision is mostly a response to the cost of bids.

In a Victorian context, feedback by market participants in the major 'building facility' projects is that bid costs by most of the final three bidders have exceeded $2-3 million. In these circumstances, the all-up cost of the bid process will exceed 10 per cent of the capital cost of the project if the project value is below $100 million. It might exceed 20 per cent for projects of $50 million.

The water projects, of which there have been three under the *Partnerships Victoria* banner, appear different in dynamics, being relatively small in size and being put to a relatively active (although now consolidating) market for water treatment facilities development and management. In these circumstances the projects can be somewhat smaller due to the market and the relatively limited capabilities of regional water authorities.

The recommendations to realign the strategic direction, scope and ambit of the *Partnerships Victoria* policy are:

- The strategic direction of the *Partnerships Victoria* policy should be informed by empirical evaluation of the performance of infrastructure project delivery (under both public and private procurement approaches) and should focus on infrastructure segments where the private sector can best add value.
- The State should sponsor a Review of Major Projects to evaluate the performance of project procurements and delivery, and to develop an empirical database of risk components. The study would mirror the approach taken in the UK Mott MacDonald Report (Review of Large Public Procurement in the UK, July 2002). It might involve a review of at least 20 projects over say $20 million across a range of sectors. It might also involve other jurisdictions and be sponsored by the proposed National Council on PPPs. Possible Terms of Reference are attached (Appendix B).

- The policy should limit its potential application to large projects such as those involving capital expenditure of over $100 million. Exceptions would include projects that are bundled (to be over $100 million), projects that are smaller but in sectors where there is a strong value for money case, such as in the water treatment projects where the internal capabilities of the relevant agencies are limited.
- The *Partnerships Victoria* policy should strategically focus on large, complex, one-off or non-standard projects, or standard government buildings in circumstances where there are challenges of a technical, innovation or design nature, e.g. co-locating child care centres within school compounds.
- The sectors that are deemed to be appropriate for private procurement should be published and should change in the light of experience (including the findings of the review recommended above), evaluation of project delivery performance and general market circumstances.
- For the time being, selected projects in the information and communication technology (ICT) sector should continue to be considered appropriate for procurement under the *Partnerships Victoria* policy, but the sector should remain subject to review. The nature and longevity of contracts and the use of a Public Sector Comparator should be modified to reflect the nature of the sector.

TABLE 3 CATEGORY OF PROJECTS

Stakeholder Sensitivity \ Size & Complexity of Project	Low	Medium	High
Low			Film & TV Studio Showgrounds Convention Centre
Medium	County Court	Portable Classrooms	Spencer Street Station Mobile Data Network
High	Prisons Berwick Hospital	Water Projects	Royal Women's Hospital Mitcham-Frankston Freeway

Stakeholder Sensitivity

- Degree of potential controversy surrounding 'private' provision
- Complexity of resolving stakeholders' issues contractually
- Degree to which long-term contract impedes service model/ philosophy

Size & Complexity of Project

- One-off nature, uniqueness. Not traditionally delivered by Public Sector
- Degree of Challenge – or Requirements for Innovation – technical design and/ approach
- Complexity of project. Size eg. Over $100m

4.4 RISK AND ITS ROLE IN *PARTNERSHIPS VICTORIA*

A recent *McKinsey Quarterly* article advised its readers that “CEOs should be heard talking about risk as often as they talk about markets or customers”. (The *McKinsey Quarterly*, 2003 Number 4 –Running with Risk). Indeed it might be said that risk is the ‘new new’ thing of finance and business.

Risk is already central to the language, conceptual underpinnings and indeed operation of *Partnerships Victoria* policies. For example there are guidelines for optimal risk allocation as a contractual matter, risk adjustments to the cost of the Public Sector Comparator and the pricing of transferred market risks in the choice of discount rate.

In discussions with key stakeholders, the most frequently quoted benefit of the *Partnerships Victoria* processes has been the sophisticated risk assessment and contractual risk allocation. It has also been said, without contradiction, that the rigour involved exceeds any risk evaluation processes ever undertaken by an Australian government.

It is a finding of this review, however, that the evaluation and adjustments made to reflect the existence and transfer of risk needs to be further revised. It needs to be based on better evidence. Further, the pricing of transferred market risk needs to be done more selectively.

4.5 CASE STUDY TO ILLUSTRATE RISK ASSESSMENTS

The consultation and submission process elicited feedback that the Draft Report would have been improved through the use of a Case Study to illustrate some of the issues raised concerning the evaluation and pricing of risk. Outlined below is a case study to illustrate just a few key points.

Let’s assume that the State has approved in principle the procurement of infrastructure services from a facility with an estimated design, construction, fit-out and commissioning cost of $100 million, plus operating costs of $5 million per annum (see Table 4). This initial cost estimate for public procurement is the basis of the cost estimate known as the Raw Public Sector Comparator. From this start-point, the project evaluation will include two critical and different risk adjustments:

- The first is the adjustment of the Raw PSC to create a risk-adjusted PSC. This adjustment accounts for a set of risk events that might impact on the cost and operating assumptions affecting the PSC. The risk-adjusted PSC is the benchmark cost for public procurement and is expressed as a Net Present Cost (using either a risk-free discount rate or a risk-adjusted rate).

- The second is the risk adjustment included in the calculation of the discount rate that is used to convert the proposed payment schedules offered via tender into a Net Present Cost. According to financial theory based on CAPM, this adjustment is to reflect 'systematic' or 'market' risk which usually attaches to revenue flows but in some circumstances may affect, i.e. vary, the quantum of the payment obligations.

In the Case Study below, the risk adjustment to the PSC is $18 million, which represents a 12 per cent addition to the Raw PSC. That adjustment includes the components of what is elsewhere referred to in this report as 'optimism bias'.

TABLE 4 THEORETICAL CASE STUDY

A $100 Million Facility	**Time Value Discount Rate**	**Risk-Adjusted Discount Rate**
Discount Rate	5.7%	8.65%
Raw Public Sector Comparator		
- Capital expenditure	$100m	$100m
- Annual Operations/maintenance	$5m p.a.	$5m p.a.
Risk-Adjustments to PSC		
- Expected Cost of Risk Events*	$18m	$18m
- Expressed as percent of Raw PSC	11%	12%
Risk-Adjusted PSC expressed as		
Net Present Cost (NPC)*	$177 million	$165 million
Tender Proposal		
- Annual Capital/Facilities Payments	$11.1m p.a.	$11.1m p.a.
- Annual Operations/maintenance**	$4.9m p.a.	$4.9m p.a.
Net Present Cost of Tender	$188 million	$150 million
Savings over Risk-Adjusted NPC of PSC	**6 per cent**	**9 per cent**
	Extra Cost	**Savings**

* Adjustments include 'optimism bias'
** Assumes 20 years and no inflation escalators

The adjustment to the discount rate, to add a premium for market risk in the Case Study above, is 295 basis points and takes the discount rate from the risk-free rate of 5.7 per cent to the rate of 8.65 per cent, which was the rate used in all eight projects examined. (The rates presently used are different, and incorporate 'for most future projects', a market risk premium of 170 basis points, as will be discussed below.)

In the table above, the 20-year payment schedule proposed in the tender is for a Facilities Capital charge of $11.1 million p.a. and an Operations/Maintenance charge of $4.9 million p.a. As a matter of illustration, the nature of these payments is a commitment to pay under a contract. They do not vary with movements in the market. They are framed such that a special purpose vehicle can secure its financing obligations and outsource operating and facilities management agreements.

These payments are converted to a Net Present Cost using a discount rate. At 8.65% the $16 million p.a. payment equates to a NPC of $150 million and is 9 per cent below the risk-adjusted PSC. However, if the $16 million p.a. proposed in the tender is converted to an NPC using a non-risk adjusted Time Value of Money discount rate of 5.7 per cent, there is no saving and the additional cost is 6 per cent.

The discount rate and risk adjustments are therefore integral to the issue of whether the commercial arrangements proposed in a tender offer value for money over public procurement.

4.6 RISK ADJUSTMENTS TO THE PUBLIC SECTOR COMPARATOR

As noted above, one of the two key risk adjustments in the evaluation of infrastructure services being procured under *Partnerships Victoria* processes is the risk adjustment to the cost of the Public Sector Comparator (PSC).

This adjustment accounts for a set of risk events that might impact on the cost and operating assumptions affecting the PSC. The risk-adjusted PSC is the benchmark cost for public procurement and is expressed as a Net Present Cost (using either a risk-free discount rate or a risk-adjusted rate). It is the best estimate of the expected cost of public procurement of the infrastructure services provided during the life of the project.

In the eight projects reviewed, the risk-adjustment process involved significant effort and involved a comprehensive list of potential risk events. In one case a panel of experts examined over 100 categories of risk events that might add to the cost of the project if undertaken under public procurement. The risks included categories such as design risk, project scope risk, native title, construction risk, commissioning risk, industrial relations risk etc.

However, the expertise of the risk evaluators and the comprehensiveness of the risk schedule does not substitute for the lack of an empirical database of what risk events major projects of this nature face and with what frequency and cost should they be expected.

Across the eight projects reviewed the average risk adjustment equated to 12 per cent of the NPC of the Raw PSC. The range was between 5 per cent for a straightforward project to 21 per cent for a more complex project. Expressed as a percentage of the capital expenditure involved in the projects, the risk adjustments averaged around 17 per cent.

As noted in section 4.3, the findings of the UK Mott MacDonald Report included a quantification of the average optimism bias for ‘standard buildings’ of 24 per cent. Another study estimated the average ‘inaccuracy’ of cost estimates for a set of transport projects in Europe at 26 per cent and in the US at 24 per cent (*Underestimating Costs in Public Works Projects*, APA Journal, Summer 2002, Vol 68, No.3, p.279).

It should be noted that the above estimates in the range of 24-26 per cent are not directly comparable with the risk adjustments to the PSC, as the external ‘inaccuracy’ and ‘optimism bias’ estimates are taken from Business Case stage to final completion, whereas the timing of the risk adjustments made to the PSC will usually be well after the Business Case and done only once the precise specifications for the project are well understood and reasonably settled. Consequently the risk adjustment should be less than the more comprehensive estimates for ‘inaccuracy’ and ‘optimism bias.’

However, because of the absence of an empirical database relevant to Victoria and the precise type of projects involved, it is not possible to say whether the adjustments made in these eight projects are too high or too low. In one submission to the review it was expressed as a likelihood that the risk adjustment to the PSC would be higher in future if less risk was being assumed in the discount rate (discussed below in section 4.7).

In any event there may be benefits for Victoria, across its range of major projects, to move to an approach to risk assessment and management that builds on an empirical base, such as that undertaken in the Mott MacDonald Report. The specific recommendations are that:

- The State should sponsor a Review of Major Projects to develop an empirical database of risk components. The study would mirror the approach taken in the UK Mott MacDonald Report (*Review of Large Public Procurement in the UK,* July 2002). It might involve a review of at least 20 projects over say $20 million across a range of sectors. It might also involve other jurisdictions and be sponsored by the proposed National Council on PPPs. Possible Terms of Reference are attached (Appendix B).

- Risk adjustments to the Public Sector Comparator should be based on the best empirical evidence of the likelihood and cost of particular categories of risk events. That evidence should be compiled in an accessible form, such as those developed for the UK Green Book and included in the Mott MacDonald Report.

4.7 RISK-ADJUSTED DISCOUNT RATES

Present application of the *Partnerships Victoria* policy involves evaluating tenders by calculating a Net Present Cost (NPC) or Net Present Value (NPV) using the corporate financial tool known as Discounted Cash Flows (DCF).

Each of the eight projects reviewed involves an NPC (i.e. a net cost to the State): a revenue component to the State is present in only two projects and accounts for only a portion of those projects' costs. Consequently the flow of funds under the eight projects evaluated is almost exclusively in one direction (i.e. from the State to the private operator) and the discounting of cash flows involves the valuation of net payments rather than net revenues.

The choice of discount rate has recently changed. For the first eight *Partnerships Victoria* projects, a discount rate of 8.65 per cent nominal has been used, based in part, on the UK use of a 6 per cent real discount rate. The 8.65 per cent has now been recognised as excessive. It included a premium of 295 basis points above prevailing government bond rates (5.7 per cent for ten year bonds) to reflect a margin for market risk. Based on the documents reviewed and the briefings provided, the evidence of significant transferred market risk has been either incomplete or theoretical. The premium imbedded in the discount rates accounts for over $350 million of the payments committed under the initial eight contracts.

Under the Technical Note issued in July 2003[6], projects such as accommodation projects (e.g. the County Court and Berwick Hospital) would be evaluated using a 5 per cent real discount rate. This would lower the market premium inferred by around 100 basis points compared to the accommodation projects reviewed. The rate would be 6 per cent real for water projects and 8 per cent real for telecommunications, media and technology projects. These rates are based on a reassessment of the 'systematic' or 'market' risk as defined in the *Capital Asset Pricing Model* (CAPM). There is also a precondition to the application of these risk premia, that there actually be market risk in the public procurement option that is effectively transferred. According to the Technical Note, if there is no transferred market risk the premium should be zero.

[6] *Use of Discount Rates in the Partnerships Victoria Process, Partnerships Victoria* Guidance Material, Department of Treasury and Finance, July 2003, Technical Note p.18.

The Draft Report recommended that where the State is evaluating options for it to pay for a set of services under a facilities agreement, it should discount the prospective payment stream at the time-value of money unadjusted for risk (i.e. a zero market premium). The recommendation generated a significant degree of comment. The submissions included a small number who claimed the approach would be technically wrong, some who said it would be straightforward and correct and a significant number who said it might be theoretically correct but would be practically difficult and would in any event come up with the same result. It is noteworthy, that of all the advisers involved in the initial eight projects who provided submissions to the review, the defence has been of the new policy on discount rates (July 2003), and not the earlier policy involving a higher discount rate.

The consensus of those supporting the current Technical Note and wanting no change, and those who don't think it's quite right and want change, is that there should be no risk premium and no risk-adjusted discount rate in circumstance where there is no transferred market risk or no correlation between the cash payments made by the State and movements in the market.

In the language of the financial experts, 'it is important to note that if the covariance of the expected net cash flows with the market returns is zero … then the expected cash flows are uncorrelated, there is no non-diversifiable risk and, as a consequence, the expected net cash flows are discounted by the pure time value of money' (Submission of Capital Research). This is reiterated in the Technical Note where it is further noted that it is only where there is systematic market risk (as defined by the Capital Asset Pricing Model) in the public procurement option and that risk is commercially transferred as part of the contract, that there should be a risk-adjusted discount rate.

As a factual matter, it needs to be said that the eight projects include contractual payments of over $2700 million from the State and its agencies to a set of private infrastructure operators. These payments are committed under contracts signed by the State and its agencies. The quantum of the obligations can be estimated using the State's inflation forecasts. The variability, to the extent that it exists theoretically as a possibility, must presuppose a deviation from the expectations of the signed contracts. Variability of this nature does not correlate with movements in the market. Further, sovereign risk is generally viewed as either imbedded in the risk-free rate, diversifiable, or otherwise classified as non-systematic (Davis & Handley, *Cost of Capital for Greenfields Investments in Pipelines,* April 2002).

Further, there might be major shifts in the property market, a crash in the stock market, and even a recession; and these contractual payments will not be affected. They are obligations of the State under contract, the payments involved being not at all variable with market movements; they are uncorrelated with market risk as defined in the Capital Asset Pricing Model. Indeed the fixed and certain nature of the payments are a key feature for the State in swapping from uncertainty with public procurement, as well as for the private operators who can use the certain nature of the payments to secure their financing obligations and outsource operating and facilities management agreements.

As previously noted, the recommendation for use of a time-value of money rate is the same as that made in standard textbooks such as Brealey and Myers[7]. The preferred methodology for assessing the present value of a contractual payment stream (as distinct from a net revenue stream from a business), should be to take the minimum payment stream – the certain or certainty-equivalent payments – and discount them at the time-value of money. The best approximation of the time-value of money is the risk-free rate applicable to government bonds of the same duration as the agreement. This approach should apply to any organisation looking to evaluate a set of options for payments under a bond, a lease or a facilities agreement. It is unrelated to the capability of the government to actually borrow money at the risk-free rate.

Consequently where the State is evaluating the cost of its potential financial commitments, whether the payment is for capital or interest under a bond, rent under a lease, payments under a mortgage or facilities agreement, the approach to calculating the Net Present Cost should be the same, assuming that the quantum is equally calculable and the degree of certainty of obligation is equivalent. The Net Present Cost of a given payment stream (with an equivalent degree of contractual certainty) does not change to reflect the purpose for which the payment is made, the nature of the project, or the industry into which the payment will be received.

If the evaluation of the eight projects had used this methodology, the applicable discount rate would have been around 5.7 per cent nominal rather than 8.65 per cent. Expressed as a real risk-free rate it would have been, and still is, around 3.5 per cent real. (During the period 2000-2003 the average yield on long-dated CPI indexed bonds – a proxy for a real risk-free rate – was 3.4 per cent).

The UK PFI project evaluation has in the past used a 6 per cent real discount rate, but moved to 3.5 per cent real from April 2003. In doing so, its explanation was that the discount rate had been 'unbundled', so that the time-value of money is separated from risk adjustments to the project cash flows. Under the UK policy the time-value of money is referred to as the Social Time Preference Rate (STPR) and calculated with regard to observations, inter alia, around consumption preferences (*UK Green Book*, 2003, Annex 6). To the extent that this is a different conceptual basis to the CAPM-based calculation of the time-value of money, this review recommends the standard corporate financial principles outlined in Brealey and Myers[8].

[7] Brealey R, Myers S, Partington G, Robinson D, *Principles of Corporate Finance,* McGraw-Hill, Sydney, 2001.
[8] Ibid.

The UK PFI reforms also noted that the frequency with which market risk was in fact transferred was in a 'limited number of cases' only. It should be noted that in the history of PPPs in the UK a 'market premium' had been assumed for *all* projects (based on a 6 per cent real discount rate). The finding that the projects warranting a 250 basis point premium is 'limited' in number is therefore a significant finding.

Of the eight projects examined, there is only one in which real and significant market risk is transferred and that is the Docklands Film and TV Studio, where the revenue risk is partially transferred, under the contract, to the private operator and the State is entitled to a percentage of the net earnings. In these circumstances the State's evaluation of the tender should discount the cost side of the equation at the time-value of money and the forecast net revenues to the State from the profit sharing formula at a risk-adjusted rate based on the CAPM beta estimates for the appropriate industry (e.g. media and entertainment).

The submissions received by the review that expressed concerns about the practicality of the draft recommendations, were primarily concerned with the pricing and calculation of market risk. If there is no market risk actually transferred, the task of pricing it, is clearly difficult – but obviously moot. Where actual market risk is transferred the recommendation of the review is to have a risk-adjusted discount rate, rather than to adjust the cash flows. But that should be in very few cases. As one major infrastructure investor has noted, PPPs are, from their perspective, projects 'with no demand risk'[9]

It is recommended that the present approach to risk assessment and the use of discount rates be unbundled into separate components – a risk-adjustment for estimated costs, an adjustment for the time-value of the money to be expended, and, to the extent that there is any transferred market risk (as defined in CAPM), an additional adjustment to add a risk premium to the discount rate for calculating the present value of any revenue stream:

- Risk-adjustments to the cost of the PSC should be based on the best empirical evidence of the likelihood and cost of particular categories of risk events. That evidence should be compiled in an accessible form, such as that developed for the UK Green Book and included in the Mott MacDonald Report.

- The practice of evaluating tenders involving net cash payments by the State, by discounting the minimum contract payment schedule by a discount rate that automatically imbeds an assumed risk premium (ie. the 170 basis points imbedded in the discount rate for 'most projects' in the July 2003 policy) should be discontinued.

– The evaluation of tenders involving net payments by the State should discount the contract payment stream at a discount rate that reflects only the time-value of money, based on an estimate of the risk-free rate such as the Commonwealth Bond Rate that best matches the term of the project – e.g. 5.7 per cent nominal for 12-year bonds, or 3.5 per cent real.

– In cases in which there is a net revenue inflow to the State in its PSC and there is market risk (as defined in CAPM), actually transferred under the *Partnerships Victoria* contract, the discount rate for that revenue should be a risk-adjusted one. However those cases should be limited in number and should be the exception.

4.8 PUBLIC SECTOR COMPARATOR

The Public Sector Comparator (PSC) is an analytic tool to guide value for money evaluations and risk management and contractual negotiations. It seeks to establish a 'base case' of what public sector provision of the project might look like and cost.

The UK PFI reform process elicited some strong criticism of the Public Sector Comparator. The Public Accounts Committee of the House of Commons noted that 'some public sector comparators have contained material errors and omissions. Others have been given a spurious precision as a result of over-complexity, a pre-occupation with financial modelling, and a failure to take account of uncertainties. Some public sector comparators have been manipulated to get the desired result. There is a need for a more intelligent use of public sector comparators by departments, with due recognition of the inherent uncertainties involved in the calculations and an awareness of the limitations of the resulting forecasts'.[10]

The UK Treasury's report, *PFI: Meeting the Investment Challenge* (July 2003) noted at para 7.10 that:

> 'The Government believes that a rigorous economic assessment is important to ensure that the right procurement option is chosen on the basis of value for money. The Government agrees with the NAO, however, about the dangers of putting disproportionate emphasis on a single figure comparison. It therefore believes that the PSC continues to have an important role … and needs some reform in itself.'

The Victorian experience is mixed. Of the eight projects so far contracted, the first was done with a 'reference case' and the next seven with a PSC. Of the seven, at least two were done in circumstances where the State had never undertaken such a project and indicated that it wouldn't in those cases.

[9] *Public Infrastructure Bulletin*, Issue Two, Sept. 2003, Australian Centre for Public Infrastructure.

However a PSC was then developed, at great cost (up to a $1 million) and in great detail. Although there were benefits to the exercise, a more reality-based 'benchmark' or 'reference case' approach might have been less theoretical and more credible.

Further, if the policy does evolve into one that concentrates on areas involving one-off or non-standard projects, the present concept of a Public Sector Comparator will become less relevant and must be reformed. In unique one-off projects, public sector provision may not be an option. This is already the case for some information technology projects. These cases highlight the need for a reference case based on a set of benchmarks or the next-best alternate option (in information technology that should more often be an off-the-shelf technology than a hypothetical version of a public-sector created solution).

It is recommended that:

- The Public Sector Comparator should be reformed to become just one factor in procurement decisions and conclusions as to value for money. The use of a PSC should be discontinued in circumstances where public provision has not been done in the past and is not a reasonable option going forward. In such circumstances the analytic comparison should be against a reference case or a range of benchmarks.
- In information and communication technology (ICT) projects, the reference case, subject to strategies to the contrary settled by Cabinet and the State Chief Information Officer, should more often be an off-the-shelf technology benchmark than a hypothetical version of a public sector created solution.

It should be noted in the context of the above recommendations, that the Department of Treasury and Finance has already signalled some relaxation on the use of the PSC in its July 2003 PSC Supplementary Technical Note.

4.9 PUBLIC INTEREST TEST

The public interest test used as part of the *Partnerships Victoria* processes, is a formal means of identifying government policies and legislation that could relate to any of eight nominated areas of the public interest. The test then assesses whether any particular strategy should be adopted to protect the public interest in that area. Public interest tests viewed in the course of the review were competently performed and served their purpose.

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[10] *Delivering better value for money from the Private Finance Initiative*, House of Commons Public Accounts, 28th Report, June 2003.

In the overall project evaluation processes, the public interest evaluations may have involved one-tenth of the resources and cost involved with the development and quantification of the Public Sector Comparator.

Considering that the public interest test may not be well understood, it is recommended that agencies make the test results available on their websites.

One other issue relates to timing. Presently the test forms part of a business case that is viewed by government when deciding whether or not to fund a project. In this context, it serves as a check that, where necessary, measures will be adopted to protect the public interest. However, given that the test is performed before government has made public commitment to a project, there are practical limitations on the extent of public consultation that may be undertaken to inform the test – formal consultation may raise expectations that may in turn limit government flexibility. These limitations would be relieved by adoption of the recommendation of the review that the State publish a forward pipeline of major projects that are under consideration.

4.10 TRANSPARENCY

The review has identified a need to improve transparency in the projects and processes surrounding the *Partnerships Victoria* policy. In addition to the recommendation to undertake and publish a report on the performance of major project delivery, it is recommended that the State publish details of the forecast payment schedules under contracts signed under the *Partnerships Victoria* policy. It is also recommended that to improve long term infrastructure planning, the State publish a forward 'pipeline' of major projects under consideration (consistent with the present multi-year planning initiative). This pipeline would indicate the projects that are being considered for *Partnerships Victoria* procurement.

It is recommended that:

- The State should publish details of the forecast payment schedules under contracts signed under the *Partnerships Victoria* policy and these should be posted on the *Partnerships Victoria* website.
- To improve long term infrastructure planning, the State should publish a five and ten year forward 'pipeline' of major projects (e.g. over $20 million) under consideration, including those being considered for *Partnerships Victoria* procurement.
- The volumes of guidance material compiled for the Partnerships Victoria policy should be available upon request to researchers, libraries and community groups at no charge; in the interests of encouraging better understanding of the efforts being undertaken to protect the public interest.

In relation to the final recommendation, the Department of Treasury and Finance have pointed out that copies of the materials are available online at www.partnerships.vic.gov.au.

4.11 ENCOURAGING COMPETITION AND VALUE FOR MONEY

The UK Treasury commissioned PricewaterhouseCoopers (PwC) to examine 64 PFI projects in terms of the actual rate of return achieved, compared to an evaluation of what the return might have been based on a CAPM-derived risk-adjusted *Weighted Average Cost of Capital (WACC)* (*Study into Rates of Return Bid on PFI Projects*, October 2002). The returns evaluated exceeded the 'benchmark' WACCs by an average of 2.4 per cent. Adjusted for the cost of unsuccessful bids, the conclusion of HM Treasury is that it 'seems to be 1.7 per cent above what one would expect'. *(PFI: Meeting the investment challenge*, July 2003, p.126).

Given the size of the UK market, the level of investment in PPPs (£34 billion) and the number of projects so far undertaken (over 450 to date), a finding that outcomes are not as competitive as one might expect is quite significant. It should not be assumed in an immature market such as Australia that PPP outcomes will always be competitive.

As noted above it is not uncommon for unsuccessful bidders to incur bid costs exceeding $2-3 million. The number of players who can afford to put at stake that amount is very small. To sequentially risk those amounts, after one or two unsuccessful bids, reduces the number of participants even further, potentially to a level below a critical mass.

As one submission to the review by a foreign construction company emphasised, 'PPP processes and practices weigh against a decision to invest in a PPP bid budget. In particular the cost, in terms of third party charges and the commitment of internal resources, of running a PPP bid is excessively and unsustainably high.'

To maximise the chances of real value for money outcomes, the State should seek to ensure that there is a sufficient degree of competition. To encourage players to participate and to keep participating, it is essential that the strategic direction of the Government's plans are clear, that a pipeline of potential projects is available and finally the State must ensure that processes are as streamlined as possible to reduce bid costs. It should also seek new and innovative ways of structuring financial and partnership arrangements.

It is recommended that:

- The State should not assume that the present structure and size of the PPP market in Australia is diverse and active enough to be fully competitive. This should be taken into account in the evaluation of tenders, with the State explicitly retaining the right to declare a potential outcome as 'not value for money'.

- The State should actively monitor the size and activity base of actual and potential *Partnerships Victoria* partners, with a view to ensuring that there is a critical mass of potential players capable of delivering up to 10 per cent of Victoria's infrastructure investment, specifically in the strategic sectors identified.

In relation to the first recommendation above, the Department of Treasury and Finance has noted that there are three cases to date where the Government has declared that no bid has offered value-for-money viz Westgate Container Terminal, Fibre Optic Project and the Box Hill hospital car-park.

4.12 NEW APPROACHES

The State should also look for opportunities within the *Partnerships Victoria* ambit to pilot new financial and partnership structures including the involvement of non-profit and other public sector agencies.

There are two examples that may indicate a future direction in this regard.

The first relates to the Showgrounds redevelopment where it has been suggested that the State may benefit from a partnership structure involving parties bringing different commitments and ambitions to the table, and where the value-for-money quest becomes one of multi-dimensional benefit maximisation rather than cost minimisation. The recommendation concerning PSC reform is highly applicable in this case, where the focus should not be on a contrived option that the State is not going to build, but instead on a set of reference cases each with a different set of costs, benefits and risks.

The second example is the announcement of a strategic alliance between the Dutch Investment Bank ABN Amro and Development Australia Fund Management Limited to create a special investment vehicle for superannuation funds seeking to invest in Social Infrastructure investments. It is said that 'seed assets for the new fund will be acquired from ABN AMRO and comprise interests in Spencer Street Station, Wyuna Water and the NSW Schools Project'. The initiative is noteworthy in that it seeks to create a conduit between the pool of investment dollars coming from compulsory superannuation, and the tremendous demand evident for expenditure in long-term infrastructure.

The initiative is important and also challenging. A number of *Partnerships Victoria* projects have involved quite lengthy contracts with the argument being that the promoters need to have full equity 'at stake' in year 20, 25 and 30. However as noted by ABN Amro it 'will retain a 25% interest in Spencer Street Station until sometime after the station is commissioned'. In other words up to 75 per cent of the equity in the project may be transferred from the first year of operation.

It is recommended that:

- Consistent with the UK reforms, the State should seek to pilot new financial and partnership structures for *Partnerships Victoria* projects that 'combine the benefits of private sector risk taking with the Government's comparative advantage in securing funds'.
- In structuring long term contractual arrangements under *Partnerships Victoria* procured projects, the State should not assume that they will be dealing with the lead equity investors beyond the medium term.

4.13 INFRASTRUCTURE PLANNING

The Terms of Reference require that in the context of the review of *Partnerships Victoria* delivered projects, an assessment be done of the role, function and structure of the now dormant Infrastructure Planning Council. There is clearly a set of functions in infrastructure planning, management and delivery that deserves greater attention. There is also a set of initiatives underway as well as a set of additional recommendations in this report.

The existing initiatives include the Gateway Initiative which includes a Multi-Year Strategy and efforts at systemising the external review of project approaches and issues at specific milestones (or gateways).

The additional recommendations from this report that relate to infrastructure planning include:

- the publication of the forward pipeline of major projects under consideration;
- a study along the lines of the Mott MacDonald evaluation of major projects delivered;
- the syndication of lessons across government on issues such as successes and failures in public and private procurement and contingency planning for default in private contracts.

These recommendations are directed at improving infrastructure planning, delivery and project management across the whole of the government regardless of size and channel of delivery.

A further relevant initiative was the announcement of the Premier on 10 November 2003 that he had written to other members of the Council of Australia Governments to propose the creation of a National PPP Council. The announcement noted that:

- *A national PPP Council would examine possible projects and would discuss existing projects.*

- *Victoria would like to see up to six meetings of the working party per year, with responsible Ministers to meet at least once a year.*

- *Other roles for the proposed council would include developing a national database covering PPP project pipelines and any possible coordination regarding project milestones, consultants used and companies involved in bids.*

- *The council would identify issues warranting joint work in areas such as tax, accounting, bidding costs, common processes and standardisation of risk allocation and contracts.*

The State should be commended on its initiative in relation to multi-jurisdictional collaboration. There are a number of recommendations made in this review that may be within the scope of the National PPP Council and its working party – those relating to a proposed Review of Major Projects (including the creation of a database of risk events), the publication of a forward pipeline, the streamlining of processes and documentation and the resolution of accounting for PPPs.

It is recommended that:

- The recommendations of this review relating to a proposed Review of Major Projects (including the creation of a database of risk events), the publication of a forward pipeline, the streamlining of processes and documentation and the resolution of accounting for PPPs be referred to the proposed National PPP Council and its working party as part of their initial work program.

4.14 CAPABILITY BUILDING

A most important role that appears to have least clarity of ownership is that of building capability and coordinating whole-of-government planning and delivery of infrastructure.

The State is resource-limited in project management and financial evaluation skills. Further, those skills are spread thinly across government, with resources supplemented to a very significant degree by external advice. The State would be well advised, to further develop internal resources with skills in financial evaluation, infrastructure planning, procurement and project management rather than have the learning and development dissipated among external advisors.

There is also a need, for lessons to be syndicated across government on issues such as successes and failures in public and private procurement and contingency planning for default in private contracts. Indeed the building of appropriate skills across government should become a key objective of infrastructure policy makers, and not just in a *Partnerships Victoria* context.

The present Gateway Initiative goes some way towards a whole-of-government approach to bringing greater rigour to project assessment and management. It should be used as a base from which further efforts are made including the type of evaluation recommended that might mirror the approach taken in the UK Mott MacDonald Report (*Review of Large Public Procurement in the UK*, July 2002).

It is recommended that:

- The building of an appropriately sized internal capability within government involving project management and financial evaluation skills, become a key objective of infrastructure policy and not just in a *Partnerships Victoria* context.
- At the earliest possible time, there be an organisational realignment that enables the skills of financial and project evaluation to be centrally based within government. The most appropriate home for this team is *Major Projects Victoria* within the Department of Infrastructure. The present reliance on external financial advice should be supplemented with an increased role from the Treasury Corporation of Victoria.

4.15 STREAMLINING THE BIDDING PROCESS

The review received feedback from industry participants that the cost of unsuccessful bids had run into millions for specific bidders. (It should be noted that one company believes that the costs are high but that the estimate of $2-3 million may be an exaggeration.) In any event it is noteworthy that even one major construction company has described the present process and bidding costs as ‘excessive’ and ‘unsustainable’.

There is a clear link in logic between bidding costs, the level of ongoing participation in bidding, the level of competition between bidders and the likelihood of competitive outcomes. For the State to get value for money it must therefore seek to lower process costs including bidding and contractual processes.

It is therefore recommended that the objective of streamlining the bidding and contractual processes be one of continued priority, to ensure bidders are encouraged to participate.

The review has received a great deal of specific feedback on improvement opportunities in this area, and there is some concern that this report may not do justice to the proposals. A list of the suggestions is outlined in Appendix C. It is recommended, among other things, that this topic, the streamlining of bidding and contractual processes (including the suggestions in Appendix C) be further examined in the further revision of the policy as well as being an initial working item for the National PPP Council and its working party.

The feedback, primarily anecdotal, has raised issues such as:

- ‘It's fine for the State to change lawyers but they shouldn’t keep changing the standard indemnity clauses’.
- ‘The probity auditors have gone too far … not only can’t you talk to anyone in the department without them being there, but you can’t even be in a government building’.
- ‘The documentation required for a bid included multiple hard-copies of multiple volumes of Quality Manuals. Why not just reference our website?’.
- ‘Why are all the bidders bearing the costs of environmental testing. Wouldn't one from the state be better for all parties?’.
- ‘The policy is for risk to be managed by the party best able to manage it, so why is the State seeking to transfer the risks of getting a planning permit?’.

In relation to tender rescoping, BAFOs (requests for best and final offer) and tender abandonment, it is recommended that the State develop guidelines on how it views its responsibilities in such circumstances. The guidelines should outline the circumstances in which compensation maybe appropriate, to compensate bidders for additional costs imposed, as a result of 'process changes' by the State. The mode of application of the guidelines could be defined in bid documents.

In relation to concerns that probity requirements are stifling legitimate information gathering by bidders, it is recommended that, consistent with UK practices, a minimum amount of time be allocated for informal discussion between individual bidders and the client agency (and not just the financial advisers to the State).

It is recommended that:

- The objective of streamlining the bidding and contractual processes be one of continued priority, to ensure bidders are encouraged to participate. The suggestions in Appendix C should be examined as part of the ongoing revision of the policy, as well as being one for the National PPP Council and its working party to pick up as an initial working item.
- The State develop guidelines on the circumstances in which compensation may be appropriate, specifically where additional costs are imposed on bidding participants, as a result of 'process changes' by the State, including abandonment of the tender.
- Consistent with UK practices, a minimum amount of time should be allocated for informal discussion between individual bidders and the client agency (and not just the financial advisers to the State).

In relation to the final recommendation, the Department of Treasury and Finance notes that it has been already been the practice to some extent in some recent cases.

APPENDIX A

LIST OF RECOMMENDATIONS

The recommendations to realign the strategic direction, scope, and operation of the *Partnerships Victoria* policy are as follows:

1. The strategic direction of the *Partnerships Victoria* policy should be informed by empirical evaluation of the performance of infrastructure project delivery (under both public and private procurement approaches) and should focus on infrastructure segments where the private sector can best add value.

2. The State should sponsor a Review of Major Projects to evaluate the performance of project procurement and delivery, and to develop an empirical database of risk components. The study would mirror the approach taken in the UK Mott MacDonald Report (Review of Large Public Procurement in the UK, July 2002). It might involve a review of at least 20 projects over say $20 million across a range of sectors. It might also involve other jurisdictions and be sponsored by the proposed National Council on PPPs. Possible Terms of Reference are attached (Appendix B).

3. The policy should limit its potential application to large projects such as those involving capital expenditure of over $100 million rather than the existing policy of $10m of NPC. Exceptions would include projects that are bundled (to be over $100 million), and projects that are smaller but in sectors where there is a strong value for money case, such as in the water treatment projects where the internal capabilities of the relevant agencies are limited.

4. The *Partnerships Victoria* policy should strategically focus on large, complex, one-off or non-standard projects, or standard government buildings in circumstances where there are challenges of a technical, innovation or design nature, e.g. co-locating child care centres within school compounds.

5. The sectors that are deemed to be appropriate for private procurement should be published and should change in the light of experience (including the findings of the review recommended above), evaluation of project delivery performance and general market circumstances.

6. For the time being selected projects in the information and communication technology (ICT) sector should continue to be considered appropriate for procurement under the *Partnerships Victoria* policy, but this aspect of policy should remain subject to review. The nature and longevity of contracts and the use of a Public Sector Comparator should be modified to reflect the nature of the sector.

7. The present approach to risk assessment and the use of discount rates be unbundled into separate components – a risk-adjustment for estimated costs, an adjustment for the time-value of the money to be expended, and, to the extent that there is any transferred market risk (as defined in CAPM), an additional adjustment to add a risk premium to the discount rate for calculating the present value of any revenue stream.

   – Risk-adjustments to the cost of the PSC should be based on the best empirical evidence of the likelihood and cost of particular categories of risk events. That evidence should be compiled in an accessible form, such as that developed for the UK Green Book and included in the Mott MacDonald Report.

   – The practice of evaluating tenders involving net cash payments by the State, by discounting the minimum contract payment schedule by a discount rate that automatically imbeds an assumed risk premium (ie. the 170 basis points imbedded in the discount rate for 'most projects' in the July 2003 policy) should be discontinued.

   – The evaluation of tenders involving net payments by the State should discount the contract payment stream at a discount rate that reflects only the time-value of money, based on an estimate of the risk-free rate such as the Commonwealth Bond Rate that best matches the term of the project – e.g. 5.7 per cent nominal for 12-year bonds, or 3.5 per cent real.

   – In cases in which there is a net revenue inflow to the State in its PSC and there is market risk (as defined in CAPM), actually transferred under the *Partnerships Victoria* contract, the discount rate for that revenue should be a risk-adjusted one. However those cases should be limited in number and should be the exception.

8. The Public Sector Comparator should be reformed to become just one factor in procurement decisions and conclusions as to value for money. The use of a PSC should be discontinued in circumstances where public provision has not been done in the past and is not a reasonable option going forward. In such circumstances the analytic comparison should be against a reference case or a range of benchmarks.

9. In information and communication technology (ICT) projects, the reference case, subject to strategies to the contrary settled by Cabinet and the state Chief Information Officer, should more often be an off-the-shelf technology benchmark than a hypothetical version of a public sector created solution.

10. The State should publish details of the forecast payment schedules under contracts signed under the *Partnerships Victoria* policy and these should be posted on the *Partnerships Victoria* website.

11. To improve long term infrastructure planning, the State should publish a five and ten year forward 'pipeline' of major projects (e.g. over $20 million) under consideration, including those being considered for *Partnerships Victoria* procurement.

12. The volumes of guidance material compiled for the *Partnerships Victoria* policy should be available upon request to researchers, libraries and community groups at no charge, in the interests of encouraging better understanding of the efforts being undertaken to protect the public interest.

13. The State should not assume that the present structure and size of the PPP market in Australia is diverse and active enough to be fully competitive. This should be taken into account in the evaluation of tenders, with the State explicitly retaining the right to declare a potential outcome as 'not value for money'.

14. The State should actively monitor the size and activity base of actual and potential *Partnerships Victoria* partners, with a view to ensuring that there is a critical mass of potential players capable of delivering up to 10 per cent of Victoria's infrastructure investment, specifically in the strategic sectors identified.

15. Consistent with the UK reforms, the State should seek to pilot new financial and partnership structures for *Partnerships Victoria* projects that 'combine the benefits of private sector risk taking with the Government's comparative advantage in securing funds'.

16. In structuring long term contractual arrangements under *Partnerships Victoria* procured projects, the State not assume that they will be dealing with the lead equity investors beyond the medium term.

17. The building of an appropriately sized internal capability within government involving project management and financial evaluation skills, become a key objective of infrastructure policy and not just in a *Partnerships Victoria* context.

18. At the earliest possible time, there be an organisational realignment that enables the skills of financial and project evaluation to be centrally based within government. The most appropriate home for this team is *Major Projects Victoria* within the Department of Infrastructure. The present reliance on external financial advice should be supplemented with an increased role from the Treasury Corporation of Victoria.

19. The objective of streamlining the bidding and contractual processes be one of continued priority and ongoing revision, to ensure bidders are encouraged to participate. A list of suggestions is included in Appendix C.

20. The State develop guidelines on the circumstances in which compensation maybe appropriate, specifically where additional costs are imposed on bidders, as a result of 'process changes' by the State including abandonment of the tender.

21. Consistent with UK practices, a minimum amount of time should be allocated for informal discussion between individual bidders and the client agency (and not just the financial advisers to the State).

22. The recommendations of this review relating a proposed Review of Major Projects (including the creation of a database of risk events), the publication of a forward pipeline, the streamlining of processes and documentation and the resolution of accounting for PPPs be referred to the proposed National PPP Council and its working party as part of their initial work program.

APPENDIX B

REVIEW OF MAJOR PROJECTS

It has been recommended that the State of Victoria jointly sponsor – with other parties to the proposed National PPP Council – a multi-jurisdictional Review of Major Projects to review the performance of infrastructure procurement and to develop an empirical database of risk components for the purposes of better risk management in the context of major project delivery, under both public and private procurement:

- The study would mirror the approach taken in the UK Mott MacDonald Report (*Review of Large Public Procurement in the UK,* July 2002).

- The projects to be reviewed should cover at least 20 completed projects valued at over $20 million, across a range of categories and jurisdictions, chosen for their capacity to offer useful insights going forward.

- The review would include an assessment of what the UK Green Book now refers to as the 'optimism bias' which, for each category of project, being the estimation difference between the Business Case and the final outcome in relation to project duration and cost, including capital expenditure and whole-of-life operations and maintenance costs. Where possible it should include an assessment of the forecast versus actual benefits.

- The review would also examine evidence of issues including the project costs of over-runs, scope-creep and contractual default and revision.

APPENDIX C

SUGGESTIONS RELATING TO BIDDING AND CONTRACTUAL PROCESSES

A significant number of comments and submissions to the review related to the cost of bidding and contractual processes.

The following collection of suggestions made to the review and is provided here as a means of communicating the views of many market participants.

It should be noted that there are a number of suggestions that are already policy but may not be as fully implemented as industry would like.

PREPARATION

- Engage the market before inviting expressions of interest.
- Where small and relatively uncomplicated projects are involved, provide simplified processes with limited scope, less onerous risk transfer and simplified commercial arrangements.
- Capture the lessons of experience in areas where it may bring efficiency to the bidding process.
- Be familiar with actions taken elsewhere, particularly in the UK.

DOCUMENTATION

- Standardise documents, particularly contracts.
- Require consistency in terminology, structure and 'boiler plate' clauses; also locate any clauses that are project specific among ancillary documents.
- Avoid low value variations in documents.
- Ensure technical requirements are clearly defined.
- Avoid ambit in early draft contracts.
- Always release full contracts with the project brief.
- Communicate priorities, for example where there may be competing objectives of time, cost and quality.
- Defer the requirement for full bid documentation until later stages of bidding.

INFORMATION TO BIDDERS

- Always disclose the Raw Public Sector Comparator.
- Commit to an increased level of interaction with bidders, being prepared to answer questions and identify any proposed approaches that would be unacceptable or undesirable.
- Clearly set out requirements and be more available for consultation, for the purpose of reducing the risk of bidders delivering inappropriate or non-compliant bids.
- Minimise probity restrictions on technical feedback.

TIME AND DUPLICATION

- Commission fact-finding exercises that would otherwise necessarily be undertaken by each bidder (site characteristics, geo-technical, native title, environmental matters, etc.).
- Do not require fully underwritten bids – consider whether an approved negotiated term sheet would suffice.
- Develop programs of similar projects, to achieve a reduction in transaction costs through common approaches.
- Avoid Best And Final Offer processes.
- Develop standard government processes and documentation to expedite government approval.

APPENDIX D

LIST OF PARTNERSHIPS VICTORIA PROJECTS

Contracts have been signed for eight *Partnerships Victoria* projects:

- Victorian County Court
- Mobile Data Network
- Docklands Film and Television Studio Complex
- Berwick Community Hospital
- Wodonga Wastewater Treatment Plant
- Echuca/Rochester Wastewater Treatment Plant
- Enviro Altona
- Spencer Street Station Redevelopment

Three projects for which bids were invited did not proceed as *Partnerships Victoria* projects:

- Regional Fibre Optic Initiative
- Box Hill Hospital Car Park
- Westgate International Container Terminal

Four projects were in the bidding process throughout the review:

- Emergency Alerting System
- Metropolitan Mobile Radio
- Ballarat and Creswick Reclaimed Water
- Mitcham-Frankston Freeway

During the course of the review, a preferred bidder was announced for one project:

- Correctional Facilities

Expressions of interest were invited for two projects during the period of the review and have since closed:

- Melbourne Showgrounds Redevelopment
- Royal Women's Hospital Redevelopment

Documents relating to the eight projects for which contracts have been signed have been examined by the review.

APPENDIX E

Major stages in delivering a *Partnerships Victoria* project

Boxes on the left hand side show the points at which Cabinet approval (or approval of a Cabinet committee) is required.

The service need

Key tasks:
- Identify service needs
- Focus on outputs
- Consider broad needs, over time
- Allow scope for innovation

Option appraisal

Key tasks:
- Consider options
- Consider application of *Partnerships Victoria*
- Evaluate financial impacts, risks and other impacts

Business case

Key tasks:
- Confirm the project offers net benefit
  - Quantify risks and costs
  - Commence development of a PSC
  - Conduct cost-benefit analysis
- Assess *Partnerships Victoria* potential
- Obtain funding and project approval

Funding approval

Project development

Key tasks:
- Assemble resources — steering committee, project director, probity auditor, procurement team
- Develop a project plan
- Further develop the PSC
- Develop commercial principles
- Consultation

Approval to invite Expressions of Interest

Approval to issue a Project Brief

Bidding process

Key tasks:
- Develop Expression of Interest invitation
- Seek approval to issue the EoI
- Evaluate responses and develop a shortlist
- Develop a Project Brief and contract
- Seek approval to issue the Project Brief
- Conduct clarification sessions
- Evaluate bids

Project finalisation review

Key tasks:
- Confirm achievement of the policy intent
- Confirm value for money
- Report to the Minister
- Advise the Treasurer of intent

Final negotiation

Key tasks:
- Establish the negotiating team
- Set the negotiation framework
- Probity review
- Report to Minister and Treasurer
- Execute contract
- Financial close

Contract management

Key tasks:
- Formalise management responsibilities
- Monitor project delivery
- Manage variations
- Monitor the service outputs
- Maintain the integrity of the contract

APPENDIX F

TERMS OF REFERENCE

TERMS OF REFERENCE

The purpose of this review is to enhance the future achievement of value for money in the public interest in projects undertaken pursuant to the *Partnerships Victoria* policy.

The Review will investigate, report on and make recommendations regarding the following matters in relation to projects delivered under the *Partnerships Victoria* policy:

1. the process and evaluation techniques undertaken, including:
    - the public interest test
    - the public sector comparator
    - risk assessment
    - quality assurance, and
    - any additional criteria which might be appropriate in assessment;

2. the extent to which government control, fiscal options and policy flexibility is constrained by *Partnerships Victoria* arrangements, particularly in long-term contracts;

3. the cost to bidders of complying with bid requirements;

4. best practice models of this means of providing infrastructure; and

5. any other matters arising out of the review of those projects that could enhance the achievement of value for money outcomes for all Victorians through application of the policy.

In the context of the consideration of the above matters, the Review will also:

6. assess the role of traditional methods of government financing of public infrastructure; and

7. assess the role and effectiveness of the Infrastructure Planning Council and advise on the efficacy, structure and function of any successor body to the Council.

APPENDIX G

SUBMISSIONS TO THE REVIEW

The review thanks the following people and organisations for their contributions, many of which were quite extensive:

- Abigroup Ltd
- ABN AMRO
- Anonymous
- AusCID
- Babcock & Brown Pty Limited
- Baulderstone Hornibrook Pty Ltd
- BEST Pty Ltd
- Capital Research Pty Ltd
- CDL & Associates Pty Ltd
- Central Highlands Water
- City West Water Ltd
- Clayton Utz
- Coliban Water
- Commonwealth Bank of Australia
- Corrs Chambers Westgarth Lawyers
- Engineers Australia, Victoria Division
- Ernst & Young
- Freehills
- Gadens Lawyers
- GHD Pty Ltd
- Graeme Joyce Pty Ltd
- Hastings Funds Management Ltd
- Ian Hundley
- King & Co Property Consultants
- KPMG Corporate Finance (Aust) Pty. Ltd.
- Macquarie Bank
- Minter Ellison Lawyers
- Monash University, Department of Management
- North East Water
- Paradigm Advisory
- Peter Dwyer
- PricewaterhouseCoopers
- Property Council of Australia (Victorian Division)
- QLD Department of State Development
- Serco Group Pty Ltd
- Transurban Infrastructure Developments Ltd
- TTF Australia Ltd.
- University of Canberra, School of Management & Policy