INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

BUILDING AUSTRALIA TOGETHER

A submission on the future directions for Public Private Partnerships

MARCH 2013

Infrastructure Partnerships Australia is a national forum, comprising public and private sector CEO Members, advocating the public policy interests of Australia's infrastructure industry.

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FOR MORE INFORMATION

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1 About IPA

Infrastructure Partnerships Australia is the nation's peak infrastructure body. Our mission is to advocate the best solutions to Australia's infrastructure challenges, equipping the nation with the assets and services we need to secure enduring and strong economic growth and importantly, to meet national social objectives.

Infrastructure is about more than balance sheets and building sites. Infrastructure is the key to how we do business, how we meet the needs of a prosperous economy and growing population and how we sustain a cohesive and inclusive society.

Infrastructure Partnerships Australia seeks to ensure governments have the maximum choice of options to procure key infrastructure. We believe that the use of public or private finance should be assessed on a case-by-case basis. Infrastructure Partnerships Australia also recognises the enhanced innovation and cost discipline that private sector project management and finance can deliver, especially with large and complex projects.

Our Membership is comprised of the most senior industry leaders across the spectrum of the infrastructure sector, including financiers, constructors, operators and advisors. Importantly, a significant portion of our Membership is comprised of government agencies.

Infrastructure Partnerships Australia draws together the public and private sectors in a genuine partnership to debate the policies and priority projects that will build Australia for the challenges ahead.

More information can be found at www.infrastructure.org.au

2 Introduction

Infrastructure Partnerships Australia welcomes the opportunity to respond to the Victorian Treasury's discussion paper, *Future direction for Victorian Public Private Partnerships.* Public Private Partnerships are a proven tool for governments to efficiently deliver complex infrastructure assets and services. Given the substantial funding challenges facing Victoria (and other jurisdictions) it is important to examine how risk and reward are apportioned within PPPs and consider other, complementary reforms to extract additional value and efficiency within the capital programme.

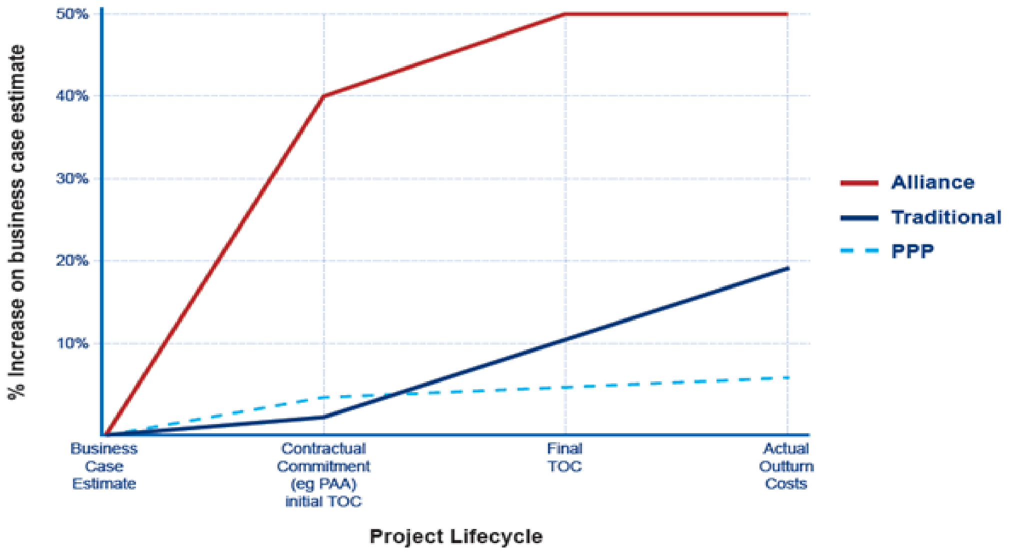
'Modern' PPP contracting models began to evolve in Australia from the early 1980s. The experience gained through these early 'path finding' projects led to a period of considerable experimentation around the proper roles for the public and private sectors in the ownership and operation of infrastructure assets.

By the early 2000s, each jurisdiction in Australia had established specialist framework policies to guide the delivery of privately financed projects. These policies were based largely on the *Partnerships Victoria* framework implemented in 2000 in Victoria; and the NSW Government's *Working with Government Guidelines.*

The experience of the established PPP model has been overwhelmingly positive for the public sector. Independent research in Australia (see Duffield et al, 2007, 2008, 2010 or Fitzgerald 2003) has found that PPPs offer substantial construction cost and time savings, compared to both traditional and alliance contracting. A paper undertaken by the University of Melbourne and released by IPA in 2007 provided the first comparative analysis of procurement outcomes; finding that PPPs outperform traditional procurement, achieving an average cost saving of 11.5 per cent.

Figure one below shows the results of the Victorian Department of Treasury & Finance's own comparative analysis, *In pursuit of additional value,* published in 2009. It shows that Public Private Partnerships perform well against traditional procurement and exceptionally well against Alliance delivery models.

Figure 1: Performance of Alliance, traditional and PPP procurement (Australia)



Source: Victorian Department of Treasury & Finance, In pursuit of additional value, 2009

These framework policies were further refined by the COAG Infrastructure Working Group, which was chaired by the Victorian Treasury, in 2008 and given national application through *Infrastructure Australia.*

The base frameworks advanced in the *Partnerships Victoria* framework and reflected in subsequent iterations have been very important in developing the national infrastructure marketplace. However, the standardisation of these frameworks (in concert with other considerations, such as political will and fiscal requirements) has meant that PPP frameworks have remained largely unchanged for more than a decade; in spite of the substantial changes in global capital markets, investor appetite and public requirements.

In particular, the opportunities to expand the scope of social infrastructure PPPs to include 'core' services in areas like health, justice and others offers an exciting opportunity to increase the efficiency and quality of public service delivery, while also driving efficiency into the operating expenses of Australia's governments. Developing a mixed market of providers also opens up more possibilities for innovation in service delivery and allows public and private provision to be benchmarked against one another.

The early experience of 'full service' PPPs in social infrastructure were mixed. The procurement of the La Trobe Regional Hospital (Victoria) and Port Macquarie Base Hospital (NSW) are often identified as reasons not to experiment with core services, because the operators ultimately returned the facilities to public operation. The experience of the Joondalup Hospital project (WA), which was procured concurrently to the Victorian and NSW projects, has been assessed as highly successful.

The experience of contestable markets for public services has found that exposing public services to competition will realise cost efficiencies in the order of 20 to 25 per cent.[1] Given the substantial funding challenge facing Australia's states, this discussion paper provides an excellent opportunity to renew experimentation with PPPs, including their role in driving a broader reform to the cost, quality and scope of public services.

Contestability can also bring improvements in productivity, service quality and flexibility of services. For example, the recently contracted Wiri Prison PPP in New Zealand will feature strong performance incentives, including that the consortium must perform ten per cent better than publicly run prisons at reducing reoffending, or will face financial penalties, bringing clear social and economic benefits to the community.

Changed capital market conditions also warrant reconsideration of the financing structures used in PPPs, particularly where adjustments can improve value for money, while maintaining optimal risk transfer to the private sector.

However, IPA would urge caution in the adjustment of financing structure, to ensure that an appropriate tension between cost efficiency and risk transfer is maintained. Adjustments (such as capital contributions, revenue guarantees, state 'wrapped' debt or direct state lending to a special purpose vehicle (alongside private debt) may each be appropriate to some projects. However,

[1] Sturgess, G. (2012), Diversity and Contestability in the Public Service Economy, NSW Business Chamber, New South Wales.

modified financing structures should only be used where the size of the project or the market conditions would result in inefficient pricing, and must be assessed on a project by project basis.

The key reason that PPPs are successful is because they align public and private good outcomes, creating financial incentives to ensure on-time delivery, design innovation and operational efficiency. Any reconsideration of financing structures must consider any impact that these adjusted models might have on the incentives within a PPP.

The necessary experimentation with the model will require political leadership and procurement excellence, and Victoria has a strong record in this field. In May 2004, Victoria led the formation of the National PPP Roundtable to drive consistency and coordination in how the states and territories procure major Public Private Partnership (PPP) projects. Victorian Government agencies and frameworks, including *Partnerships Victoria*, are both nationally and internationally regarded and have consistently delivered good outcomes to date.

Infrastructure Partnerships Australia commends the Victorian Government on its strong leadership in infrastructure procurement and we welcome the opportunity to participate in the subject review of existing frameworks.

This submission looks firstly at the need for efficient procurement in Victoria and the role of PPPs, and then considers the reform measures proposed in *Future direction for Victorian Public Private Partnerships* – both the permanent reforms and the temporary solutions to temporary challenges.

3 Case for change

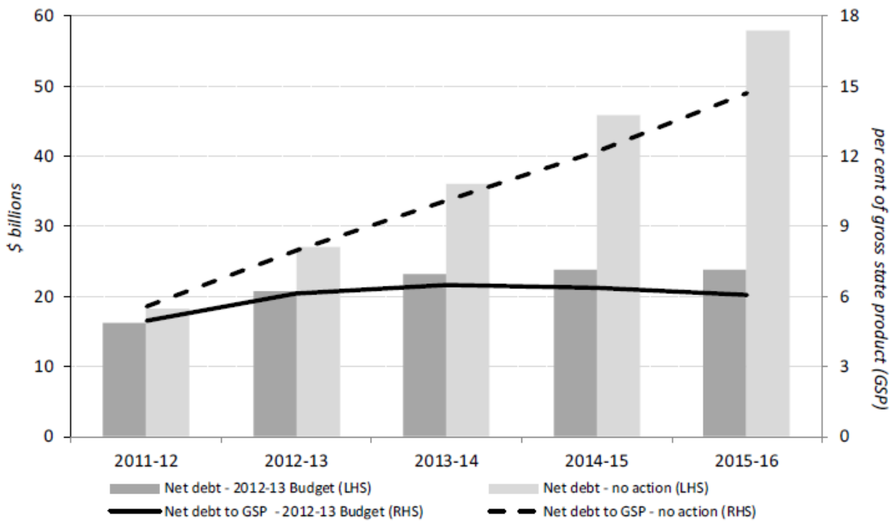
There is a growing call on the Victorian Government to fund infrastructure, yet the ballooning cost of delivering public services is constraining the Government's ability to meet its investment task.

This funding challenge is not unique to Victoria; indeed, Victoria remains the strongest state in terms of its budget position. Nonetheless, the ongoing domestic impact of global economic challenges has seen substantial retreats in government revenues, further compounding the challenge of funding the State's next round of capital investment. [2] For example, the 2012-13 Victorian budget forecast a reduction in the State's GST receipts in the order of $6.1 billion over the forward estimates.[3]

The Independent Review of State Finances (the Vertigan Review), commissioned by the Government in early 2011, concluded that Victoria's financial situation was unsustainable. The Review found that Victoria's budget position has declined since the early 2000s, and operating surpluses have averaged less than $500 million since 2008-09. Over the decade to 2010-11, average annual expenditures have grown by 7.3 per cent, while revenues have grown by 6.9 per cent, leaving a fiscal gap.

Figure 2 below shows that without the substantial reforms in the 2012/13 budget, net debt would have reached 15 per cent of GSP, a position that would be inconsistent with maintaining a AAA credit rating. [4]

Figure 2: Net debt under 2012-13 Budget compared to a 'no-action' scenario [(a)]



Source: Department of Treasury and Finance

(a) 'No action' refers to the likely net debt outcome if expenses over the budget and forward estimates grew by 7.3 per cent, which was the rate of expenditure growth between 2000-01 and 2010-11.

In a capital constrained environment, it is fundamental that the Victorian Government consider options that allow it to ensure value for money in its capital investment programme; and importantly, options to maintain (or increase) the quality of public services, while lowering the overall cost of the State's operating expenses. After all, it is the 'profit' left between the revenues of

[2] Victorian State Budget 2012-13 BP2
[3] Victorian State Budget 2012-13 BP2
[4] Victorian State Budget 2012-13; Budget Paper 2.

the State and its expense base that provide the budget capacity to sustain infrastructure investment over the longer term.

In this context, it is important to consider the potential for PPPs to play a greater role, both in ensuring Government capital investment is efficient; and in helping to repair the budget more broadly, by introducing a degree of yardstick competition into public service delivery sectors, such as health or corrections.

4 Feedback on Reform Proposals

4.1 Changing the value for money assessment

Specific areas for feedback addressed in this section:

a) Will the reforms improve or maintain competitive pressures and improve the efficiency of the bidding process?
b) To what extent will introducing the scope ladder and affordability benchmark improve the quality of tender responses?
c) Are there particular aspects of the State benchmark that would give greater clarity on scope requirements and therefore warrant greater disclosure?
d) Should the scope ladder be fixed by government prior to tender release or should it be open to bidder feedback and be a bid item?
e) How can we improve our qualitative evaluation criteria and assessment for PPP projects?

IPA commends the Victorian Treasury on its mature re-examination of the application of the Public Sector Comparator (PSC); and the options that the introduction of a project scope ladder might provide in driving additional value and ensuring that the public sector is able to refine its investment decision during project refinement.

The PSC was developed as a quantitative project cost benchmark, to provide the public sector with comfort that private sector bids were competitive, compared to traditional delivery. It was, at that time, a necessary tool to guide informed decision making and ensure that private sector project bids were competitive.

However, with the passage of time and the development of a highly competitive infrastructure market in Australia, both the requirement for, and inputs and assumptions within, the PSC have rightly been questioned. We therefore welcome the discussion paper's examination of these issues.

Infrastructure Partnerships Australia contends that the retention of the PSC in its current form does not serve any useful purpose. We therefore support the discussion paper's option that would see the PSC redefined as an affordability benchmark and reformed to better reflect likely outcomes.

While the PSC helps to ensure that the government is an informed buyer, having a strict quantitative measure also overlooks the qualitative benefits of PPPs. The 2006 Public Accounts and Estimates Committee *Report on Private Investment in Public Infrastructure* recognised that, *'acceptance of tenders at lowest cost may not ultimately be in the best interests of government';* a lesson learned from the experience on the Latrobe Regional Hospital PPP project. Additionally, the PPP model drives significant design and operational innovation, which would not be possible under a traditional delivery model. Qualitative benefits need to be afforded sufficient weight in assessments of value for money. Infrastructure Partnerships Australia supports the Victorian Government's goal of increasing the focus on innovation and quality service delivery.

Infrastructure Partnerships Australia further supports the release of the total benchmark amount to bidders, to better align government and bidder expectations from the outset, helping to improve efficiency in the bidding process.

Additionally, Infrastructure Partnerships Australia agrees that the engagement of an independent technical adviser to review the PSC, prior to release of the Request for Tender, will strengthen the robustness of the value for money assessment and help to prevent protracted procurement timelines, like those faced on the VCCC project.

In circumstances where the Government is concerned about project affordability, the use of a prescribed scope ladder may help drive additional value, while allowing like for like comparison during the bid evaluation process. However, scope ladders can increase complexity and bid costs and may impact the State's ability to accept innovative solutions. Therefore, they should be considered on a case by case basis, and when used they must be identified prior to the commencement of the bidding process and be limited to a short list of items.

4.2 Adopting modified financing structures

Specific areas for feedback addressed in this section:

a) What are the key considerations of a contribution at completion versus during construction?
b) What is the optimal level of government contribution and key considerations in determining the level?
c) Outside of government contributions, what are the most effective models for delivering value for money while retaining optimal risk allocation?
d) What alternatives to bank debt exist in current market conditions?
e) Are there other modified financing arrangements that may deliver greater value for government and taxpayers?

Replacement financier

h) Under what circumstances might it be appropriate the State have pre-emptive rights over bank debt?
i) Under what circumstances might the State have rights to replace a financier?
j) Apart from inter-creditor issues, particularly voting, what other issues might these raise?
k) What impact, if any, would this have on debt pricing and syndication strategy? Would the appetite for PPPs be affected by these structures?

One of the key benefits of the PPP model is the alignment generated between the private sector's profit motive and project outcomes, together with the discipline of private finance. Modified finance structures may be appropriate to respond to post global financial crisis market conditions that are making it more difficult to achieve value for money on major projects. However, any consideration of proposed changes must involve a clear examination of the changes to project risk born by the State.

The State must recognise the tension between achieving lowest cost and preserving both appropriate risk transfer and clear incentives to the private sector participants that drive positive outcomes. For example, the public sector taking an equity position in a project would be a fundamental change and would alter the incentives for private sector participants. Modified structures should only be used where the size of the project or the market conditions would result in inefficient pricing and must be assessed on a project by project basis.

Given the potential for an increased need for private sources of capital, the State needs to be careful when making fundamental amendments to the model to ensure competitive interest is maintained to both debt and equity providers.

State contribution

State contributions might be considered where they reduce financing costs, without imposing construction risk on the State, but must be considered on a case by case basis. In particular, a State contribution in the operational phase of a project or the State's preferred approach of a partial State contribution, paid as a lump sum on the completion of construction, warrant further examination.

These options could serve to reduce the assessed net present cost of the project, while the State retains the benefits of private finance and the optimal risk allocation. This kind of structure offers opportunities to maintain the integrity of risk transfer during the highest risk design and construction phase and could reduce the cost of capital during the high-risk operating phase through lower borrowing costs available to the AAA-rated Victorian Government.

However, compared to State contributions during construction, the preferred post-completion model introduces some inherent capital cost inefficiency. Greater capitalised interest is accumulated and underwriting fees are paid on the full amount.

For large projects where the market capacity for finance may be constrained by the project size it may be appropriate for the State to consider a contribution during construction, alongside financiers. Therefore a smaller amount of private finance would need to be raised by each bidder, ensuring that the project can be fully financed and is not priced at the cost of the last dollar. It is important to note that under this option, the State's contribution is a contribution, rather than a loan or equity, to ensure that inter-creditor complexities are not created.

To ensure the State is protected from project construction risk, under this model the government contribution is typically made available after a substantial amount of the private finance has been committed (for example after 100 per cent of the equity has been committed and 50 per cent of the debt has been injected).

For projects with significant complexity in operations, the State may wish to defer all or some of the contribution until after a reasonable operational "proving" period. This approach might better align the interests of the State and the financiers during the riskiest component of project delivery. The State contribution would be provided at the point at which brownfield investors would typically buy the assets, once a stable operational phase has commenced.

In determining the optimum level of State contribution, it is important to ensure that financiers retain a sufficient investment to remain incentivised. Limiting the State contribution to less than half of total capital means that financiers are still exposed to risk on the project as a whole.

Other models

Infrastructure Partnerships Australia generally supports 'user pays' models to help fund new infrastructure. Some form of State guarantee may be an appropriate tool in toll road projects where the private sector might be unwilling to accept full patronage risk. For example, this might come in the form of a 'cap and collar' where the State issues traffic forecasts and makes or receives payments if traffic growth is different to the forecast.

As a result of a number of difficult recent toll road procurements, it is likely that any demand risk will be priced conservatively by the market. A State guarantee mechanism may help to ease the concerns of sponsors and debt and equity providers, and help to improve value for money outcomes.

For brownfield toll roads, the State could unitise toll revenues to offer the institutional market a new quasi-debt product. For example, the State could unitise the rights to receive a certain percentage of toll road revenues for a set period. Following the "proving" period, a broker would manage the sale of the units into the market. Such a model could be used in conjunction with an availability PPP.

The State should also investigate taking long-term interest rate risk, cross currency risk and re-financing risk post construction as these measures can potentially reduce financing costs without impacting value or risk transfer benefits.

Alternatives to bank debt

Australian and overseas debt capital markets, bonds or lending from domestic or offshore superannuation and sovereign wealth funds provide potential alternate sources of debt capital for infrastructure projects.

Australian superannuation is accumulation-based (except for some legacy defined benefit schemes) and allows switching, both between and within funds into different investment options. This means that Australian superannuation funds are effectively exposed to redemption risk; contributing to the "equity bias" in default super schemes and reducing attractiveness of long-dated assets with limited liquidity such as project bonds (and also explains investor resistance to longer dated corporate bonds).

Superannuation funds typically invest in infrastructure debt as part of their allocation to fixed-income, which has increased since the contraction of global debt markets associated with the Global Financial Crisis. There is emerging evidence that the Australian funds management industry is gearing up to increase investment in infrastructure debt.

4.2.1 Replacement financier

There does not appear to be a compelling argument for providing additional rights for the State over bank debt or the replacement of a financier. In the case of non-performance, the State has existing rights to step in and resolve performance issues or terminate the project. If these sorts of changes were to be implemented, it would have to be very clear under what circumstances the State would have the right to intervene, to avoid any perception of reduced certainty for private investors.

Providing the State additional rights over bank debt is likely to result in conflicts of interest and would likely require restrictions on voting rights, limitations on access to information and restrictions on involvement in decision making forums for the State. The State has the right to enter the bidding once a market price has been established and a pre-emptive right could make the debt illiquid.

A key issue with the State having the right to replace a lender is the valuation of debt as this would be dependent on the cost and time involved in rectifying any project issues.

4.3 Expanding service delivery in PPPs

Specific areas for feedback addressed in this section:

a) What issues/impacts should government address when considering including additional services for PPPs?
b) What sectors provide opportunities for extending services under a PPP and why?
c) Are there useful incentive precedents for leveraging private sector innovations in service delivery across a public sector network?

4.3.1 Competition in public services

Creating sustainable capacity for increased taxpayer investment in infrastructure will require complex and sustained reforms to the delivery of public services – including through the innovative application of PPPs to public services. In an era of constrained balance sheets and mounting operating costs in health, education and welfare, every dollar more efficiently deployed is precious.

The need for reform has been similarly highlighted in other western nations. For example, in a 2011 speech on public sector reform, David Cameron said "*I want one of the great achievements of this Government to be the complete modernisation of our public services… Like every other western industrialised nation, we won't sustainably live within our means with unreformed public services and out-dated welfare systems.*"

The introduction of competitive tension to public service delivery has consistently been shown to improve both efficiency and quality of services, and to help resolve the challenge of the seemingly inescapable trade-off between paying more or getting less.

The 1993 Hilmer Report found that without competition there are less incentives for suppliers to improve quality and efficiency. This is evident in Australia's provision of public health services, for example, where the current limited level of competition has resulted in few incentives for efficiency improvements. Repeated in various services sectors across Australia, front-line public service managers are missing the competitive discipline of their private sector equivalents. Critically, they lack benchmarks to compare their performance to that of their peers.

Well-designed public services reform that utilises market-based solutions – including full-service PPPs – offers the opportunity to dramatically reduce government and taxpayer costs, while simultaneously delivering improved services.

For example, Western Australia's Acacia Prison delivers a substantial financial saving to Western Australian taxpayers without a reduction in service quality, and with improved accountability. The daily cost of managing a prisoner at the prison is estimated at approximately 30 per cent less than at a comparable public prison.

Domestic and international evidence shows that market-based reforms can improve the delivery of public services by:

- producing goods of the level of quality that meet consumers preferences at competitive prices and making service provision more consumer-focused;
- improving allocative and technical efficiency and reducing overall cost;

- improving accountability in service delivery and achieving a more appropriate allocation of risk.

Over the past two decades, Australia's governments have opened some of their services to competition and contracting, so that few of our public services are now delivered exclusively through a government monopoly. Recent research has indicated that competition has made a positive difference in financial performance and productivity in a range of sectors, yet further modernisation and reform is required.

4.3.2 Services PPPs

Infrastructure Partnerships Australia recommends the Victorian Government consider the best models for engaging not-for profit, non-government, and private providers in the delivery of public services, recognising that these models will have different applications in different sectors. PPPs that include a broader services component are one such model.

Over the last ten years, Victorian PPP projects have not typically included core services, focusing instead on the supporting or ancillary services. Increasing the scope of services in future PPPs provides an opportunity to improve operational efficiency across an asset's whole of life; improving both service quality and value for money.

For example, Joondalup Health Campus in Perth's northern suburbs is a full-service PPP, and is widely considered to be one of the nation's best examples of a successful healthcare PPP.

The Western Australian Government pays private operator Ramsay Health to maintain and run the facility, which is administered under a 'build, own, operate and transfer' model. The Government pays availability charges to the private operator, in return for the delivery of all health services over the 20-year concession. The operator provides emergency and all other healthcare services, and assumes the risk associated with the provision of complex health outcomes.

The experience at Joondalup shows the success that can be gleaned from including the private sector in the delivery of both infrastructure and clinical services in a PPP. Firstly, using the PPP model for the redevelopment resulted in a cost saving 23.1 per cent, compared to the PSC.

Secondly, for over a decade the private sector partner has fulfilled the terms of the contract. The Western Australian Department of Health's Licensing Standards and Review Unit inspects JHC facilities, staff and equipment every year. This process involves the appointment of independent auditors to review coding, invoicing, activity, quality, reporting and administration at the Health Campus. Every year since 2006 JHC has received an 'A' rating on this review.[5]

In 2009 the Western Australian Government approved a $393m redevelopment of the Health Campus to accommodate population growth.[6] The redevelopment will deliver extensive new facilities and expanded services for both public and private patients. Construction started in September 2009 and is set to finish early this year, months ahead of schedule.

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[5] Joondalup Health Campus (2011), Annual Report.

[6] The Global Health Group (2010), Public-Private Partnerships for Health – An Atlas of Innovation, University of California, United States.

Once the redevelopment is complete, the contract is set to be extended by ten years,[7] further signalling the facility's success.

If the scope of services is large, this tends to drive a much bigger focus on the credit quality of the operator, which may limit the range of providers that compete to deliver services, and may also impact on financing terms such as coverage ratios and pricing.

Another option which may be more efficient and flexible is to split the capital component of the project from the operations. This is the approach likely to be taken on the Sunshine Coast University Hospital in Queensland. Under a PPP structure, a private sector consortium has been selected to design, construct, finance, commission and maintain the hospital for 25 years. Separate from the PPP contract, the Queensland Government is also looking at outsourcing services at the hospital, and has approached the private sector with "requests for offers" to deliver everything from clinical services to management. This contracting structure allows for a poor performing service provider to be replaced without collapsing the capital structure.

4.3.3 Performance based contracting

It is the performance incentives built into PPP contracts that drive service improvements. By contracting for measurable outcomes, there is a strong financial incentive for the private sector to seek out innovations and systems that drive up the efficiency and quality of service delivery.

Contracting for outcomes is most effective where the financial risk of delivering specified outcomes or high-level outputs is transferred to the provider, thereby maximising the benefits of competitive tendering. Where an operator does not accept the risks it is best placed to manage, incentives to improve performance will be lacking.[8] PPPs involving performance based contracting have delivered strong outcomes both domestically and internationally in areas including health, social housing, and corrective services.

For example, the Turks and Caicos Islands Government entered into a PPP arrangement whereby two integrated health facilities were designed, built, and are operated by private partner InterHealth Canada Limited (ICL). The contract for the clinical services component details a comprehensive list of key performance indicators based on international standards, and payment to ICL can be decreased for non-compliance. The quality of healthcare services provided to residents of the Turks and Caicos Islands will be significantly improved by the new health system while public health expenditures will decrease by approximately 30 per cent.[9]

In the corrective services sector, the contracts for New Zealand's Wiri Prison PPP include strong performance incentives, including that the consortium must perform ten per cent better than publicly run prisons at reducing reoffending, or will face financial penalties – and for 17 per cent less cost than a comparable publicly run prison.

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[7] Joondalup Health Campus (2011), Annual Report.

[8] Productivity Commission (1998), Implementing reforms in government services, Melbourne cited in Perry Sperling and Ruth Parslow (1999) Occasional Papers – Health Financing Series, Voulme 4: Public and Private – In Partnership for Australia's Health, Commonwealth Department of Health and Ageing.

[9] The Global Health Group (2010), Public-Private Partnerships for Health – An Atlas of Innovation, University of California, United States.

4.3.4 Lessons from early full-service PPPs

Full-service, or operator-led, PPPs have the potential to drive significant quality and value improvements in the delivery of public services. However, successful PPPs require careful planning and execution to avoid potential difficulties such as those encountered in early PPPs, including the Latrobe Regional Hospital and Port Macquarie Base Hospital PPPs.

Australia was an early adopter of health PPPs, however, some problems were experienced at the outset. The early health PPPs were based on full service model projects, which were employed as state governments moved to reduce inefficient costs in public healthcare. However, there were inevitable teething problems, with hospital operators having trouble agreeing on budgets, calculating price increases and assessing how much risk the private sector partner would need to accept.

The Latrobe Hospital in Victoria, and Port Macquarie Base Hospital in New South Wales, later reverted back to the governments. As a result of this experience and improving budget climates, governments retreated to the current model with the PPP used for the asset, and the public sector delivering core services.

4.3.5 Case study: Latrobe Regional Hospital

Latrobe Regional Hospital (LRH) commenced operations on 1 September 1998, on time and on budget. In late 2000, only two years later, the Government assumed all operational and financial risk, with hospital ownership and responsibility for its operations formally transferred in 2002. The private sector operator was required to pay the State approximately $2 million.

After only six months of operation, the operator asked the State Government for an increase in their recurrent funding. However, as the operator was not able to demonstrate that operating losses were occurring it declined the request. The Government also resisted for fear a precedent would be set for renegotiating PPP contracts. By June 2000 however, the Government had recognised the hospital's financial troubles, and began to consider the options of a contract renegotiation, or a management process for the hospital's collapse.

Infrastructure Project Partners offered the following reasons as to why the private operator lost money:

- (i) Underestimation of staffing requirements;
- (ii) Assumption that sales tax exemption applicable to publicly run hospitals would apply;
- (iii) Assumption that private sector pay awards would apply;
- (iv) Underestimation of payroll tax;
- (v) Failure to understand the way in which Victorian public hospitals were funded for acute health services (despite being given every assistance during the bid stage);
- (vi) Underestimation of costs; and
- (vii) Assumption that the Government would be prepared to renegotiate the contract.

The private sector partner's failure to understand Victoria's case mix-funding model has been noted as a particular cause of the PPP's failure. Under the funding model, Victorian public hospitals are expected to make a 1.5 per cent productivity improvement each year, meaning that, for a given level of activity each year, Government funding falls in real terms. The successful bid was calculated in

June 1996 dollars and failed to recognise that, even by the time operations commenced, the average daily inpatient funding would have fallen.

Also, *"the operator had bid at a discount to the normal public hospital acute care service payment mechanism, believing that operating efficiencies could be achieved more in the early years of operation of a custom built hospital than in later years. However, Victorian public hospitals had become more efficient, but the operator was committed to the discount and acceptance of the contracted universal payment mechanism, which put it at a severe disadvantage and made adequate returns unlikely from the outset."*[10]

Finally, Victorian Auditor-General's reports provide evidence that in addition to funding provided under the casemix model, Victorian public hospitals were regularly receiving additional 'top up' funding grants to overcome shortfalls. These grants were not open to privately contracted service providers, leaving Latrobe Regional Hospital at a further disadvantage.

Lessons learned from the failure of the Latrobe PPP illustrate the need for transparent pre-bid processes to determine value for money, risk transfer, and the most appropriate accounting treatments.

4.3.6 Case study: Port Macquarie Base Hospital

Port Macquarie Base Hospital (PMBH) was the first public hospital in New South Wales to be delivered using the PPP model, and saw the Government's traditional role of health service provider change to that of health service purchaser. The PPP model was chosen because of a rising demand for health services in the area, a political desire to reduce public debt, and a belief that the private sector could drive competition and cost efficient services. Unfortunately the experiment failed to deliver the desired outcome.[11]

A DBFO structure was established for the whole project incorporating design, construction, financing and operation. As the first hospital PPP experiment, the PMBH structure differed from a typical DBFO. For example, the project vested the perpetual ownership of the asset in the private consortium as well as providing for the delivery of core clinical services by the private operator. The project provided for two tiers of payments: an availability charge and an annually increasing service charge.[12]

When the hospital was commissioned in November 1994 it was expected to outperform its peer public base hospitals. However, a cross-service and cross-year comparison over a range of indicators set by the Department of Health shows that the PMBH repeatedly underperformed its peers over the years. In 1998, waiting times for elective patients at the PMBH were more than double the State average, and the hospital's performance continued to fall. For the period ended June 2003, the PMBH had the largest number of patients who had waiting times longer than a year, with some patients waiting up to three years for orthopaedic surgery.[13]

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[10] English, L. M. (2004), Using PPP to Deliver Social Infrastructure: Healthcare Delivery in Victoria, The University of Sydney, Sydney.

[11] Chung, D. (2009), Developing an Analytical Framework for Analysing and Assessing Public-Private Partnerships: A Hospital Case Study, The Economic and Labour Relations Review Vol. 19 No. 2, pp. 69-90.

[12] Ibid.

[13] Ibid.

On 31 January 2005, the Labour Government paid $35 million to buy back the hospital, seven years ahead of the PPP's original end date.[14]

Important lessons were learned from the PMBH experiment.

An analysis of the PMBH project and others highlights that the success of complex service contracts including PPPs depend on a robust alignment of incentives and risks between and across project participants.

These complex issues around incentives, risks and rewards were not adequately addressed in the PMBH contract; this misalignment of interests and lack of experience of the PMBH operator meant that the project failed.

However, substantial experience both here and overseas shows that complex services contracting structures including PPPs can be successful. By including a greater service offering in PPP projects, the Victorian Government stands to gain significant benefits, both on the individual projects the model is applied to, and through their role in driving wider public service reform.

[14] Ibid.

4.4 Streamlining procurement process and bid costs

Specific areas for feedback addressed in this section:

Continue to improve PPP tender processes

a) Is there bid material that could be provided in less detail at bid stage?
b) Is there any material that you consider could be provided at preferred bidder stage or following contract close?
c) Design costs are a significant bid cost item. Are there any changes that could be made to the State's requirements in the RFP that would have an impact on bid design costs?
d) Are there innovations in the electronic presentation of tender or bid documents that could be used more readily?
e) Are there any processes or innovations used in other states or overseas on PPPs or other forms of procurement which Victoria should consider adopting?
f) Does the probity process unnecessarily inhibit innovation and achieving optimal commercial outcomes? How might this process be improved?

Bid cost contribution

g) What is considered an appropriate amount without interfering with current bid dynamics?
h) Should the contribution be set up front?
i) Do all bidders or just unsuccessful bidders receive a bid contribution?
j) What is an effective and efficient way for the State and the winning bidder to acquire intellectual property in losing bids?

4.4.1 Continue to improve PPP tender processes

The cost of bidding major projects continues to challenge both procurers and bidders. A KPMG report, released by Infrastructure Australia, found that bidders will spend an average of between 0.5 and 1.2 per cent of any project's capital cost on bidding.

However, solutions are not straightforward. The discussion paper itself notes that *'[t]here is always a balance between minimising the process costs for tenderers and maintaining sufficient information requirements and competitive pressures to ensure a value for money outcome for government.'*

Ultimately, the cost of bidding projects will accrue to the taxpayer, as these costs are recouped on future, successful bids. Therefore, a careful consideration of the documentation required at each stage of bidding is warranted. It appears that many of the required items add expense, without benefiting the public sector in terms of reaching actionable decision points.

Consideration should also be given to shortlisting fewer proponents, if doing so maintains sufficient competition and does not frustrate competition and value for money. Rationalising information requirements, shortlisting only two bidders where appropriate and avoiding BAFO processes will all help to reduce bid costs.

The approach to bid documentation should be on the key information required for bid evaluation, rather than asking a long and expanding laundry list of information. It is also important to ensure that there is not repetition of documentation requested under the EOI stage.

For management, safety, and quality systems, outlines only should be required in diagram form, with examples of projects on which those systems have had been used before, as well as addressing any project specific requirements the State might have for functionality.

In order to support the rationalisation of bid documentation, a number of administrative changes should be made, including through the electronic lodgement of all EOIs with defined lengths and formats; restricting the RFP response to one printed copy with accompanying soft copies and identifying specified inclusions or exclusions to RFP documents (e.g. expensive fly- throughs and accompanying video materials).

Respondents to a recent Baker and McKenzie survey were largely supportive simplifying the procurement process by introducing standardised terms and conditions and limited returnable schedules (83 per cent of all respondents, and rising to 90 per cent of constructors), and the majority of respondents (73 per cent) would also support a review of government probity processes, to facilitate greater information sharing. Over the longer term, governments should look to increase transparency and common information. Greater certainty and coordination in the PPP pipeline will also help to alleviate bid costs.

However, it is likely that the greatest reductions in inefficient bid costs will be delivered through running timely and efficient bidding processes. Timely decisions and a clear communication of project outcomes during the interactive bid phase will ensure that an unsuccessful bidder's inefficient monetary and opportunity costs, are each minimised.

4.4.2 Bid cost reimbursement

The issue of bid cost reimbursement is also a difficult issue for policymakers. On the one hand, it appears attractive, because it potentially lowers the barriers to entry; while on the other, routinely reimbursing bid costs is not necessarily in the public interest.

IPA submits that the focus should rather be on reducing inefficient costs from the procurement process. Reimbursement (or partial reimbursement) should be considered where project complexity or other considerations (such as promoting competition) make it appropriate. Procuring agencies should also consider a reimbursement where the procuring a project's procurement takes longer, or because client requirements require additional expense, such as through multiple BAFOs.

If the Victorian Government were to proceed with a pilot bid cost reimbursement scheme for significant projects, a defined contribution should be set up front, to be provided to all unsuccessful bidders.

4.5 Developing a streamlined PPP model

Specific areas for feedback addressed in this section:

a) What are the critical aspects of a traditional PPP procurement approach that need to be simplified under a streamlined approach?
i. What design requirements may be streamlined under a revised model?
ii. How could the procurement model more broadly be streamlined under a revised model?
b) What are the key sectors that a streamlined model could apply?
c) What is the level of market appetite for a streamlined model?

The PPP model requires an inherent and detailed scoping of project construction and operational risks and a competitive bidding process based on cost, quality and service delivery. This contributes to the superior innovation and cost outcomes delivered through PPP procurements; but also serves to make the model relatively expensive for bidders.

Additionally, the Australian market is differentiated from comparable PPP markets (such as Canada or the United Kingdom), because Australia has largely applied PPPs to a comparatively smaller number of substantially larger projects than those jurisdictions.

There is likely to be substantial utility in driving a further standardisation of bidding documentation and processes, on a national basis. Infrastructure Australia undertook early work in this area, although it is apparent that these frameworks have to date been applied differently, in different jurisdictions. As well as reducing inefficient bidding costs for major projects, another benefit from greater standardisation may accrue through a wider application of the PPP model to smaller projects.

New opportunities might exist in areas including social housing, local municipality civil works, accommodation facilities, school maintenance programmes and road maintenance programmes.

However, local authorities and state government social welfare agencies alone are unlikely to have the expertise or sophistication to be able to scope, bundle and procure privately financed projects.

We therefore contend that Partnerships Victoria should be given further resources to allow it to expand its capabilities to assist with the ongoing national refinement and development of streamlined documentation to benefit existing major procurement programmes; and assist local governments and smaller state agencies consider the options that exist to drive better outcomes.

5 Additional initiatives for consideration

5.1 Stamp duty impediments in PPPs

There is a need to address the confusing array of stamp duty regimes, in order to facilitate and streamline private sector investment in Australia's public infrastructure. Current arrangements mean that there are substantial and material inconsistencies between jurisdictions in the way stamp duties are imposed.

When governments and private organisations enter into PPPs to construct assets on behalf of a jurisdiction, various private sector investors are required to invest at different stages of the project lifecycle. Often, certain types of investors will be interested in investing in the project during its construction phase (such as contractors involved in constructing the asset), but these investors will often want to sell their equity interest, once construction of the asset is complete.

The confusing array of different land rich or landholder duties therefore acts as a disincentive, because of the substantial differences between jurisdictions.

A 2012 Infrastructure Partnerships Australia paper on this issue calls for a nationally consistent approach; and outlines a range of options to better facilitate investment through PPPs. The principal outcome sought is the elevation of this issue to the agenda of the Council of Australian Governments for consideration and resolution.

The paper, *Stamp duty impediments in Public Private Partnerships,* can be accessed online at http://infrastructure.org.au/Content/StampdutyimpedimentsinPPPs.aspx