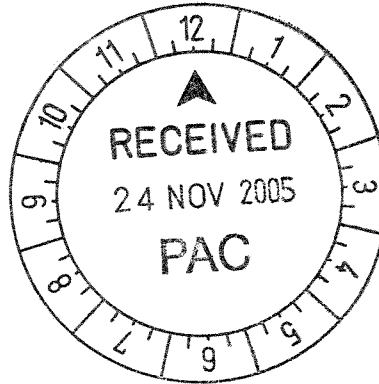


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The Committee Manager  
Public Accounts Committee  
Parliament House  
Macquarie Street  
NSW 2000



22 November 2005

*Dear Ms Buchbach,*

We are pleased to make this submission to the Committee in relation to its inquiry on Public Private Partnerships.

The submission draws on our experience as advisors to Government in NSW on the only social infrastructure PPP to have closed so far (the New Schools project), and on both the hospital projects (Mater and Long Bay) that are about to reach contract close. We also advised the RTA on Lane Cove Tunnel and on issues arising after financial close on other projects.

It also draws on experience elsewhere. We have completed more PPP transactions for governments worldwide than any other advisor and we also advise proponents on structuring and financing their bids. We have enclosed with the submission a short note to give more information on our experience; and an in-depth review we have recently published on PPP issues globally, which we hope you find informative as background.

We would be keen to give oral evidence if invited. Please let me know if we can provide any further data to assist the committee in the enquiry, or if you have any questions.

Yours sincerely



Tony Poulter  
Global Head of Project Finance

# NSW LEGISLATIVE ASSEMBLY: PUBLIC ACCOUNTS COMMITTEE INQUIRY INTO PUBLIC PRIVATE PARTNERHIPS

## Executive Summary

### *Policy*

- NSW has good policy frameworks and practices. In some areas the State has taken the lead on issues and defined best international practice.
- Since the Working With Government Guidelines were published in 2001 all participants have learnt a great deal. There is a case to update the Guidelines to consolidate recent material and developments.
- There is no need for new State legislation. It is important to clarify the Commonwealth legislation on tax allowances.

### *Evaluating and Monitoring Projects*

- The State has a good framework for evaluating projects. It could be improved further by devoting more time to ensuring that project scope has been properly costed in the early stages.
- The State does good work on preparing Public Sector Comparators. More information could be published on the techniques which are used, to ensure that a common approach is efficiently applied across projects and understood by proponents.
- On some projects there should be a two stage bidding process, with the first stage focusing on key issues such as design, to reduce the risk of abortive work on contractual and financial documentation.
- Recent steps taken to engage more with bidders during procurement are welcome and should be followed in most cases.
- The State is right to be focusing on how it can increase its resources to manage contracts. It should use these resources to publish more information about projects' performance in operation.

### *Allocation, Assessment and Management of Risk*

- Treasury and other government departments adopt the right principles when considering risk allocation. Agencies and their advisors should ensure that they apply these principles consistently through realistic negotiating positions based on standard terms wherever possible.
- Work done on risk assessment and allocation during procurement should be used to build robust contract management frameworks before a project goes into operation.

### *Sharing Knowledge*

- Knowledge could be shared more fully between agencies by establishing a public sector database of key contract terms and establishing training courses for the next

generation of PPP project directors and managers.

- The cadre of central expertise should be strengthened further by more secondments for the private sector to the agencies, Treasury or the Premier's Infrastructure unit

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### *Intellectual Property*

- Where the State wants to base PPPs on pre-existing intellectual property it may need to review contract terms to ensure that such IPR is properly respected.

### *Toll-roads*

- Some of the comments made during the recent debate about toll-roads following the opening of the Cross City Tunnel reflect misunderstandings. In particular:
  - The upfront payments made to the RTA under such projects are bid by proponents in a competitive process, and reflect the cash flow which they expect to be generated from the toll levels specified by the State.
  - Provisions in the agreements to prevent competition from other roads are specified at the beginning of the procurement, not sought by the proponents. They reflect pre-existing plans for traffic management which are the subject of consultation as part of the Environmental Impact Statement process.
- There are alternative ways of privately financing roads which would be more suitable if the State wants to manage such roads as part of the network. One option involves the State paying for the performance of the road over time, rather than having the private sector take traffic risk. This has worked well in Europe and should be considered further in NSW.

# 1. NEW SOUTH WALES, AUSTRALIAN AND INTERNATIONAL LEGISLATIVE AND POLICY FRAMEWORKS AND PRACTICES REGARDING PRIVATE SECTOR INVESTMENT IN PUBLIC INFRASTRUCTURE

## 1.1 General

NSW has good policy frameworks and practices for private sector investment in public infrastructure, which draw on international precedent and guidelines. The *Working With Government Guidelines for Privately Financed Projects* (the Guidelines) set out the framework clearly and well.

## 1.2 Some examples

The following aspects of the Guidelines are particularly good and in our view represent examples of the best international practice.

- (i) The rule that *budgetary provision* should be in place for a public sector reference project before a procurement is embarked upon, and should remain in place until any PPP contract is signed.
- (ii) *Discount rates*. NSW has a systematic approach to evaluating proposals using a risk-adjusted discount rate which reflects the allocation of risk between the public and private sectors. This is preferable to the UK approach, which is based on a standard risk-free discount rate and adjustment of cash flows for optimism bias.
- (iii) *Hedging*. During 2004 NSW introduced a new approach to handling interest rate risk in privately financed projects. Where the PPP is using bank debt or nominal bonds the State itself offers to retain long term interest rate risk while allowing for the cost of this in its assessment of the proposals. This is an innovative approach by international standards, which in our view has significant benefits. It reduces the cost of bank and nominal bond financed projects and helps to get fair competition between bank finance and other CPI finance.

There are areas where further codification would be helpful. It is now four years since the Guidance was issued. In that time five PPPs have reached financial close in NSW, and a further eight have come to the market, two of which (Long Bay & Mater) are imminently closing. Some new benchmarks have therefore emerged. In particular:

- (i) Victoria has published significant further guidance particularly on the Standard Commercial Principles. NSW has contributed to this work and in some areas followed the principles in its own practice.
- (ii) The State and private participants alike have gained a deeper understanding of contractual issues such as arrangements for setting termination payments.

There is therefore a case to update the 2001 guidelines to consolidate material in one place and provide a definite reference point.

### 1.3 Legislation

In Australia and NSW private sector investment in public infrastructure is for the most part made under general legislation, without specific statutory provision. We see no particular State legislative obstacles to successful PPPs, so that is the right approach.

Countries which have introduced new laws, particularly in the EU, Central Europe and Japan, have done so either because there were fundamental impediments to long term contracts in their commercial codes, which is not the case here; or because there was political and bureaucratic opposition to the concept of PPPs, and new legislation was seen as a way of clarifying the position. There is no reason to take this approach in NSW.

The one exception is in the area of taxation. The time taken by the Commonwealth to clarify the different concepts in 51AD and division 16D has caused uncertainty about how projects need to be structured to qualify for capital allowances, leading to unnecessary expenditure on structuring, taxation advice and negotiation. NSW and the other states have been right to press for legislative clarification of this position, which is now expected in 2006.

## 2. GOVERNMENT MODELS FOR EVALUATING AND MONITORING PRIVATE INVESTMENT IN PUBLIC INFRASTRUCTURE.

### 2.1 Evaluating business cases

The Guidelines provide a good framework for identifying privately financed projects and assessing them in the early stages of their development. We see only one area for improvement in this model. This relates to the way preliminary costings are done for the financial appraisal.

The Guidelines rightly say that, because privately financed projects are complex, they require careful and deliberate consideration before and while entering into the procurement process. Sometimes, however, a project is identified as a potential PFP, a team is assembled to give the proposal priority consideration, and the team then comes under pressure to consider the business case against a tight timetable. In such circumstances costings may not get adequate thought. Work may be done on capital costs, but insufficient consideration is sometimes given to lifecycle costs such as the maintenance of assets and the level of spending required on associated services. This causes problems later in the process.

Accurate costings will still be prepared during detailed development of a public sector comparator. However the public sector comparator cannot be properly costed until precise specifications are in place for the assets and their performance; and the lead time needed to prepare such specifications means they can only be written after the full project team is established, which often means after there has been preliminary approval for the business case.

The State should try to make sure that more resources are devoted early in the process to scoping and costing the specifications of projects, particularly in relation

to life cycle costs, so that budgetary implications can be taken into account at the outset. This will be particularly important in areas where a programme of projects is being considered, for example in health.

## **2.2 Public Sector Comparators**

PSCs are an important part of the model for evaluating private investment. Significant time is spent by the State and its advisors on preparation of Comparators, and the assessment of proposals against this benchmark can have an important effect on negotiations. In our experience from the PPPs currently being completed, the State has a good understanding of the issues which this raises.

However, given this level of knowledge, there is relatively little published by way of guidelines. It would be helpful if the State published more detail on its model for:

- (i) Raw cost estimates and allowances for risk. This would pool experience from past projects and facilitate realistic cost estimates being produced more quickly.
- (ii) Standard frameworks for quantifying risk, on the use of statistical distributions for analysis, and on how to deal with the potential correlation between risks. Guidance on this would reduce spend on advisors, improve the quality and consistency of PSCs, and lead to more robust and realistic estimates of costs.

We also suggest that it is time to confirm the policy on publication of PSCs. Section 7.1 of the Guidance refers to the need for flexibility about whether to disclose a summary of the PSC in tender documents. Recent practice in NSW has generally been to publish a high level summary of the risk adjusted PSC. We think this is a sensible approach in most cases if care has been taken to make sure that the estimates properly reflect the specification and proposed risk transfer, so that they have credibility. But the market has not always been confident that this is the case, which has led to some lack of confidence in bidding processes.

Confidence could be increased if more detailed guidance was issued, discussed with industry and consistently followed.

## **2.3 Level of information required from bidders**

NSW has always sought detailed responses to requests for proposals, including underwritten finance. This allows the State to ensure that it can rely on the bids put forward and that it fully understands their implications. It implies asking for a large amount of information, including advanced design drawings and detailed financial documentation.

In most cases we think this is the right approach. It is certainly appropriate for relatively simple projects like schools and perhaps hospitals, where design standards are well documented and contract precedents are well established. It is also suitable for toll-roads given the established precedents and the clarity on specifications. Decisions on the best bidder can be made quickly in these

circumstances, so it is clear that investing significant effort in the response to an RFP makes sense.

In some other cases it may be inefficient and unnecessary to require detailed design work associated financing documentation from all proponents – for example where the assets involved are complex and there is a lack of clear precedents for the State’s requirements. In these circumstances we would recommend that consideration is given to holding a two stage competition, in which the first stage focuses principally on design work and preliminary costings. The work required at this stage needs to be proportionate. The process currently being followed on the Sydney water desalination plant may provide lessons on this.

## **2.4 Engagement with proponents**

Experience suggests that the State should enter into discussion with proponents at an early stage in the project to clarify its intentions and proponents’ responses. Projects are better procured, and proponents are more confident about the process, where this is done. For example:

- (i) Workshops can be held when bidders are considering their response to an RFP, so that both the state and the proponents can make sure they have a common understanding on the design requirements, the options for meeting them and the meaning of certain commercial terms.
- (ii) Clarification meetings after the submissions have been returned also have a valuable role to play, making sure that each side has a common understanding of the response.

Neither will be necessary on simple projects which have clear precedents, such as most road projects. But both have a valuable role to play on more complex arrangements where there are many design issues, such as the RailCorp Rolling Stock PPP or hospital projects where interfaces with existing operations are important. Concerns about probity should not be seen as an obstacle to such discussions. The process can be managed perfectly properly.

## **2.5 Monitoring**

Governments all over the world are now recognising that more attention needs to be paid to the monitoring of PPP contracts after they are entered into. There are two aspects to this:

- (i) Departments need to plan their management of contracts and establish how performance under them is to be overseen, to ensure that the State performs its obligations and that private sector partners are held to account. This requires proper staffing of project teams with the appropriate expertise before contracts go live.
- (ii) After service commencement meaningful information about contract performance should be published. This will give a proper basis for debate on the issues raised by PPPs, and may throw light on the fact that users of privately financed facilities, such as teachers and members of the public, see benefits from the operation of privately financed contracts.

There is a balance to be struck here. Proper publication of timely information will inform the debate. But the State needs to make sure it does not damage constructive relationships with private partners by appearing to publish material selectively in order to criticise performance. In our experience NSW Treasury and other departments are fully aware of this.

### 3. **THE FRAMEWORK FOR RISK ALLOCATION BETWEEN THE PUBLIC AND PRIVATE SECTORS AND ITS APPLICATION, ESPECIALLY HOW WELL RISK IS ASSESSED, ALLOCATED AND MANAGED.**

#### 3.1 Allocation

Overall, the principle that risk allocation should be optimised to deliver value for money over the life of a project is well understood and well implemented across NSW, by both the State and proponents. In our view NSW Treasury, departmental officials and project managers try to take a sensible commercial approach in the best interest of the taxpayer.

In applying these principles to particular contracts some inefficiencies arise because of the tactics of negotiation on both sides. Issues that are dealt with at a high level in the Guidance have been negotiated in detail over the past four years, so market precedents have become established. Yet significant negotiation time and fees are still spent on such issues for each project as a result of position-taking by both sides.

Two steps could mitigate this:

- (i) Publication of updated and more detailed guidance on acceptable contract terms, in the light of Victorian Standard Commercial Principles.
- (ii) Clear instructions from the State to its advisors, particularly legal advisors, that it expects them to adopt these terms with minimum amendment, rather than cherry pick provisions from previous contracts which may not - in combination - be appropriate.

Here are some specific examples of areas where we believe that risk allocation has sometimes been inefficient, or negotiations unnecessarily prolonged, as a result of stances taken in the negotiating process:

- *Reduced Payment should be the prime remedy for poor performance.* Sometimes the State also seeks wide indemnities which proponents will be unwilling to give.
- *Damage to assets.* It should generally be recognised that it is not efficient to try to transfer uncapped responsibility for the costs of rectifying malicious damage when the private party cannot fully mitigate this risk.
- *Latent defects in existing assets.* The responsibility for remedying these can only be transferred at a sensible price where the State makes available sufficient information about the assets



Individually these are small points, but there are other examples. Negotiating each item on every project increases the cost and length of the process without getting a better result for the State. Where possible the State should start procurements with standard terms or developments of them that have been agreed on previous transactions.

### **3.2 Assessment**

NSW has a clear and thorough process in assessing risks in proposals for PPPs, particularly where they can be quantified. Proposal evaluation is always based on good project risk registers, and the process is clear, fair and detailed. The steps in relation to PSCs that we have suggested at 2.2 above would improve matters further.

### **3.3 Risk management**

As more complex projects come forward it will be important for the State to develop fuller risk management plans over the project life, drawing on the assessment and allocation of risks at the procurement stage. In particular:

- (i) The allocation of risks between the parties and the creation of precise measurement and payment protocols often crystallise analysis and quantification of risks that would not otherwise be explicit within the State sector. The opportunity should be taken to make sure that these risks are fully understood by the operational management team and that resources are directed to managing them. Responsibility for this will often extend beyond the immediate project team.
- (ii) State agencies will sometimes need to focus more carefully on risks to their own performance under the contract, for example in providing timely information or approvals, or making facilities available to the private sector. The enforcement of performance obligations on the private sector partner will be dependent on the public sector itself having arrangements to manage its own obligations in this respect.

## **4. THE EXTENT OF OPPORTUNITIES TO SHARE KNOWLEDGE ACROSS AND BETWEEN AGENCIES**

All jurisdictions that have PPP programmes recognise the importance of sharing knowledge. This stops agencies reinventing the wheel and ensures that the State has as much knowledge of its negotiating position as the private sector does.

However, it is a common problem internationally that experience transfer depends too heavily on the use of advisors who, subject to confidentiality and probity considerations, are asked to transfer experience within project teams based on their knowledge of previous projects. The obstacles to better sharing are partly institutional (getting the right structure) and partly to do with resources (recruiting or training new project directors, because the people who do the first PPPs do not have the personal capacity to do all the others that are now planned).

In NSW, the following steps which have been taken to address this are very sensible:

- Encouraging previous project directors to share their personal experience with agencies embarking on new projects.
- Involving NSW Treasury officials in project steering groups to identify where there are opportunities for cross-fertilisation of ideas.
- Establishing the Premier's Infrastructure Unit, which is drawing together expert resources which will increase capacity to share experience, particularly on projects which are posing difficulty.

Other steps that should be considered in order to build on this include:

- Providing within the public sector a database of key contract terms.
- Training courses for the next generation of PPP project directors and managers.
- More long term secondments of private sector experts, into agencies, Treasury and the Premier's Infrastructure Unit, particularly in legal and commercial disciplines.

## **5. MANAGEMENT OF INTELLECTUAL PROPERTY**

In our experience the State manages intellectual property issues well. It recognises the value of its own intellectual property, acknowledges the need to deal with intellectual property that may be contained in proponents' proposals with due confidentiality, and proposes appropriate contract terms on the subject.

Issues may arise on future projects if the State seeks proposals which build on intellectual property that is already used internationally in industries that use proprietary technology. In these cases some restrictions on the State's use of such IPR for purposes outside the PPP contract may need to be considered in order to get best value. This should be possible without harming the State's own ability to get the benefit it requires under the PPP.

## **6. OTHER RELEVANT MATTERS: TOLL-ROADS**

There has been intense debate about toll-roads since the opening of the Cross City Tunnel. Much of the comment has implied that the terms of the contracts are inappropriate and cast doubt over PPP projects generally. In our view this reflects fundamental misunderstandings about the terms of the contracts. In particular:

- The provisions which restrict use of certain local roads, in order to encourage traffic to use a new project, are typically specified by the RTA before a project enters procurement. They result from the traffic management planning which takes place before the private sector is involved, and they are published before the PPP procurement as part of the Environmental Impact Statements. These are not requirements set by the private sector.

- It is true that without such provisions some toll road projects could not be privately financed except at higher toll levels. However, the toll levels are set by the State, and are then taken as a fundamental requirement by the bidding consortia. This is a public policy and planning decision. It is open for the RTA to determine that it would rather have fewer restrictions, higher tolls and fewer motorists using the new tunnel. The question is whether this scenario would deliver more benefit to the public as a whole.
- Given the above factors, it is wrong of commentators to criticise the upfront payments that are made by toll road companies to the RTA when the transactions are signed. These payments are bid during the process and reflect what the toll road company thinks it can afford, taking account of the tolls set by the State. Without these payments the private companies would simply expect to make higher profits for shareholders. If there is concern on this issue the solution is for the State to consider, when it receives proposals, whether it would do better to forgo the payments and instead reduce the level of proposed tolls.

If the State wants to retain discretion to change traffic management policies during a contract without having to pay compensation – in effect to manage privately financed roads as part of the overall network - then it can do so by tendering the projects on a different basis. For example, roads could be built, maintained and financed by the private sector, but with the private company receiving income from the State in return for keeping the road available and operating well, rather than from users in the form of tolls. The State could still levy tolls or introduce other forms of road pricing if appropriate leaving traffic risk to be assessed and provided for appropriately in the RTA's budget and accounts. There are good precedents in Europe for roads to be privately financed on this basis. We believe it should be considered for NSW.

## Summary of PricewaterhouseCoopers' PPP Experience

PwC is the leading adviser to Government on PPP projects in New South Wales, Australia and globally.

### Australian Experience Advising Governments on Social and Economic Infrastructure PPPs that have reached Financial Close

Of the 24 social and economic infrastructure projects to reach Financial Close to date in Australia (with a total value of approximately \$9 billion) PwC advised Government on 11 of the deals representing around 60% of the value. The list of completed projects for which we provided financial advice is as follows:

Project	State	Approx size
NSW New Schools 1	NSW	\$100m
Lane Cove Tunnel	NSW	\$1,500m
Berwick Community Hospital	VIC	\$100m
Echuca Rochester Wastewater Treatment Plant	VIC	\$50m
Spencer St Station	VIC	\$300m
Mitcham Frankston Freeway	VIC	\$1,800m
Royal Melbourne Showgrounds Redevelopment	VIC	\$150m
Mobile Data Network	VIC	\$100m
Darwin City Waterfront	NT	\$600m
Southbank Education & Training Precinct	QLD	\$450m
CBD Courts	WA	\$200m
<b>Total</b>		<b>\$5,350m</b>

Source: Project Finance International Global Infrastructure Yearbook 2004 and PwC analysis.

In New South Wales five social and economic infrastructure projects have reached financial close with a total value of \$4,460m. PwC advised on two projects, NSW Schools and Lane Cove Tunnel, with a value totalling \$1,600m.

## Australian Experience Advising Governments PPPs in the market (at or beyond shortlisting)

Of the 16 projects currently in the market in Australia, eight are in the New South Wales (total value in excess of \$2,640m) and PwC is advising Government on three of the projects, representing approximately 67% of the value.

Project	State	Approx size
Newcastle Mater Hospital Redevelopment Project*	NSW	\$130m
Long Bay Forensic & Prison Hospitals PPP Project*	NSW	\$130m
RailCorp	NSW	\$1,500m
<b>Total</b>		<b>\$1,760m</b>

Source: Project Finance International Global Infrastructure Yearbook 2004 and PwC analysis

**Note:** \* The contract terms on the Mater and Long Bay deals are currently being finalised, with Contractual Close imminent on both.

## Global Experience

Internationally, we have acted as lead financial adviser on over 250 successfully completed PPP projects with a value of over \$55billion covering all sectors including schools, housing, rail, road, hospitals and prisons. We designed the structure in the UK and Portugal for privately financed roads that do not depend on user-paid tolls. The following league tables from Project Finance International, the authoritative journal for the sector published by Thomson Financial, show the rankings in 2004.

### Global by value of closed deals for 2004

Rank	Adviser	No. of deals	Value (US\$m)
1	Macquarie	22	10,188
2	PRICEWATERHOUSECOOPERS	36	7,430
3	Taylor de Jongh	2	7,200
4	RBS	2	5,356
5	Ernst & Young	40	4,328
6	UBS	2	4,179
7	KDB	5	3,700
8	Lazard	2	3,449
9	ABN AMRO	10	3,416
10	Citigroup	7	2,650

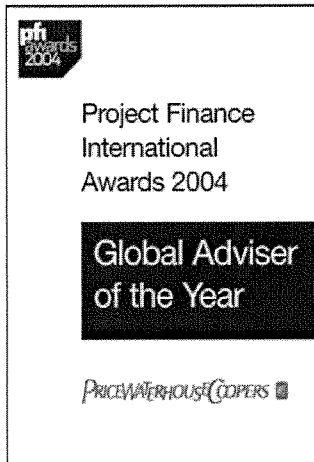
Source: Project Finance International, January 2005

## Global by number of closed deals for 2004

Rank	Adviser	No. of deals	Value (US\$m)
1	Ernst & Young	40	4,328
2	PRICEWATERHOUSECOOPERS	36	7,430
3	Macquarie	22	10,188
4	Grant Thornton	20	1,394
5	KPMG	16	2,453
6=	ABN AMRO	10	3,416
6=	Dexia	10	934
8=	Citigroup	7	2,650
8=	Investec	7	973
10	KDB	5	3,700

Source: Project Finance International, January 2005

In January 2005 we were named Project Finance Adviser of the Year globally for 2004. We were given the equivalent awards in 2002 and 2003 for both Asia Pacific and Europe.



The image shows a horizontal award certificate. At the top left is the 'PFI Awards 2004' logo. The main text reads 'PFI Awards 2004 Global Adviser of the Year PricewaterhouseCoopers'. Below this is a quote: "Its global reach in the public private partnerships (PPP) advisory market was second to none." attributed to Rod Morrison, Project Finance International. The certificate contains several columns of small text detailing PwC's global reach in PPP deals, mentioning projects in Australia, Canada, and the UK, and highlighting PwC's role in various infrastructure and healthcare projects. At the bottom right is the PricewaterhouseCoopers logo.