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Public Private Partnerships - Managing the Challenges

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Public Private Partnerships - Managing the Challenges

1. Introduction

Private Public Partnerships (PPPs) present a number of challenges for both government and private sector participants.

Probably the first challenge is definitional - what is a PPP?

Secondly, government faces an ideological challenge to the basis on which it seeks to implement PPPs, usually on the basis that government is able to fund borrowing requirements more cheaply, and therefore should deliver its own infrastructure, rather than via PPPs.

Thirdly, government needs to create an environment which encourages sufficient private sector participation in PPP deals to create the level of competition needed to deliver value for money outcomes. Policies, processes and tools need to be further developed so as to achieve an appropriate balance between government's desire for certainty; the private sector's desire to generate an adequate return on its shareholders' funds; the taxpayer's desire for value for money; the user's desire for adequate services; and the protection of the public interest.

Recent Australian government policy initiatives have seen a renewed vigour on the part of government, and the private sector and other stakeholders, to meet these challenges. Although government policy development has gone some way towards better managing the challenges, there are still many areas for further improvement. The growing need for improved infrastructure facilities requires that governments, the private sector and other stakeholders continue to work together to ensure these challenges are met.

This paper considers some of the continuing challenges in the areas of policy, process, risk allocation and contracts, and makes a number of suggestions as to how these challenges might be better managed.

2. Policy

2.1 Government policy positions in Australia

Federal and State governments are well aware of the need for co-ordinated policy in order to harness private sector involvement in infrastructure development. Whilst various State governments have had policy guidelines regarding private sector participation in public infrastructure development for many years, recent times have seen a much more structured and co-ordinated policy focus, and a growing culture of flexibility and innovation on the part of government, kicked off with the publication by the Victorian government of its Partnerships Victoria policy in 2000.

All Australian governments, including the Federal government, have in recent years released PPP policies and guidance material of differing levels of detail and with other regional differences, but which all have the common objective of increasing private sector confidence in the development of PPPs. The various PPP policies are as follows:

- Commonwealth - Commonwealth Policy Principles for the use of the Private Financing, June 2002;
- Victoria - Partnerships Victoria, 2000;
- Queensland - Public Private Partnerships Policy: Achieving Value for Money in Public Infrastructure and Service Delivery, September 2001;

- New South Wales - Working with Government: Guidelines for Privately Financed Projects, November 2001;
- Western Australia - Partnerships for Growth: Policies and Guidelines for Public Private Partnerships in Western Australia, December 2002;
- South Australia - Partnerships SA: Private Sector Participation in the Provision of Public Services, September 2002;
- Tasmania - Private Sector Participation in Public Infrastructure Provision - Policy Statement and Guiding Principles, July 2000;
- Northern Territory - Territory Partnerships: Policy Framework, February 2003; and
- Australian Capital Territory - Statement of the Objective and Principles for the Private Provision of Public Infrastructure, December 2002.

Victoria has led the way in recent PPP initiatives. The Partnerships Victoria guidance material has built on Australian and UK experiences and is very comprehensive. Being the first detailed document of its kind in Australia, it has had a significant influence on the policy documents of the other States and Territories, which have made attempts to implement consistent approaches to PPP policy and guidelines.

The Partnerships Victoria policy has recently undergone an independent review conducted by Peter Fitzgerald. The Fitzgerald report issued in March 2004 made a number of significant recommendations, most (but not all) of which have been supported by the Bracks Government. Several of the recommendations are discussed in this paper. Other reviews and inquiries underway include the Inquiry into Private Sector Involvement in Public Infrastructure being undertaken by the Public Accounts and Estimates Committee of the Victorian Parliament.

2.2 Common features

Principles common to the PPP policies and guidance material in each State and Territory include the following:

- **Private sector confidence** - an objective of fostering private sector confidence in the ability of government to facilitate PPP projects and properly assess PPP proposals, with a view to encouraging private sector investment in the development of PPP bids. (The underlying objective here is to ensure that there are enough players in PPP bidding processes (particularly for smaller, social infrastructure projects), to create the degree of competition required to deliver real value for money outcomes);
- **Value for money** - the objective of selecting the project delivery model which delivers the best value for money outcome for government;
- **Whole-of-life** - encouraging the private sector to adopt a whole of life approach to the design and construction of the asset, with a view to obtaining the optimal balance between the cost of building the facility and its ongoing operation and maintenance costs;
- **Innovation** - encouraging innovation in the delivery of infrastructure and related services to the community (for example, all policies encourage government agencies to specify contract requirements in terms of outputs (the end result), rather than inputs (the means of delivery));

- **Effective risk allocation** - optimum risk transfer (i.e., allocating risks to the parties best able to manage them at least cost), as opposed to maximum risk transfer;
- **Payment for services** - thinking about infrastructure in terms of the services it delivers (rather than the asset itself), and structuring the payment mechanism to the delivery of services, so that government only pays for the services it receives. If the asset is built but doesn't deliver the services to the required standard then, under the PPP approach, the payments should be reduced;
- **Asset utilisation** - examining and pursuing strategies to use assets beyond their specific purpose to maximise the effectiveness of the investment in the assets;
- **PSC** - the use of benchmarks, or a Public Sector Comparator (PSC), to test the value for money of PPP proposals;
- **Not privatisation** - distinguishing PPPs from privatisation. To this end the PPP policies draw a distinction between:
 - core services, which government will continue to deliver to the public (such as teaching in schools and medical services in hospitals); and
 - non-core services, which the private sector can deliver (such as providing the accommodation through which core services are delivered, and providing support services such as security and maintenance);
- **Consistency with government objectives** - ensuring projects are consistent with the long term service delivery strategies and capital investment of government agencies;
- **Safeguarding the public interest** - protection of public interests, by assessing PPP proposals against public interest criteria relating to effectiveness (in meeting government's objectives), accountability, transparency, equity, public access, consumer rights, security, privacy, and rights of representation and appeal at the planning stages by affected individuals and communities;
- **Clarity of process** - clear articulation of the process for establishing a PPP and the points at which Cabinet approval to proceed is required;
- **Consistent national approach** - commitment towards the development of a consistent, national approach to the development of PPPs, with a view to increasing private sector confidence in the processes and reducing transaction costs;
- **Competitive tendering and probity** - ensuring projects are subject to a competitive tendering process in which procedural fairness and probity are maintained; and
- **Transparency and accountability** - not diminishing the availability of information to Parliament, taxpayers and other stakeholders on the use of government resources, subject to recognition of the need to protect private sector intellectual property rights and commercial confidentiality where appropriate.

2.3 Points of difference

Whilst the various PPP policies and guidance materials share many common principles, there are some points of difference including the following:

- **Delivery methods** - The main point of difference between the various policies is the project delivery methods which they cover. Some policies, such as the Commonwealth and New South Wales policies are quite explicit in their focus on privately financed PPPs, as opposed to publicly financed PPPs. Others, such as the Victorian and Queensland PPP policies, whilst more inclusive on their face, are also primarily directed at privately financed PPPs (as evidenced by their encouragement of long term serviced based payment structures). Indeed, all of the 8 Partnerships Victoria projects reviewed as part of the Fitzgerald review are privately financed projects.

The Northern Territory PPP policy, on the other hand, adopts a highly flexible and inclusive approach to PPP delivery models by expressly including all members of the Australian PPP family, including publicly funded PPP delivery models such as project alliances, and design, construct and maintain (DCM) and long term service agreements. This approach provides a framework in which all possible PPP delivery models can be considered with a view to selecting the delivery model which provides the best value for money outcome for government. The West Australian, South Australian and Tasmanian PPP policies also show a broader delivery model focus.

The focus of some PPP policies on privately financed projects is a deficiency which is discussed in more detail in section 2.4 and addresses the first challenge noted in section 1 - that of what really is a PPP? It is also a deficiency which has been identified in the Fitzgerald review of the Victorian PPP policy, which includes a recommendation that the State seek to pilot new financial and partnership structures that combine the benefits of private sector risk taking with government's comparative advantage in securing funds.

- **Policy focus** - The stated focus of some PPP policies, such as the Tasmanian PPP policy, continues to be on overcoming fiscal constraints. This can be contrasted with the current Victorian and NSW PPP policies, where the stated focus is on achieving value for money, rather than access to infrastructure financing without additional government borrowing. Adopting any suggestion that PPPs are merely a form of government balance sheet dressing only opens them to being legitimately criticised as just that, and allows their true potential to be obfuscated.
- **Commonwealth tax implications** - The Commonwealth PPP policy explicitly recognises the potential for the private sector's use of tax effective arrangements to undermine the Commonwealth's tax base, and requires that these costs to be taken into account when assessing the relative value for money of a privately financed project at a whole-of-government level. Clearly, the cost to the Commonwealth's tax base is not an issue which concerns State and Territory governments. Indeed, the history of PPP projects in Australia has been quite the opposite, and the present issues associated with section 51AD and Division 16D of the Commonwealth Income Assessment Tax Act are issues which the State governments have, to some extent, brought upon themselves by seeking to tap into depreciation and other allowances available to the private sector under the Commonwealth Income Assessment Tax Act to fund State infrastructure projects controlled by tax exempt government agencies.
- **Commitment to proceed** - The Victorian PPP policy includes a commitment from the government to proceed with a project for which a project brief has been issued provided a conforming bid offering value for money in comparison with the Public Sector Comparator is received. The policies of the other States and Territories have not been quite so bold.

- **Accounting treatment** - The Tasmanian PPP policy specifically prohibits agencies from entering into finance lease arrangements for capital assets. This position can be contrasted with, say, the positions in New South Wales and Victoria where the drivers are value for money and optimal risk allocation rather than the achievement of an 'off-balance sheet' transaction. The Department of Defence's Patrol Boat project failed to proceed as a privately financed PPP project due, in part, to its inability to achieve an operating lease classification. Contrast this, for example, with the Victorian Berwick Community Hospital and Spencer Street Station redevelopment projects, which are both recognised as financing arrangements on the State of Victoria's balance sheet. This is an important consideration as again any suggestion that the true driver is to facilitate government balance sheet window dressing merely allows ideological challenges to be launched without really addressing the key issue - that of value for money.
- **Disclosure of PSC** - The approach with respect to the disclosure of the Public Sector Comparator differs across the policies. Some policies, such as the Victorian, New South Wales and Northern Territory policies adopt a flexible approach and say that the PSC (or a summary of it) will be disclosed where this is likely to assist the bidding process. Others, such as the Queensland, Tasmanian and Commonwealth policies, are silent on this issue.
- **Project value** - The Fitzgerald review of the Victorian PPP policy includes a recommendation (which has been accepted by the Bracks Government) that the policy only apply to large projects such as those involving capital expenditure of over \$100 million, subject to exceptions such as 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. This can be contrasted with the PPP policies of the other States and Territories which indicate the policy can apply to smaller projects (NSW - \$20 million (contract value); Qld - \$30 million (capital value); \$50 million (NPV); NT and ACT - \$20 million (NPV); SA, WA and TAS - no threshold). The real constraining factor here, however, is not the particular threshold specified in the policy, but rather bid costs - unless the transaction costs associated with establishing a PPP project can be reduced below present levels then the scope for smaller projects to be delivered as PPPs is limited. There is also a tension between a high project value threshold and the need for sufficient deal flow to provide a competitive PPP market (particularly in the social infrastructure context).

2.4 Considering all the options

As noted above, whilst many Australian PPP policies define PPPs broadly to include any relationship between a government party and a private party to deliver public infrastructure or facilities and related ancillary services, a number of the policies and associated guidance materials focus on privately financed PPPs, as opposed to publicly financed PPPs.

One question which is frequently asked in relation to privately financed PPP projects is how it is possible for such projects to be delivered at a lower overall cost to government than publicly financed projects, given government can borrow finance at a lower cost than the private sector.

The simple answer is, assuming all things are equal, that it is not possible. However, the better answer is that all other things are usually not equal, and that there are other differences between privately financed and publicly financed projects which can enable a privately financed delivery model to provide a better value for money outcome than a publicly funded alternative. In this regard, the value for money drivers for privately financed PPPs are typically stated to be the following:

- **Risk transfer** - PPPs allow government to transfer risks to the private sector which the private sector party is better able to manage at a lower cost than government, thereby reducing the overall cost of the project to government. Historically the private sector has managed delivery risks better than the public sector. This is not surprising (or indeed meant to be a criticism of the public sector) given the different drivers of the private sector and the public sector. It may be trite to say it but the key driver for the private sector is the profit imperative, which essentially means controlling the costs of delivery by managing the risks appropriately. On the other hand the key driver for the public sector is risk mitigation which usually leads to more expensive cost outcomes on delivery.
- **Whole-of-life costing** - The long term nature of PPPs often requires the private sector party to assume responsibility not only for the design and construction of a facility, but also for its operation, maintenance and refurbishment. This provides a commercial incentive for the private sector to adopt design and construction methodologies which will minimise the overall cost of building, operating and maintaining the facility through life. In other words the private sector is incentivised to deliver a more efficient operational outcome by capturing operating efficiencies at the development phase.
- **Innovation** - PPP projects focus on output specifications, thereby providing private sector bidders with the opportunity to develop innovative design and other solutions so as to meet government's requirements at lower cost. Further, the private sector is incentivised to create innovative solutions to unforeseen risks as they emerge (for example on the Melbourne City Link project, unforeseen construction risks which crystallised with possible timeline implications were imaginatively overcome through innovation).
- **Asset utilisation** - Some PPP projects provide opportunities for third party use of the facility, thereby generating revenues which would not be derived if the facility were built, owned and operated by government (due to the absence of commercial motivation). These third party revenues can reduce the cost government would otherwise pay as sole user of the asset, or alternatively open up opportunities for upside revenue sharing.

But are the above value for money drivers limited to privately financed PPP projects? Put another way, is it possible to develop a project utilising a project delivery model which captures these value for money drivers, but which uses public sector funding instead of more expensive private sector finance, thereby further reducing the overall cost of the project to government?

The answer, for many projects, is probably yes.

Consider, for example, the \$2.2 billion Pacific Highway Upgrading Program on the Central and Northern coasts of New South Wales. These upgrades are being delivered using a design, construct and maintain (DCM) delivery model. The NSW Roads and Traffic Authority (RTA) enters into a single contract with the private sector for the design, construction and, for a 10 year period, maintenance of the upgrade. This delivery model has enabled the RTA to:

- transfer to the private sector risks which the private sector was willing to manage at lower cost than the RTA, thereby reducing the overall cost of the projects to the RTA;
- provide the commercial motivation (via a lump sum maintenance fee) required to encourage the private sector to adopt a whole-of-life approach to the design, construction, and maintenance of each project; and

- provide the private sector with an opportunity to develop innovative solutions which satisfy the RTA's output focused requirements for each project.

Furthermore, all of the above value for money drivers are being achieved without the utilisation of private sector finance.

There is also no reason why the DCM or design, construct, maintain and operate (DCMO) delivery models cannot provide opportunities for third party revenues, for suitable projects.

Of course, the above example does not necessarily demonstrate that all road projects can be delivered at a lower cost to government by utilising a publicly financed delivery model (such as the DCM/O model), rather than a privately financed delivery model (such as the build own operate and transfer (BOOT) model which has been adopted for Melbourne's and Sydney's tollroad projects). Each project, and its risks, needs to be considered on its merits so as to identify the project delivery model which best achieves government's objectives for that project. For example, most rural highway projects would be unlikely to generate the traffic revenues required to support a traditional user pays BOOT delivery model.

Consider also the National Museum of Australia project in Canberra, delivered by the private sector under a public sector financed *project alliance* delivery model. By most accounts, this project achieved high levels of innovation, with resultant time and cost savings for government which would not have been achievable under a traditional public delivery model.

What the above examples do demonstrate is that a project does not necessarily need to be privately financed in order for government to capture the benefits which a Public Private Partnership can deliver. To ensure the best value for money outcome is achieved, all possible PPP delivery models need to be considered.

A stated objective of some of the current generation of government PPP policies is the maximisation of value for money, as opposed to overcoming fiscal constraints and Australian Loan Council borrowing limits. To this end, the policies generally require all privately financed PPP projects to be measured against a Public Sector Comparator (PSC) - a theoretical benchmark reflecting the cost of government delivering the required project outputs based on the relevant government agency's assessment of the most efficient alternative delivery method. The PSC may be based on a delivery option involving the private sector participation. Indeed, for many large scale infrastructure projects, delivery by the private sector is now the only realistic option.

A deficiency, however, in the current PPP policies is that they do not allow the market to determine which delivery model will best achieve government's objectives (including the achievement of best value for money). Rather, they require government agencies to:

- call for bids based on the PPP delivery model which the government agency (rather than the market) considers will best achieve government's objectives; and
- test the value for money of bids against a PSC encapsulating the agency's (rather than the market's) best estimate of what the project would cost under what the agency considers to be the most efficient alternative delivery model (which may or may not also involve some private sector participation).

Accordingly, it is possible that the government agency may choose a sub-optimal delivery model for purposes of calling for bids, and/or may choose a sub-optimal delivery model for the purposes of building the PSC. Optimism bias in determining the risk-adjusted project cost under the PSC delivery model is also an ongoing issue.

As an alternative, it is suggested that governments should consider allowing bidders to form their own view as to the most suitable delivery model (perhaps within defined parameters).

This would allow the market to determine which delivery model best meets government's requirements and objectives, and enable government to compare competitively bid prices for the delivery models proposed by bidders. Such a process should provide government with even greater certainty that the project delivery model selected represents the best value for money outcome for government. At the very least, government agencies should consider and assess the full range of PPP delivery models (including those not involving private sector finance) before proceeding to call for bids based on a privately financed delivery model.

Adopting such an approach would also address the concerns being expressed by some stakeholders regarding the involvement of the private sector in the development of infrastructure, based on an objection to the private sector's higher cost of funding it.

2.5 Reducing bid costs

It is clear from the submissions to the Fitzgerald review of the Victorian PPP policy that the high cost of bidding for PPP projects is one of the most important PPP process challenges which needs to be addressed.

The submissions suggest that a number of private sector participants have withdrawn from the PPP market as a consequence of the high cost of bidding and the lack of opportunities due to slow deal flow.

The Fitzgerald report contains a useful collation of the suggestions made in the various submissions as to how bidding and contractual processes could be streamlined with a view to reducing bidding costs in order to encourage greater participation in bidding, more competitive bidding processes, and hence better value for money outcomes.

The suggestions from the Fitzgerald report are as follows:

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 claims 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.

Most of these suggestions are not new. As noted by Fitzgerald, a number of them are already reflected in the various PPP policies, but perhaps not implemented as widely as the private sector would like. A number of the suggestions need to be balanced, however, against competing objectives, such as the government's desire for certainty and appropriate probity requirements.

3. Process

3.1 Effective market engagement

An important process challenge for PPP projects is effective market engagement, i.e. ensuring bidders bid what government wants. It is in the interest of all parties, particularly government, that bidders have a clear understanding of government's objectives, requirements and priorities.

A complicating factor to effective market engagement in the Australian context is the tension between:

- a more frequent, informal and effective dialogue between the government agency and bidders; and
- the risk of statements made during such discussions giving rise to legal claims by unsuccessful bidders alleging unfairness or impropriety in the tender process.

It is clear from cases such as *Cubic*¹, that informal discussions between the government agency and bidders involving active (as opposed to scripted) dialogue increases the risk of misleading and/or inappropriate statements being made (albeit perhaps unintentionally) which can subsequently give rise to claims and court proceedings which can adversely affect the procurement process and the project. It is clearly in the interests of both government and bidders that appropriate levels of probity are maintained throughout the tender process so as to avoid such situations.

The practical steps which government can take to promote effective market engagement include the following:

- **Market sounding** - government agencies should always engage in a market sounding process *prior* to EOI release to assess market interest and the likely level of competition;
- **Clear articulation of requirements** - government agencies should think long and hard about their objectives and requirements before calling for bids so that they can clearly articulate their requirements in the tender documents. Agreement should be reached between all internal government stakeholders before the tender documents are released. Priorities between competing objectives, such as time, quality and cost, should be specified to the extent possible;
- **Feedback** - ensure there are opportunities for bidders to receive feedback on the technical aspects of their proposals before final bids are to be submitted (particularly for those projects where a government agency will provide "core services" by operating a facility which is to be delivered and maintained by the private sector). Whilst there have only been limited opportunities for such feedback in the past, on the Victorian New Prisons Project, technical workshops were conducted with each of the bidders separately to enable technical input into their design concepts, a matter of particular concern to the State given the sensitive nature of the facilities. These opportunities need to be properly planned and structured to ensure bidders are treated equally and the content of the feedback is properly thought through. They should also be limited to technical issues as opposed to risk allocation. Informal discussions on risk allocation prior to bid submission allows the private sector a "free kick" at the government's agency's preferred risk allocation at a time when bidders are not subject to competitive pressure (which is maximised at the time of bid submission); and
- **Disclosure of PSC** - disclose the raw PSC to the market to assist in quickly identifying any mismatches in expectations.

The implementation of such measures should also reduce the need for Best and Final Offer (BAFO) processes. But implementation of them might come at a cost to the private sector - a willingness to forego entitlement to have government approaches exposed to claims risk where

¹ *Cubic Transportation Systems Inc v State of New South Wales* [2002] NSWSC 656

a more open process is being run by government. In other words the government could legitimately seek releases from litigation exposure where it agrees to informal feedback discussions in a freer probity environment.

3.2 Maintaining competitive tension to prevent deal creep

The Vice President of the Australian Council for Infrastructure Development (AusCID) and the chairman of the successful Lane Cove Tunnel consortium, Mr Tony Shepherd, recently acknowledged the efforts of the NSW Roads and Traffic Authority (RTA) in tackling the problem of "deal creep" which often characterises PPP deals during the period between appointment of a preferred bidder and financial close.

The Lane Cove Tunnel experience is not unique to Australian PPPs. A number of Australian government authorities have had recent successes in controlling deal creep during the preferred bidder phase on major PPP deals. Other recent Australian PPP deals which have seen short, sharp preferred bidder phases with little, if any, deal creep include the A\$2.23 billion Western Sydney Orbital (WSO) project (now known as the Westlink M7 project) and the recent NSW New Schools project. Contrast this with certain earlier projects which experienced lengthy negotiation phases following the appointment of a single preferred bidder (in some cases over 18 months), and allegations of significant deal creep during this preferred bidder phase.

The benefits

Commercially astute government authorities are recognising the benefits of advancing the contractual documentation (including the debt and equity documentation to which the government contracting agency is not a party) as far as practicable within the competitive environment of the bidding and evaluation phase, and prior to the selection of a preferred bidder. The benefits for government of this approach are threefold:

- **More certainty** - Firstly, it allows government to select a preferred bidder with a much higher degree of certainty that the best value for money proposal is being chosen. The achievement of best value for money for government under a PPP delivery model is often dependant on government's ability to effectively transfer to the private sector risks which government would bear under a government project delivery model. If full documentation of risk allocation is left to the preferred bidder phase, governments can find that risks which they thought the private sector would bear are, in fact, borne or shared by government, and that a better value for money outcome may have indeed been achieved with another bidder or by adopting an alternative project delivery method. By fully documenting the deal prior to selecting a preferred proponent, governments can select a preferred bidder confident of the terms on which the final deal will be struck, and the value for money which the deal will deliver to government.
- **Shorter negotiation phase** - Secondly, the negotiation phase is shortened as the competitive tension encourages bidders to drop non-substantive points and continually sharpen their pencils on substantive risk allocation issues. Requiring bidders to progress their debt and equity documentation prior to preferred bidder phase exposes the unresolved issues between the debt providers, equity investors, contractors and operators and encourages these parties to resolve these issues internally rather than try to push the risk back to government - an all too easy option when there is only one horse left in the race. The negotiating position of government following selection of a preferred proponent is rarely as strong as it was prior to that point. Government's best chance of securing a favourable risk profile is by negotiating, and securing binding commitments from each consortium to, the contractual terms prior to the appointment of a preferred bidder, not after.

- **Reduced transaction costs** - Thirdly, although the tender costs for the second placed bidder may be higher, the combined tender costs incurred by government and bidders are reduced both as a consequence of a shorter period of engagement and reduction of the protracted legal negotiations usually associated with preferred bidder dealing.

Not always appropriate

Of course, it may not always be practicable or appropriate for government to advance the legal documentation with two or more bidders in a competitive environment. For example, if a clear stand-out winner is identified early in the evaluation process and it is not considered likely for the second-placed bidder to catch-up, even if it was to accept government's preferred risk allocation without qualification, then it may not be sensible to put the second-placed bidder to the expense of advancing its contractual documentation so as to create a competitive environment within which the contractual documentation with the first-placed bidder can be progressed.

BAFOs or progressive advancement

The traditional approach to advancing contractual documentation during the evaluation phase is to reissue identical documentation to the remaining bidders, often as part of a "best and final offer" (BAFO) process. One difficulty with this approach is that it may involve government making common concessions on risk allocation to all bidders, in circumstance where not all of the bidders requested the concession. For those bidders which did not request the concession, the competitive advantage that they enjoyed over the other bidders with respect to that issue is lost. If such a bidder is ultimately the successful bidder, government has also made a concession which it need not have made and for which it may not have received any value.

A preferable approach is for government to reissue, during the evaluation phase, documentation to each bidder which is unique to that bidder and which has been prepared having regard to that bidder's response to the documents issued with the request for tenders. Of course, to maintain fairness, government needs to be consistent in its responses where two or more bidders have requested similar amendments. Where concessions are made, bidders should be reminded that they can always revert to government's original preferred risk profile if they consider this will deliver a better value for money outcome for government.

Another drawback of the traditional BAFO approach is that it is not very iterative and involves significant additional bid costs. A better approach is for government to issue requests for clarification and revised documentation to bidders progressively throughout the evaluation process. In this regard it can often take more than one request for clarification and response for the parties to fully understand each other's positions with respect to a particular issue and to negotiate an optimal outcome. A progressive Q&A process during the evaluation phase enables the parties to more quickly arrive at a final position, thereby reducing bid costs.

Tender costs

Bidders say that requiring more than one bidder to proceed to advanced or full documentation leads to higher, and unnecessary, tender costs. Whilst tender costs for the unsuccessful bidders may be higher, the process actually reduces the overall tender costs incurred by government and the bidders once the reduction in the length of the tender process and resultant reduction in tender costs for the successful bidder and government are taken into account. Accordingly, provided there is sufficient deal flow and unsuccessful bidders win their fair share of projects, everyone should benefit from the overall reduction in bid costs over the longer term.

That said, there is a case for government considering making a contribution towards the costs incurred by the second-placed bidder in proceeding to advanced or full documentation, in return for the higher levels of competition and certainty which the process delivers to

government. Government can also assist in containing bid costs by deferring the requirement for full documentation, particularly all debt documentation, until late in the tender process (but still before a single preferred bidder is appointed).

4. Risk allocation

4.1 Principles versus practices

The risk allocation principles of the various PPP policies are easy to state but more difficult to implement. The objective of the policies is efficient/optimal risk allocation, that is that risks should be allocated to the party that is best able to manage the risk at the least cost.

Whilst the principle of efficient risk allocation appears to be generally agreed by both government and the private sector, the proper application of the principle to specific risks on various projects continues to be the subject of considerable negotiation. The reasons for this include the following:

- **Subjective views** - Each party comes to the transaction with its own subjective views as to:
 - the respective abilities of the parties to manage various risks;
 - the likelihood of certain risks occurring and their consequences; and
 - the costs which the other may incur in managing risks.

These subjective views, even if reasonably and honestly held, often differ.

- **Complexities** - Many risks are not wholly within the control of one particular party. For some risks the ability of a particular party to manage the risk, and the costs which it will incur in doing so, will depend to a large extent upon how the other party conducts itself. In these cases, risks need to be shared, and obligations or restrictions need to be imposed on the party that is not best able to manage the risk in order to assist the party responsible for managing the risk. There are often many ways in which such risk can be sliced, diced and allocated and hence considerable scope for debate and brinkmanship.
- **Difficult risks** - Similarly, for some risks (such as uninsurable events) neither party is particularly well placed to manage the risk. In a 2001 survey conducted by the Chamber of Commerce and Industry of Western Australia and the Institution of Engineers Australia on risk allocation in major West Australian construction projects, 35% of respondents said that risks which had been allocated to them were "impossible to manage". This figure rose to 67% of contractor respondents (as opposed to principals or consultants)².
- **Other influences** - The principles of efficient risk allocation do not operate in a vacuum - there are other important influences on risk allocation which are also at play. In a 1999 survey of participants in infrastructure projects conducted by the Victorian Department of Treasury and Finance, it was found that the 3 most influential factors on risk allocation were:
 - commercial requirements (linking risk and return);

² Institution of Engineers, Australia and Chamber of Commerce and Industry of Western Australia *Effective Risk Allocation in major projects: Rhetoric or reality? 2001* http://www.ieaust.org.au/policy/publications_by_year3.html

- bargaining power; and
- debt financiers' requirements³

In the context of PPPs, the risk allocation underpinning the PSC and the dollar values attributed to retained and transferred risks can also have a bearing on the willingness of government to depart from its preferred risk allocation.

These influences dictate that, inevitably, risks will not always be allocated in accordance with the principles of efficient risk allocation. The reality is that sometimes risks will be allocated to the party least able to refuse the risk rather than the party best able to manage the risk. This is of course heightened at the time the government is maintaining maximum competitive tension, i.e. just before the announcement of preferred proponent.

4.2 How can the challenge of risk allocation be better managed?

Measures which government and other PPP participants can take to better manage the challenge of risk allocation include the following:

- **Don't lose sight of the basic principles** - Firstly, government agencies need to be careful, when drafting the contractual documentation on which bids will be based, not to lose sight of the principles of efficient risk allocation. There is often a strong temptation to start with an aggressive draft and see how the market responds before making the difficult calls on the difficult risks. The fact that government is often in a strong bargaining position at the start of the tender process exacerbates this temptation. One of the risks which government agencies run when they adopt such an approach is that bids will incorporate pricing that reflects the allocation of unmanageable risks to the private sector.
- **Price the risk** - Where a party considers the allocation of a particular risk to it offends the principles of efficient risk allocation it should be prepared to separately price the risk and advise the other party of the price. This would enable the other party to make an informed value for money assessment. Too often it seems that bidders are unwilling to separately price government's preferred allocation of a particular risk, making it difficult for government to assess whether the bidder's preferred risk allocation does, in fact, represent a better value for money outcome.
- **More precise drafting** - More precise drafting (i.e. avoidance of the "catch-all") can often turn the objectionable into the acceptable, thereby reducing negotiating time and costs. This is particularly the case with the government tendency to include broad indemnities at the back end of the project agreement - potentially undoing the carefully negotiated risk allocation contained in the balance of the agreement, and introducing the unpriced unmanageable risk element.
- **Alternative risk transfer** - Effective risk management requires smarter thinking and investigation of alternatives to what usually happens with delivery risk - loading it on the balance sheet of the D&C contractors, or chasing ephemeral insurance options in a market currently characterised by volatility. The usual approaches to risk allocation will also become historical if all States and Territories adopt the recent Victorian amendments to the Wrongs Act dealing with proportionate liability, which have the (possibly) unintended effect of allowing the

³ Department of Treasury and Finance, Victorian Government *Private Provision of Public Infrastructure: Risk Identification and Allocation Project - Survey Report* (1999), 8.

judicial process to determine the allocation of risk after the event. So if a deal has been done to lay off a particular risk against a D&C contractor balance sheet in the project agreement, but a court later decides that the D&C contractor was only responsible for 10% of the crystallised risk, that leaves the carefully negotiated risk allocation in tatters, with the party suffering loss being required to pursue the other 90% against a third party with which it possibly has no contractual relationship. But what are these alternative risk mechanisms? The reinsurance market has been developing for some time the concept of catastrophe bonds, which allow parties wishing to lay off risk to access a much broader capital market than the reinsurance market alone. This will need to be the subject of much greater focus as there is an enormous pool of international capital which might be accessed via these alternative risk transfer mechanisms.

5. Contracts

5.1 Standardisation of contracts

Apart from the documentation issued by the NSW Roads and Traffic Authority (RTA) for its recent Sydney toll road projects, the non-standard nature of contractual documentation for most PPP projects is one of the factors which contributes to the high costs of bidding for PPP projects. The shorter tender processes and lower transaction establishment costs seen on the RTA's Western Sydney Orbital and Lane Cove Tunnel projects (which used the same documentation issued on the earlier Cross City Tunnel project) provide clear evidence of the benefits of a more standardised approach to PPP documentation. Lower bid costs will also lead to greater willingness to participate in bids and hence more competition for projects, resulting in better value for money outcomes for government.

Accordingly, the standardisation of contractual documentation is clearly a desirable objective.

That said, every project is different and has its own unique issues and requirements. Accordingly, there will almost always be a need to tailor the contractual documentation to address project specific requirements (as occurred on the recent Sydney tollroad projects). Further, the commercial dynamics of a social infrastructure PPP, where there is a government sourced revenue stream, are quite different from those of an economic, user pays, PPP project, which requires (or allows) different approaches to the allocation of certain risks. This is particularly pertinent with respect to the interface (and risk allocation therefore required) between the services being provided by the private sector and the core services being retained by the State. Even so, there is still considerable scope for greater consistency in:

- boilerplate and non project-specific clauses (eg termination, force majeure, uninsurable events, representations and warranties)
- ancillary documents, such as charges, novation deeds and the like.

The objective of more standardised documentation must also be balanced against the desirability of continuous improvement in contractual documentation. There needs to be a recognition and acceptance that the documentation will evolve over time:

- to capture the lessons learned on previous projects (such as issues which weren't addressed in the documentation at all, or which could have been avoided if the drafting had been clearer); and
- in light of changed circumstances, such as the respective capacity of the private sector and government to manage certain risks.

Given the obvious benefits of more standardised documentation, and the stated commitments of the various governments to achieving consistency in contractual documentation, we need to ask ourselves why it hasn't occurred and what can be done to improve the situation. No doubt each government thinks consistency is a desirable outcome, so long as the other jurisdictions adopt its preferred documentation. For example, one might ask why the draft contractual documentation for the Mitcham-Frankston Freeway project is not more consistent with the documentation which the market has accepted on the recently Sydney tollroad projects. But this ignores the fact that the MFF documentation was developed out of the Melbourne City Link documentation which preceded many of the Sydney toll road projects.

One obvious reason is the personal views and preferences of the individuals involved in the drafting of the contractual documentation. Each government agency, and the individuals within each agency, bring to the contract drafting task their own preferences as to how provisions should be drafted, based on their own unique experiences. The different advisors used by government agencies to assist with the preparation of contractual documentation also bring their own views and preferences to the contract drafting task. There will also always be a desire on the part of some individuals to 'put their own stamp' on the contractual documentation, and not simply adopt without question the work of others.

In order to gain widespread acceptance of "standard" PPP contract documents, a set of documents needs to be developed with wide stakeholder involvement, so that those who will need to use and live with the documents are comfortable with their terms. And here lies the great challenge - how to get broad stakeholder consensus without getting bogged down in the process of obtaining it. One of the States needs to adopt a leadership role here. The take up of the Partnerships Victoria policy and guidance materials by the other jurisdictions suggest that the publication by, perhaps, the Victorian or New South Wales government of a set of standardised provisions incorporating appropriate input from the different government agency stakeholders would provide a strong lead which would encourage other jurisdictions to follow suit.

Perhaps the establishment of the proposed National PPP Council will assist the States and Territories to meet the challenges involved in moving towards more standardised contractual documentation.

Another possibility is to follow the Victorian policy of placing all major contracts (and not just a summary) on the internet - it certainly makes unrealistic positions taken by parties less sustainable if a negotiated outcome in respect of a broadly similar concept is there for all to see on the web!

5.2 Contractual negotiation

Contractual negotiation should be a matter of clearly knowing where the parties have reached agreement, so that the parties are able to isolate the areas of disagreement and resolve them. Unfortunately some contractual negotiations become bogged down in an atmosphere of distrust where points are not made or conceded on the basis of the commercial requirements of the parties but rather as part of some rather unwieldy game of chess where brinkmanship is more important to see who blinks first. This inevitably leads to protracted negotiations and bad blood.

This style of negotiation can really only be constrained by the commercial parties who need themselves to develop the necessary relationship of trust to make decisions on the hard issues (with advice no doubt from legal and commercial advisors) instead of relying on the advisors running the negotiations and making the decisions. After all it is the commercial parties who will be in the long term relationship not the advisors, and they will need to begin developing the trust and problem solving mechanisms which will be required to see them through the long haul.

6. Conclusion

Private Public Partnerships clearly give rise to many challenges for both government and private sector participants.

Although recent policy development has seen improvements in the way some of these challenges are now managed, there are still many areas where there is room for further improvement.

This paper has identified a number of these challenges and suggested ways by which they might be better managed.

Given the need for government to effectively harness private sector input in the development of public infrastructure in order to satisfy the community's growing demand for infrastructure services, it is essential that public and private sector stakeholders continue to work together in an effort to meet these challenges.