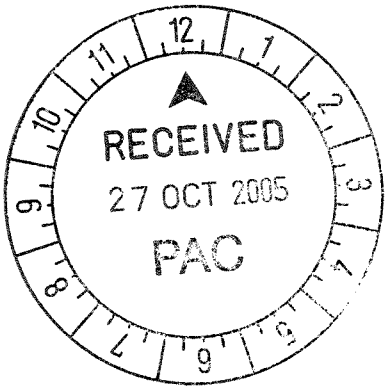
17

B A B C O C K & B R O W N

Sydney Melbourne Brisbane San Francisco San Diego Las Vegas New York Greenwich Dublin Madrid London Paris Milan Munich Johannesburg Kuala Lumpur Hong Kong Tokyo



27 October 2005

Ms Vicki Buchbach
Public Accounts Committee
Committee Manager
NSW Parliament House
Macquarie Street
SYDNEY NSW 2000

Dear Ms Buchbach,

I refer to the call for submissions by the Public Accounts Committee into the public-private partnerships issued on 3 September 2005.

Please find attached our submission paper prepared by Babcock & Brown's PPP Infrastructure team. As noted in our submission, we applaude the Committee's initiative in calling for submissions and we welcome the opportunity to discuss our submission with you in further detail.

Yours sincerely

John Bowyer
Head of PPP Infrastructure
Babcock & Brown Limited

Encl.

Public Accounts Committee Inquiry Into Public-Private Partnerships: Submission

This submission has been prepared on behalf of Babcock & Brown by the team responsible for delivering the majority of PPPs in Australia including the New Schools PFP and Lane Cove Tunnel Project in New South Wales; Latrobe University Medical Centre, Latrobe Regional Hospital, County Court of Victoria, Berwick Hospital, Spencer Street Station and Emergency Alerting Systems in Victoria; Southbank TAFE in Queensland; Perth CBD Courts Project in Western Australia; Darwin Convention & Exhibition Centre in the Northern Territory as well as other similar projects around Australia.

Babcock & Brown was the successful bidder on the Royal Melbourne Showgrounds Project, is currently the only bidder requested to submit a revised proposal on the Long Bay Forensic Hospital Project in New South Wales and has lodged proposals for the New Schools 2 Project and the Rolling Stock PPP, also both in New South Wales. Babcock & Brown also retains a key position in the Convene Melbourne Convention Centre bid.

Although all of the projects referred to above are worthy of further discussion in terms of the benefits of PPPs to Government and the community, this submission focuses on the New Schools Project as a particular case study because of it has been successfully delivered in New South Wales and is therefore of particular relevance to the Inquiry.

1 Introduction

We applaud the Committee's initiative in calling for submissions to its inquiry into public-private partnerships (PPPs) and, although we recognise and promote the benefits of the PPP model demonstrated through the many successfully delivered PPPs projects both locally and internationally, we agree with the Committee's sentiment that the time has come to take a fresh look at the way in which PPPs deliver services in New South Wales.

Our focus in this submission is on the following matters where we believe our recent experiences may be of particular value to the inquiry:

- Government models for evaluating and monitoring private investment in public infrastructure (with particular emphasis on the use of the public sector comparator (PSC)); and
- The framework for risk allocation between the public and private sectors and its application; especially how well risk is assessed, allocated and managed.

We also look at the issue of bid costs and process related matters, including the requirement to submit fully documented subcontracts at bid stage and the administration of the final stage of the evaluation and selection process, as further areas of potential opportunity to improve outcomes for the Government.

Our further focus in this submission is on the procurement of social rather than economic infrastructure[1] again on the basis that this is the area where our recent experiences may be of

[1] See Table 7.1 *Working with Government: Guidelines for Privately Financed Projects*, NSW Government, November 2001, for differences between economic and social infrastructure delivery.

particular value to the inquiry but also because we anticipate a very strong pipeline for social infrastructure projects in New South Wales and other Australian jurisdictions.

This submission firstly overviews the key reasons why PPPs have the potential to offer improved value-for-money to the public compared to conventional procurement methods, and provide practical examples both in NSW and overseas which support this proposition. We then acknowledge some of the factors which have contributed to the success of these projects and discuss some opportunities (within the terms of reference identified above) for improving the efficiency and effectiveness of Government actions in PPP procurement and thereby for maximising the value to the public of PPPs.

2 Benefits of PPPs

2.1 Improved Value-For-Money

PPPs have the potential to offer improved value-for-money to the public compared to conventional procurement methods for the following reasons[2]:

- The procurement of design, construction, operation and maintenance of the facility over the life of the project within an integrated package encourages maximum innovation from the private sector to improve the design and performance of the facility and reduce its whole of life costs. Innovation is supported by the Government specifying its requirements in terms of outputs rather than inputs.

  A whole of life approach to delivery of an asset also ensures that it is fully maintained throughout its life, which is not often the case under conventional procurement methods where maintenance needs are often seen as discretionary and subordinated to other priorities particularly when budget cuts are implemented.

- 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 also be created through a performance-based payment regime such that the private sector's investment in the project is always at risk.

- Appropriate third party usage of the facilities, or other third party revenue opportunities generated by the underlying capital investment, can reduce the net cost of the facility to government.

  As well as providing a direct subsidy benefit through third party revenue generation, the addition of complementary assets can also greatly enhance the overall amenity of the primary public asset. For example the addition of commercial developments, including retail, residential and car parking developments; greatly improved the overall amenity to the community on projects such as the Melbourne Showgrounds, Spencer Street Station and Darwin Convention & Exhibition Centre.

---

[2] Based on *Private Provision of Public Infrastructure and Services*, Office of Financial Management Research & Information Paper, New South Wales Treasury, TRP 02-3, April 2002.

We agree with Treasury's stated position. In fact, the most successful PPP projects with which we have been involved have all of these elements.

Another benefit to government which is often cited in support of PPPs is the ability to overcome budget constraints through off-balance sheet borrowing. With New South Wales and other States having low levels of debt however, this is not considered an attraction in its own right. As such, improved value-for-money is the primary reason for considering private financing and delivery of public infrastructure.

The value-for-money benefit has been demonstrated in a number of successful PPP projects such as the New Schools Project being delivered by Axiom Education, a consortium comprising St Hillers & Hansen Yuncken (D&C) and Spotless Facilities Management (O&M) and led by former ABN AMRO Infrastructure Capital employees now with Babcock & Brown's global infrastructure team. This project involved the construction of 6 primary schools accommodating 3,800 students, 2 secondary schools accommodating a further 2,000 students and a school for specific purposes accommodating 85 children with special needs. A fundamental premise of the Axiom approach was giving consideration to the 30 year maintenance requirement and output specification issued in respect of the project when contracting and delivering the design, construction and commissioning of the project ensuring that the quality of the end product delivered was as important to Axiom Education as it obviously is to end users including the NSW Department of Education, teaching staff and students alike..

In particular, improved value-for-money has been demonstrated in the New Schools Project through the following benefits:

- Timely delivery of facilities (completed on-time and within budget in 2005, compared to 2010 which is the time they would have been delivered under a conventional unpackaged government procurement methodology)
- Delivering economies of scale through procuring the schools as a package rather than individual assets
- Multi-use facilities and intelligent design (addressing playground and after hours security concerns) will benefit the whole community
- Superior education and leisure environments for students well into the future
- Dedicated and responsive maintenance regime
- Easing the administration burden on principals allowing them to focus on their core responsibility of delivering quality education for all pupils.

The current experiences of the participants in this project are also positive. The deductions due to KPI breaches are extremely low and the State Users are receiving a significantly higher level of service than through traditional procurement.

Another key area where PPPs can deliver value-for-money is through projects based on world class architecture, design and sustainability. The County Courts of Victoria building, the Spencer Street Station development and the Darwin City Waterfront development are all

examples of iconic projects in terms of design which are not only beneficial in their own right but also greatly enhance their surrounding environments.

Finally, an example of a PPP delivering improved value-for-money through risk transfer to the private sector is the Tower Hamlets project in the UK which was successfully delivered by a Babcock & Brown led consortium. During the construction phase of that project, the design and construction contractor became insolvent and was successfully replaced by the private sector project vehicle. Babcock & Brown is currently shortlisted or at preferred bidder stage on three PPP projects in the United Kingdom with a total gross development value in excess of AUD 600 million. As noted above, Babcock & Brown is the only bidder requested to submit a revised proposal on the Long Bay Forensic Hospital project in New South Wales and it has lodged proposals for the Rolling Stock PPP and the New Schools 2 Project also in New South Wales. PPP projects continue a major focus for Babcock & Brown and, to this end, we are actively pursuing other PPP transactions in Australia.

2.2 Other Benefits

In addition to the primary benefit of delivering improved value-form-money, PPPs also delivery the following benefits to government and the community:

- Efficiency derived through the application of far greater discipline by the relevant government agency to firstly justify the business case and secondly to provide detailed costing for comparison with the private sector project

- Ability of Government to not only drive efficiency, but to also drive major asset reform more rapidly than would be possible under traditional public procurement methods. This benefit is particularly compelling to the community in light of the staggering backlog of infrastructure maintenance and replacement. For example, there are a number of schools that consist of a collection of demountable structures.

- Political benefits to Government through the delivery of successful projects such as the New Schools Project which achieved very high satisfaction rating from principals and a secure and responsive learning environment for school students for 30 years.

3 Reasons for Success & Opportunities for Improvement

PPPs are complex transactions, the success of which depends on the bringing together of a variety of stakeholder interests and the integration of a range of core components including design, construction, operations & maintenance and finance and specialist skills including insurance, legal, tax and accounting.

However, perhaps most fundamental to the success of a PPP is the Government's role in developing a project brief (including a well developed reference project, output specification and a meaningful PSC) which ensures that the needs of Government and the public are satisfied and which creates confidence in the integrity of the evaluation process.

A foundation for the success of the New Schools Project for example was the quality of the Government's project brief which included a well developed output specification and transparent evaluation criteria including, in particular, a meaningful PSC (the importance of

which is discussed further in section 4 below). Interestingly, this particular Government Department had significant recent experience in the procurement of similar schools and this was evident from both the quality of the Project Brief and the accuracy of the PSC. This is not always the case across the various Government departments with which we deal.

Despite the now extensive track record of PPPs in Australia and in the United Kingdom, we believe there are still a number of areas where opportunities exist to improve the efficiency and effectiveness of Government actions so as to maximise the value of PPPs to the public. In particular, refinement of the construction and use of the PSC as an evaluation tool, the risk allocation framework, the requirement to lodge fully documented subcontracts and the Government's administration of the final stage of the evaluation and selection process are each areas of opportunity which are discussed in further detail below.

4 Evaluation Models: PSC

4.1 Role of the PSC

As noted earlier, improved value-for-money is the primary objective of involving the private sector entities in the provision of public infrastructure services. It is critical therefore that an accurate, transparent and objective measure is used to determine whether a proposed project offers value-for-money and also to determine, in a competitive environment, which competing bid offers the most value-for-money. The PSC is the primary quantitative tool used in performing the following roles:

- Providing a reliable means of demonstrating value-for-money
- Providing a consistent benchmark and evaluation tool
- Promoting full cost pricing at an early stage in the procurement process
- Encouraging bidding competition by creating confidence in the financial rigour and probity of the evaluation process
- Acting as a key management tool during the procurement process.

The PSC is fundamental to the PPP project; therefore it is critical that it is prepared carefully and comprehensively. It is also important to recognise the inherent limitations of the PSC which arise because of the difficulty in forecasting costs over the life of the concession (which may be up to 35 years) and because of the subjectivity associated with estimating the impact of risks on costs over the life of an asset.

4.2 Constructing the PSC (Social Infrastructure)

As provided for in the NSW *Working with Government: Guidelines for Privately Financed Projects*, PSCs for social infrastructure should be constructed as a cash-flow model under traditional delivery methods because, unlike economic infrastructure, social infrastructure is primarily funded by payments from the Government. Furthermore, the cash flows for social infrastructure in the PSC should include three core components:

- Base costs of delivering the services specified in the project brief
- Estimate of the expected cost of risks that could potentially crystallise over the life of the project (both those retained by the Government and those transferred to the private sector)
- Competitive neutrality adjustment (if applicable)

The base cost and risk components set out in the first and second bullet points above are of particular interest to the private sector because of their relative contribution to the overall PSC and because of the scope for error in their calculation. A number of technical issues surrounding the formulation of these components are discussed below.

4.3 Technical Issues

The following technical issues associated with the formulation and use of the PSC are worth considering in light of the inquiry's objective to improve the efficiency and effectiveness of Government actions in PPP projects:

(a) Defining the PSC Reference Project and relevance of the Output Specification

One of the keys to constructing a meaningful PSC is the identification of the Reference Project which is based on the most likely and efficient form of delivery that could be employed to satisfy all elements of the output specification. The boundaries of the Reference Project are defined by reference to the output specification. Because the output specification should focus on the end result rather than the means of delivery, it is the framing of a method to meet the output specification from government's perspective that critically defines the PSC.

(b) Accuracy of base cost component

The base cost component of the PSC includes all capital and operating costs, both direct and indirect, associated with building, owning, maintaining and delivering the service (or underlying asset) over the concession period and to a defined performance standard as required under the output specification.

To ensure accuracy, the base cost component should be priced by a competent cost estimator and based on a sufficiently detailed design which reflects, for example, not only the quantities but also the type of materials and finishes that would be incorporated in the final design in accordance with the requirements of user groups which are often only developed after the release of the initial project brief and initial PSC. In addition, the Project Brief is often enhanced through user group consultation after the initial PSC is formulated.

We recognise that it may be necessary to release the initial PSC before the full level of detail is specified. However, in those circumstances, the process should accommodate the revision of the PSC to account for such developments to the project brief.

(c) *Escalation of base costs*

The initial PSC is generally constructed based on the market conditions at the time of its formulation. While we do not disagree with this method, a PSC formulated in this way should be made subject to escalation over the period from the date of formulation by the Government (or, more precisely, from the date of price currency of its inputs) to the date to which the private sector's bids are to be held firm.

For the purposes of transparency and so as to create confidence in the evaluation process, the Government should, upon release of the PSC, also state how it is to be adjusted over time for escalation (e.g. "the PSC is issued in 30 June 2005 dollars and will be subject to X% p.a. escalation calculated on a daily basis"). There are a number of independent and directly relevant industry benchmarks that can be used here, such as those published by the various Quantity Surveyor firms.

In our experience, there are a number of recent examples of PPP Projects around Australia where significant escalation has occurred in the market without the PSC having been adjusted to reflect such escalation. This is an area that may be worthy of further consideration by governments to ensure that the PSC properly performs its role as providing a reliable means of demonstrating value-for-money and of providing a consistent benchmark and evaluation tool.

(d) *Project Specific Risks*

Many projects have project-specific risks, such as particular site conditions, contamination etc that are identified but not in sufficient detail to establish an accurate cost prior to the compilation of the PSC.

When these situations occur we believe it would be better to either undertake this testing prior and costing prior to finalising the PSC, or the PSC should be amended once this work has been done. This is particularly relevant for factors such as contamination where bidders are unable to undertake site testing and can only rely on preliminary test results from work done by the State (which is generally not sufficient to assess and cost risk).

(e) *Method of Valuing Risk*

Risk is an inherent part of any project and should be adequately reflected in the PSC. Broadly, risk should be included in the PSC through the following method:

- Including the costs of project specific risk in the cash flow numerator; and
- Without double counting, applying a discount rate (cost of capital) which reflects the level of project risk.

We advocate valuing risk in the cash flow numerator of the PSC through the inclusion of contingencies for specific risks on the basis that this approach offers the following advantages:

- By valuing risk as a separate cash flow item, the parties are better able to focus on the key factors affecting optimal risk allocation
- Cash flow valuation takes better account of the timing of risk by analysing the profile of each risk (i.e. some risks manifest during the D&C phase whereas others only manifest in the operating phase)
- The value and impact of a risk may vary over time
- This is consistent with how projects are modelled and financed

As noted above, the discount rate (cost of capital) applied to the cash flows should take into account the contingencies included in those cash flows. However, the discount rate should not be the Government's cost of capital but should be adjusted to take into account that notwithstanding the contingencies and other allowances for risk there is still risk within the transaction.

4.4 Disclosure and Revision of the PSC

We acknowledge that one of the key objectives of government in undertaking PPPs is to promote effective competition during the bid process. We consider that open disclosure of the PSC has the following potential advantages in this regard:

- Focuses attention on government expectations and provides bidders with a check as to whether their scoping of the project is broadly consistent with that of government. If for example the prices of the bidders are all inconsistent with the PSC, there is a strong chance that the private sector has been pricing on a different set of assumptions to the government which is likely to lead to a flawed bidding and evaluation process.
- Encourages further innovation by creating a more fully informed market
- Increases the private sector's confidence in the system and understanding of government output requirements.

As acknowledged above, there may be circumstances where the PSC requires revision during the bidding process however this should only happen if the scope of the Project changes or it becomes apparent that a significant component has been omitted or mispriced. Where a revision is necessary, bidders should be given sufficient information regarding the circumstances of the revision to enable them to adjust their bids accordingly.

5 Framework for Risk Allocation

The primary objective of the risk allocation framework should be to achieve *optimal risk allocation* as opposed to maximum risk allocation. This objective recognises that if risk is inappropriately transferred to the private sector, government may pay a premium or jeopardise the long-term sustainability of the project. This is often the case for some of the risks identified in 4.3 (d) above.

This objective should be taken into account in the formulation of the project brief based on the types of risks that the private sector has been able to efficiently price in prior projects. For projects which break new ground and for which there may not exist relevant precedents, we believe it is valuable for the government to consult the market prior to releasing the project brief. We note that this was the approach taken by the NSW Government on the current Rolling Stock PPP.

Once the optimal risk allocation has been developed, the party to whom a particular risk has been allocated (which should be done on the basis of their ability to manage or mitigate the consequences of that risk) should be given maximum flexibility to manage that risk. This ensures that the risk is able to be priced in the most efficient manner.

Finally, it is also worth considering a third category of risks – shared risks. These are risks which are generally uncommon and project-specific and/or where there is insufficient information to accurately price. In these circumstances it may be better to establish some form of risk-sharing mechanism and identify that early in the process, rather than dealing with it in later negotiations. This will result in a more competitive price from bidders, rather than higher prices with large contingencies.

6 Transaction Costs and Process Related Matters

It is widely recognised, including by Treasury, that the extensive work involved in a competitive tender and in developing executable contracts can generate high transaction costs for both public and private sectors[3]. Although the majority of these transaction costs are initially borne by the privates sector (it is not unusual for bid costs alone on some projects to run into the millions of dollars), these costs are ultimately borne by the Government and the community through higher prices.

Two matters relevant to the issue of minimising transaction costs are discussed below.

6.1 Requirement to lodge fully documented subcontracts

One of the key matters which Government considers in assessing a bid by the private sector is the certainty of its terms and certainty of its deliverability. In particular, the private sector is asked to demonstrate that it has appropriate terms in place with its core subcontractors (in particular, the D&C contractor and the O&M contractor and other service providers).

On most projects we have been involved with, this has been demonstrated through the execution and lodgement of detailed term sheets agreed between the project vehicle and the core subcontractors. On more recent projects however, we have noticed a move by Government to requiring fully documented subcontracts to be submitted.

We believe that this additional requirement to submit fully document subcontracts reduces the overall benefit to Government and that the submission of detailed term sheets produces a better outcome for the following reasons:

---

[3] *Private Provision of Public Infrastructure and Services*, Office of Financial Management Research & Information Paper, New South Wales Treasury, TRP 02-3, April 2002.

- The nature of term sheets, as opposed to full subcontracts, focuses the consortium partners' attention on the key commercial terms rather than on detailed legal drafting, thereby improving the overall risk allocation within the private sector consortium and as between the private sector and Government

- The time required to prepare terms sheets, as opposed to full subcontracts, means that the parties have more time to focus on other important areas of the bid including design development, delivery programming, operations planning and pricing refinement

- The external legal costs associated with preparing fully documented subcontracts can be prohibitive and are one of the largest contributors to overall bid costs

- Term sheets are more flexible than subcontracts in accommodating changes made to the head contract as a result of final negotiations between Government and the private sector.

6.2 Final Stage of Evaluation and Selection Process

Critical to the maximisation of the value-for-money benefits to Government and the community, is the selection of the most competitive bid for a particular project. In order to achieve this, Government must necessarily undertake a competitive bidding process which generally includes Expression of Interest, Request for Detailed Proposal and Best and Final Offer stages.

While on the one hand there are obvious benefits to Government and the community in sustaining the competitive bidding process for as long as possible, as noted above it is also widely recognised that the extensive work involved in a competitive tender and in developing an executable contract can generate high transaction costs for both public and private sectors. The challenge, therefore, is to achieve the right balance between these competing drivers so that transaction costs are minimised but always so as to preserve integrity in the process by ensuring that the most competitive bid (in terms of efficiency and effectiveness) is selected.

7 Conclusions

We agree with Treasury's stated position that privately financed projects should demonstrate superior value-for-money to the Government and community compared to conventional, publicly funded approaches to infrastructure procurement. We also believe that there is now an extensive track record of PPPs delivering superior value-form-money as well as a number of other benefits including improved efficiency, the ability to drive major asset reform within rapid timeframes and wider political benefits derived from community satisfaction with successfully delivered projects.

Despite this track record of PPPs in Australia and in the United Kingdom, we believe there are still a number of areas where opportunities exist to improve the efficiency and effectiveness of Government actions so as to maximise the value of PPPs to the public. Refinement of the construction and use of the PSC as an evaluation tool and refinement of the risk allocation framework, for example, are both areas of opportunity for improved

efficiency and effectiveness. In particular in relation to the PSC; defining the Reference Project, ensuring accuracy of the base cost component, accounting for escalation, dealing with project specific risks, the method for valuing risk and minimising transaction costs are all areas which we believe are worthy of further consideration by Government.

Finally, Babcock & Brown again congratulates the Committee for its inquiry into PPPs, welcomes the opportunity to discuss this submission with you in further detail and looks forward to working with the NSW Government on future projects.