



New South Wales  
T R E A S U R Y

# **PRIVATE PROVISION OF PUBLIC INFRASTRUCTURE AND SERVICES**

Office of Financial Management

Research &  
Information Paper

## **PREFACE**

This publication contains an edited version of an address given to the Australian Council for Infrastructure Development by the Secretary of NSW Treasury, John Pierce, and the Secretary of the Victorian Department of Treasury and Finance, Ian Little, in Sydney on Friday 5 April 2002 and in Melbourne on Friday 12 April 2002.

The input of officers from both departments is gratefully acknowledged, particularly that of Simon Palagyi of NSW and Glenn Maguire of Victoria.

Further detail on both States' policies for private financing / public private partnerships can be found in the documents listed in Appendix A.

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# **PRIVATE PROVISION OF PUBLIC INFRASTRUCTURE AND SERVICES**

*An address to the Australian Council for Infrastructure Development by John Pierce, Secretary of NSW Treasury and Ian Little, Secretary of the Victorian Department of Treasury and Finance.*

## **INTRODUCTION**

Over the last 2 years, the Governments of New South Wales and Victoria have both embarked on an extensive review and refinement of their policies for private sector involvement in the provision of public infrastructure.

This has culminated in the release of the *Partnerships Victoria* and the NSW *Working with Government* policies, which both pave the way for increased involvement of the private sector in the provision of infrastructure to the community.

Private sector involvement in public infrastructure provision is not a new thing. Over recent years, this involvement has been across a variety of sectors – including road, rail, water, telecommunications, prisons, hospitals and the Olympic infrastructure in NSW – and the scope of services provided by the private sector has ranged from serviced accommodation to full service delivery. These projects have provided both States with valuable lessons in what works and what doesn't, and how deals should be structured to ensure the best outcomes for the community.

While each State may use different terms to describe these arrangements – Public Private Partnerships (PPPs) in Victoria, and Privately Financed Projects (PFPs) in NSW – the policies and projects being delivered under them have a number of common essential elements. The similarity of both Governments' approach to private sector participation is not a coincidence. The common experiences of both States with past projects have informed the new policies, and the excellent technical work undertaken by Victoria in putting together the Guidance Material accompanying its policy has been largely adopted by the NSW Guidelines. There is no point reinventing the wheel.

Indeed, this joint address reflects the spirit of cooperation between the States that has informed the development of our policies. We believe that this cooperation has importance beyond just the drafting of policy documents.

## **THE NEW POLICIES**

Given the extensive past experience of both Governments in private financing and public private partnerships, what is notable about the revised policies?

Firstly, the policies allow the use of private financing and public private partnerships in all sectors of Government, including social infrastructure, such as schools and hospitals. Social infrastructure projects are distinguished from more conventional privately delivered projects in that users are not charged directly for their use of the asset.

Instead, the services provided by the infrastructure are funded through payments from the Government to the private sector provider. This distinguishing feature creates some different financial, risk and contractual issues compared to user-charged economic infrastructure, and the NSW and Victorian guidelines endeavour to establish a robust framework for addressing these issues.

Secondly, the policies provide that, while the private sector may be responsible for the financing, construction and maintenance of social infrastructure, and some non-core services, the Government would still provide the core services to the community, such as teaching students and providing clinical services to patients.

Thirdly, the policies require that privately financed options demonstrate superior value-for-money to the Government and community compared to conventional, publicly funded approaches to infrastructure provision. This is the sole reason for considering private financing and delivery – with both States having low debt levels, off-balance sheet borrowing is not an attraction in its own right.

The value-for-money determination will be facilitated through the construction of a “Public Sector Comparator” (PSC). The PSC is a model of the costs to Government of undertaking the project itself through conventional publicly financed and managed approaches. Importantly, to ensure comparability, the PSC will include an allowance for the costs of risks that are likely to crystallise over the life of a project, and which would be allocated to the private sector under a privately financed approach.

Fourthly, the policies provide for tests to ensure that the public interest is protected in privately delivered projects. PFPs/PPPs are assessed against public interest criteria including effectiveness, impact on key stakeholders, accountability and transparency, public access and equity, consumer rights, security, and privacy. This assessment takes place before the project is put to the market.

Finally, the policies both set up project development frameworks and processes, which are aimed at ensuring a fair and transparent tender process and a value-for-money outcome to the Government and community. A Cabinet committee ultimately oversees these processes.

## **IMPROVED VALUE-FOR-MONEY**

Why should governments use privately financed and partnership approaches to infrastructure provision?

These policies are not based on any ideological assumptions about the relative ability of the private or public sectors to successfully construct and operate infrastructure. Nor are they simply about creating opportunities for private sector profit, without genuine risk transfer. Rather, they are based on sensible economics and the over-riding principle of obtaining superior value-for-money for the community.

Both governments believe that private provision of public infrastructure has the potential to offer enhanced value-for-money compared to conventional approaches, for the following reasons:

- Firstly, the integration of design, construction, operation and maintenance over the life of an asset, within a single project finance package, can encourage maximum innovation from the private sector to improve the design and performance of the infrastructure and reduce its whole-of-life costs. Innovation will be supported by the Government specifying what it wants in terms of outputs – the services that the asset is to provide – rather than inputs. A whole-of-life approach to the asset’s delivery can also ensure that it is fully maintained throughout its life, which is not always the case under direct Government management, where maintenance needs are frequently subordinated to other priorities.
- Secondly, transferring risks to the private sector, where it is better placed than government to manage those risks, can further improve the cost and quality of infrastructure. Strong incentives for performance can be imposed by a performance-based payment regime, such that the private sector’s investment in a project is always at risk. The phrase “where the private sector is better placed to manage risk” should be emphasised. Early in both States’ experience the temptation was for maximum transfer of risk, and inevitably risks were sometimes transferred that ultimately came back to Government. The focus has now shifted to “optimum” risk transfer – Government will retain risks where it is in a better position to manage them or deal with their consequences.
- And finally, appropriate third-party usage of the facilities, either concurrently or “out-of-hours”, can reduce the net cost of the facility to the government. In many cases, the private sector is better placed than the government to manage third-party usage, allowing the government to focus on its core activities.

## **IS GOVERNMENT FINANCE CHEAPER?**

Why would a government seek to use private sector finance to build infrastructure, when it can borrow at lower interest rates by issuing government bonds?

It is a myth that governments have access to “cheaper” finance to undertake projects – a government’s ability to borrow more cheaply is purely a function of its capacity to levy taxes to repay borrowings. Credit markets (rightly) perceive this coercive power as reducing the risk of their investment, and are therefore willing to lend to a government at lower rates than to a private sector borrower.

However, when it comes to raising finance for a project on a non-recourse basis, it is the risk of the individual project that determines the real cost of finance.

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

A key objective of both State’s policies is to achieve a more comprehensive, up-front consideration of the costs of these risks to the government, to allow a truer comparison of the cost of conventionally financed infrastructure with privately financed options.

The importance of the finance element of privately provided infrastructure lies in the incentive it can provide for the performance of the infrastructure, and the disciplines external financiers can provide on the delivery of projects to time and budget. It is difficult to replicate the strength of these incentives and disciplines within a conventional funding process where all the risks of delivery reside with the government.

## FISCAL IMPLICATIONS

Both NSW and Victoria have well articulated fiscal strategies that are underpinned by legislation. While there may be differences in precise details and measures underlying these strategies, both are based on common key principles.

One of these common key principles is ensuring that any liabilities or financial obligations entered into by the government are “sustainable”. This does not mean that a government should never borrow to finance infrastructure. There are strong arguments, on both economic efficiency and inter-generational equity grounds, why a portion of a government’s infrastructure, which has benefits beyond the current period, should be financed by debt.

Precisely what level of liabilities is “sustainable” is a matter of some debate. However, as a matter of principle, a “sustainable” level of liabilities is one that is low enough to weather a sharp economic downturn without harsh corrective action, in the form of spending cuts or tax increases, being required to avoid a debt “blow out”.

Reducing and maintaining liabilities at a sustainable level, therefore, ensures that a government’s ability to respond to uncertain expenditure priorities in the future is not constrained, and that a government’s ability to service its financial obligations is not compromised.

With this in mind, both NSW and Victoria do not regard the use of private finance or public private partnerships as a means of expanding the overall level of resources available to it to spend on government-funded social infrastructure.

Even though social infrastructure may be *financed* by the private sector, the government, through payments made through the contract’s life will ultimately *fund* it.

These payment commitments are as real as those associated with servicing balance sheet debt and in the context of a government’s fiscal strategy, need to be considered in a similar manner.

Indeed, with both States having AAA balance sheets, it is these ongoing availability and performance payments (or depreciation and debt servicing), which are more important constraints on governments.

Private provision of public infrastructure is therefore not a “magic pudding” that can alleviate the resource constraints all governments necessarily face. Unlike in the United Kingdom, where its “Private Finance Initiative” was introduced initially to circumvent strict fiscal constraints, neither State views private provision of social infrastructure as a way of disguising borrowing off-balance sheet.

In NSW, the Premier has made this clear: “... the aim of the program is to provide better services to the public, not borrow money.” And, in Victoria, when releasing the Partnerships Victoria guidance material, the Treasurer said: “The policy is financially responsible, with private sector proposals only proceeding if they could demonstrate better value for money than the public sector could achieve on its own.”

Consequently, the availability of private finance is not regarded as a means of wholesale acceleration of government-funded projects – ideally, projects that will ultimately be funded by the public purse should be approved on the basis of conventional capital funding prior to being considered for privately financed or partnership delivery. In the event that a project is implemented through a PPP or PFP approach, the capital funding allocated to it would be replaced with funding over the life of the contract with the private sector.

As well as being financially responsible, such an approach would ensure that a government’s investment decisions are not skewed towards projects that, by their nature, are more suited for PFP or PPP delivery.

Of course, for projects where the government does not ultimately fund the service, but the private sector provider charges users directly, this fiscal constraint does not apply. The availability of private finance to undertake these projects can result in such infrastructure being provided earlier than it otherwise would be, given the competing priorities for the government’s limited investment funds.

This does not mean that such projects do not need to demonstrate net benefits to the community, nor consistency with the government’s policy and development priorities. They need to face the same threshold tests as budget-funded projects – they must be socially and economically justified, and in the public interest. In addition, projects with third party revenues need to have a charging and access regime that is both equitable and efficient.

## **PROCESSES AND RESOURCES**

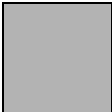


Both States’ policies establish processes to be followed by government agencies in the development of a PFP or PPP. This is not process for process’s sake, but is directed towards ensuring that:

- the central government, and ultimately a Cabinet Committee, oversees a project’s development, bringing both a consistency of approach and accountability;
- tender processes are transparent and fair;
- the private sector has a degree of confidence in how a project will be developed, thereby eliminating much of the “process risk” associated with a project’s development, and lowering transaction costs; and
- the government and community can have confidence that a value-for-money outcome has been obtained.

### ***Approval Processes***

The following diagram shows an outline of the approval processes in both States – Cabinet Committee approvals are required at least three times during the project’s development, which follows a basic two-stage tender model:

<b>New South Wales</b>	<b>Victoria</b>
Project approved in-principle, and funded	Project approved in-principle, and funded
<i>Project Development</i>	<i>Project Development</i>
Approval to invite Expressions of Interest	Approval to invite Expressions of Interest
<i>Expressions of Interest and Shortlisting</i>	<i>Expressions of Interest and Shortlisting</i>
Approval to invite Detailed Proposals	Approval to Issue Project Brief
<i>Detailed Proposals and Evaluation</i>	<i>Detailed Proposals and Evaluation</i>
Approval to appoint Preferred Proponent	
<i>Negotiations</i>	
Approval to Proceed	
Treasurer's Approval under PA(FA) Act	<i>Project Implementation</i>
<i>Project Implementation</i>	

	Mandatory Cabinet Committee approval		Cabinet Committee approval required in some circumstances		Statutory approval
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In both States, a project must be approved in-principle by the relevant Cabinet Committee, and funding for any likely government contribution confirmed, prior to any approach to the market. A further approval would also be required after substantial pre-tender work has been undertaken, and prior to expressions of interest being sought. These two approvals are necessary to offer confidence that the project is:

- consistent with the government's policies, and is of sufficient priority to receive funding; and
- likely to have the necessary features of a PFP or PPP, including sufficient market appetite, to result in a value-for-money outcome.

In New South Wales, the Cabinet Committee's approval to proceed to the first stage of a tender process will normally delegate the subsequent approval of a short-list and a Request for Detailed Proposals to the responsible Minister and the Treasurer. However, for large or particularly sensitive projects, a further Cabinet Committee approval may be required prior to seeking detailed proposals. In addition, the Cabinet Committee's approval of the appointment of a preferred proponent would usually be required.

In Victoria, it is usual for a separate Cabinet Committee approval to be obtained prior to issuing a Project Brief (which seeks detailed proposals from the short-listed proponents). This would usually be the final Cabinet Committee approval sought during the project development process, with the selection of a preferred proponent and negotiations delegated to the responsible Minister, in consultation with the Treasurer.

In addition to the Cabinet Committee oversight, which is a product of government policy and convention, New South Wales has a statutory approval requirement prior to the execution of contracts for a PFP. The Parliament, through the Public Authorities (Financial Arrangements) Act, has approved an authority entering into a "joint financing arrangement", which most PFPs would comprise, but subject to the approval of the Treasurer.

To a large extent, the Cabinet Committee approval process serves as the mechanism for the Treasurer's consideration of a joint financing arrangement, however, as a matter of law a separate statutory approval must be obtained. Such an approval is usually obtained prior to the execution of contracts, or is a condition precedent within a contract.

To support the project development process, and to facilitate the Cabinet Committee's consideration of projects, both States have established specialist Private Projects and Partnerships units within their Treasuries. This recognises that PFPs and PPPs require a core understanding of common commercial, financial and contractual issues upon which the entire public sector can draw. The need for the centralisation of such expertise within government was identified by a large number of submissions to the NSW Government's Green Paper, and support for this to be located within the central government was high.

However, the role of these units is not to be the primary driver of the development of individual projects. A successful project needs the full commitment and leadership of the relevant service agency, and project outcomes are best specified and managed by the service agency.

Instead, the units will take an active role, in partnership with agencies, in supporting the project development process through expert financial, commercial and contractual advice and in maintaining integrity of PPP/PFP policy and process.

The units will have an ongoing policy development role and will also play a key role in determining the feasibility of various proposals for private sector provision.

Some of you may look at these process maps and sigh at their length and rigidity. If our first message to you today was not to sell PPPs as a "magic pudding", the second would be not to "buck" the process.

One of the main reasons for specifying the process is to ensure that when projects go to market and the private sector starts spending serious dollars, the projects are ready.

Ready in two senses – that budget funding has been obtained, and that government has thought deeply enough about the services it wants from the project and their likely cost, that there are no surprises when bids come in.

Getting ready in these senses takes government some time, and it is a little frustrating when the private sector urges faster project delivery. The frustration stems from our experience that rushed project preparation risks projects stalling and failure later on.

## **NSW AND VICTORIA – WORKING TOGETHER**

NSW and Victoria have been working together closely during both the development and implementation phases of our new policies.

As well as the "formal" side of things, with our policy and guidelines documents, the NSW and Victorian Governments have been working together informally on a range of policy and project-specific issues, through our respective Treasury units. This has encompassed:

- the sharing of resources and experiences, including project documentation;
- discussing project-specific or sector-specific matters during the pre-tender stage;
- examining opportunities to align project development programs so that similar projects are released to the market at similar times, economising on the project development and bid process.

In addition to the informal cooperation between NSW and Victoria, a Heads of Treasuries Working Group on Private Sector Provision of Infrastructure has been operating over the past twelve months, drawing on all States, Territories and the Commonwealth. While jurisdictions are obviously at different stages in the development and implementation of their policies, this forum has been a valuable mechanism for investigating a range of matters relating to PFPs and PPPs, including:

- technical aspects of PSC development, including discount rates;
- longer term contract management and human resource issues; and
- accounting for privately provided infrastructure by public sector entities.

## **CHALLENGES AHEAD**

There are a range of challenges facing both governments and the private sector in realising the full value-for-money potential PFPs and PPPs can offer. We believe that a number of those challenges can be addressed through substantial intergovernmental cooperation.

### ***Minimising Transaction Costs***

It is widely recognised that the extensive up-front work involved in a competitive tender process, and in developing a contract can generate high transaction costs for both public and private sectors. If not appropriately managed, these transaction costs can detract from the potential value-for-money benefits from privately financed projects.

Victoria and NSW both see an important role for intergovernmental cooperation in minimising the transaction costs associated with private financing. The close working relationship between the two States to date reflects the desire to harmonise policies and processes to the greatest extent possible.

While it is unlikely that a single “standard contract” will ever be capable of accommodating the unique risk issues associated with individual projects, a more standardised approach to tender processes and risk allocation will go a long way to reducing the up-front costs associated with developing a project.

### ***Tax issues***

Many arrangements for PFPs and PPPs, particularly those that involve the government using the infrastructure to provide services, are likely to be covered by the so-called “leasing provisions” of the Commonwealth *Income Tax Assessment Act*. These provisions (Sections 51AD and Division 16D) operate to deny the owner asset-related tax deductions (predominantly depreciation), working against the potential value-for-money of a transaction.

While originally introduced to combat tax avoidance, these provisions have had the unintended effect of introducing unnecessary complexity into the roles played by private sector providers, hindering the achievement of value-for-money outcomes. The States also consider the relevant tax law to be out-dated as it does not align well with the evolutionary changes made to the way that governments engage the private sector.

Both the NSW and Victorian Governments made submissions to the Ralph Review of Business Taxation in 1999, in which we recommended the amendment of these sections to remove impediments to private provision of public infrastructure. While the Ralph Review endorsed this view, and recommended the abolition of 51AD and the replacement of 16D, the Commonwealth is yet to determine its position. Currently, a working group of State and Commonwealth Treasuries, the Australian Taxation Office, and private sector representatives, are developing options for reforming the provisions. We would support any action by the Commonwealth to improve the unnecessarily severe taxation treatment of certain PFP and PPP arrangements.

### *Accounting Issues*

We have mentioned that, in the context of the fiscal implications of a PFP or PPP, whether a project is reported on- or off-balance sheet is somewhat of a “red herring” – the contractual commitments to pay for the availability of infrastructure are just as real, regardless of how they are accounted for.

While the accounting treatment does pose presentational issues, it is certainly not a determinant of the fundamental value-for-money of a project.

We do recognise, however, that greater certainty is required on the accounting treatment of privately financed projects, preferably in the form of a dedicated accounting standard.

A recognised Australian Accounting Standard capable of addressing the complex risk allocations issues in a PFP/PPP transaction does not exist, and the existing standard on accounting for operating and finance leases has tended to be adopted by some parties as a default.

An inter-jurisdictional group has been working actively to develop proposals for a better accounting treatment of these transactions, to ensure that they are appropriately reported within a State’s accounts.

It is hoped that this work will ultimately result in an approach that is acceptable to governments, Auditors-General and the Australian Accounting Standards Board, and which appropriately reflects the substance of these arrangements.

### *Stronger Operators*

From our perspective, financiers and builders too often dominate consortia. These groups are very important, but by and large government interacts with them only during the project development and construction phases.

In contrast, government deals with the infrastructure operator for twenty or thirty years. We would like these operators to be a stronger component of the consortia so that:

- we can judge their experience and capability; and
- they can judge whether the service delivery task and risk transfer is sustainable over such a long period of time.

### ***Contract Management***

Following on from the previous point, contract management is obviously critical to getting the best out of the contract for the decades after the infrastructure is built. Generally, government is not as good as it should be at contract management.

We are trying to get better, for example, we often employ the senior contract manager during the project preparation stage so that they understand the black and white letter aspects of the contract and hit the ground running.

## **CONCLUSION**

In conclusion, there are four key points that we would like to leave with you:

### ***Not a “Magic Pudding”***

PPPs/PFPs do not provide governments with an additional bucket-of-money for use on infrastructure projects. PPP/PFP projects must compete for funding against other government projects and be fully funded before we take them to the market. Not only does this show that government is committed to the project but it means that there is no need to confirm funding at contract approval stage. It also means that if the private bids don't show value for money we can proceed with traditional procurement if necessary.

Of course, self-funded projects (such as toll roads) are a different matter. They can be brought forward, but still need to be consistent with government policy and socially and economically justified.

### ***Don't “Buck” the Process***

The process is there to protect not only government integrity but also to protect bidders. We need to do the development work to get the project in proper shape to put to the market. We need to gain the necessary approvals that indicate government's commitment. This can take some time, particularly when we are doing a pioneering project in a new sector, but will save you time and expense once we begin the formal tender process. We will do our best to ensure that the process runs smoothly.

### ***Stronger Operators***

The operator members of the winning consortiums are the ones that will be primarily responsible for delivering the contracted services upon commissioning of the facilities. Our primary concern is that the contracted services continue to be delivered, to the agreed performance standards and at the agreed payment arrangements, year after year. We need strong and competent operators for PPPs/PFPs to be successful. It is these parties, in particular, with which government will have the close relationship over the course of the contract. These relationships need to be professional but also need to be constructive and this is a responsibility of government as much as of the operator.

### ***NSW and Victoria: Working Together***

NSW and Victoria have been working together to ensure that our general policies and processes for the private provision of public infrastructure are consistent. We will focus now on working together at the project level. This involves not only providing each other with lessons learnt on projects in particular sectors but also with assistance on live projects. This involvement should lead to an even closer alignment in areas such as risk allocation. We are firmly committed to the principle that cooperation between our governments is essential to the future success of PFPs and PPPs in delivering value-for-money and meeting, and hopefully surpassing, the community's expectations of service delivery standards.

## **APPENDIX A – Further Information**

The NSW Government's policy and guidelines for Privately Financed Projects are contained in the following documents:

*Working with Government: Policy for Privately Financed Projects*, NSW Government, November 2001.

*Working with Government: Guidelines for Privately Financed Projects*, NSW Government, November 2001.

A Green Paper preceded the release of the NSW Government's policy and guidelines documents:

*Working with Government: Private Financing of Infrastructure and Certain Government Services in NSW – A Public Discussion Paper*, NSW Government, November 2000.

The above documents are available at <http://www.nsw.gov.au/wwg>

The Victorian Government's policy and guidelines for public private partnerships are contained in the following documents:

*Partnerships Victoria*, State of Victoria, June 2000.

*Partnerships Victoria Guidance Material – Overview*, State of Victoria, June 2001.

*Partnerships Victoria Guidance Material – Practitioners' Guide*, State of Victoria, June 2001.

*Partnerships Victoria Guidance Material – Risk Allocation and Contractual Issues Guide*, State of Victoria, June 2001.

*Partnerships Victoria Guidance Material – Public Sector Comparator – Technical Note*, State of Victoria, June 2001.

The above documents are available at <http://www.partnerships.vic.gov.au>