

Mythbusters

Facts and fictions about Public Private Partnerships

Victoria takes a straightforward approach to Public Private Partnerships (PPPs) – we only use PPPs if they represent good value for money and are in the public interest. However, there are many misconceptions about PPPs. This document is designed to address some of the common misconceptions about PPPs in Victoria.

A PPP¹ is a service contract between the public and the private sector where the Government pays the private sector to deliver infrastructure and related services over the long-term. PPPs typically make the private sector parties who build public infrastructure financially responsible for its condition and performance throughout the asset's lifetime.

Victoria's PPP policy, *Partnerships Victoria*, requires that all projects must offer value for money as a government investment, independent of the delivery method.

In a typical *Partnerships Victoria* project the government would:

- engage one party to design, finance, construct, maintain and, in some cases operate the facility
- only make payments after the facility has commenced operations
- provide payments over the term of the contract based on services delivered against the achievement of key performance indicators – with these payments being at risk for non-performance.

It is important to note that under *Partnerships Victoria* policy the responsibility for delivering core services is retained by government and the project must pass a rigorous public interest test.

The success of *Partnerships Victoria* projects relies upon real risk transfer reinforced by the commitment of private finance over an extended term.

Partnerships Victoria policy achieves the best value for money on major and complex projects, where there is opportunity for innovation and risk sharing. This is done by stimulating innovation through competitive bidding, use of output (ie. services) rather than input specifications, appropriate transfer of risk and facilitating whole of life cost considerations.

Importantly projects will only proceed as a PPP if this provides better value compared with what the same project could achieve under a more traditional procurement method. A Public Sector Comparator (PSC) is used in this value for money comparison assessment.

The *Partnerships Victoria* policy ensures:

- the risk² related to infrastructure finance, construction and operation is transferred to the party best able to manage it
- the project is allocated a whole of life cost, with an incentives regime for the private sector to complete the job on time and on budget as well as service it over its lifetime
- infrastructure and services developed by the private sector can be used in an innovative and commercial manner, thus offsetting costs by generating extra revenue that government would not normally be able to achieve.

¹ PPP is the term used in Australia. Internationally some countries, including the UK, refer to PFI (Private Finance Initiative).

² Or more strictly, the financial consequences if the risk eventuates.

Myths and Headlines

Partnerships Victoria projects don't provide value for money

Better value is not just cheaper – it is not just about beating the PSC. It also means the overall outcomes achieved, such as a higher quality and better maintained infrastructure over the longer term. It is about obtaining the best deal for Victoria in the delivery of infrastructure across a number of factors, including price, quality of service delivery to the community, design amenity and **sustainability** of the arrangement.

For instance, compared to traditional built infrastructure, PPPs have provided flexibility and higher quality in design. This has achieved efficiency in operations and will reduce maintenance and provide capacity to expand infrastructure to meet future needs without disruption to operations. These are features of both the Royal Women's Hospital project and the *Partnerships Victoria* Correctional Facilities.

Competition between bidders and the potential for innovation, which produces savings in operational costs or related commercial opportunities to generate revenue, reduce the overall cost to government.

PPPs are shrouded in secrecy because the public won't accept the deals required by the private sector

Partnerships Victoria is about contestability and transparency. Government will only enter a partnership after a competitive and rigorous bidding process, overseen by a probity practitioner. A private sector proposal will only be accepted where it is demonstrably better value for money than public sector provision.

Although contracts for PPP projects have been released, the Government has also committed to releasing project summaries under a new *Partnerships Victoria* disclosure policy. The project summary will comprise firstly a summary of key project features, intended to provide a snapshot of the rationale, value and parties in the project, and secondly a summary of the key commercial features of the project.

Partnerships Victoria is a very clear public interest, value for money approach – and it's very different to the approach adopted in previous decades.

In the late 1980s and early 1990s, for example, the key driver for PPPs was to finance infrastructure off the government balance sheet. In the second half of the 1990s, the drivers for private sector provision were private sector growth and efficiency, coupled with maximum risk transfer. As a result, both of these historical approaches led to some unsustainable contracts – and some unsatisfactory outcomes for both government and the private sector.

The *Partnerships Victoria* policy is flexible and reflects lessons learnt, but it is not used as a one size fits all solution to large-scale infrastructure projects. Partnerships projects represent around 10% of infrastructure investment.

An application of this learning is the EastLink project. EastLink avoids many of the criticisms levelled at other road infrastructure projects – demonstrating the flexibility and value that PPPs can bring to these sorts of projects. EastLink has the lowest per kilometre toll rate of any toll road in Australia, with proposed toll rates a key part of the value-for-money evaluation. The Victorian Government remains free to make transport changes and there are no forced road closures as a result of the project. The full Eastlink Project Deed is publicly available, excluding commercial in confidence material.

Sensational headlines like... *Victoria has bought a \$1.8 billion roof for our redeveloped Southern Cross Station*

Saying Victoria has bought a \$1.8 billion roof for Southern Cross Station is a cute headline, but it's wrong. That amount is not just a payment for design and construction of a world class iconic structure. It is the sum of payments over 30 years, which incorporate the cost of maintaining and operating the station over this period, together with allowances for inflation. The value of the project, in addition to the eye catching roof, new station facilities and signalling, is that it is reinvigorating the western edge of Melbourne.

You could undertake the \$1.8 billion exercise with your house purchase, by simply adding to your capital repayments, the interest and, maintenance costs of the house plus the utility bills over 30 years to arrive at a very high number – but not one that represents the purchase cost of a house.

Some also argue that PPPs allow governments to cross-subsidise the related commercial developments. This is also incorrect. Quite the reverse is true. The opportunity for additional development generates new opportunities for returns that result in a lower net cost to government.

High bid costs reduce competition and the value achievable

Partnerships Victoria is committed to improving the PPP process and is working closely with the PPP sector to streamline bidding costs.

Victoria has already taken many industry suggestions on board, including adopting standard commercial principles in PPP projects and increasing the use of the interactive tender process in projects.

Myths and Headlines

Partnerships Victoria projects are used to take expenditure off the Government's Balance Sheet

The balance-sheet treatment of a project is not the driving force behind the use of a PPP delivery approach in Victoria. The majority of *Partnerships Victoria* projects delivered to date are on the Government's balance sheet (and the accounts are audited each year).

In Victoria the decision about how a project is funded is separate to the decision of how it is delivered (with the exception of the large scale self-funded EastLink project). PPPs compete for budget funding along with all other capital projects. Full capital budget funding is set aside for non-self funding projects before market interest is formally sought, allowing a project to proceed to traditional delivery should private bidders not offer value for money.

Inclusion of a *Partnership Victoria* facility on the State's balance sheet does not mean that risk has not been transferred. Under new Australian Accounting Standards it is increasingly likely for PPPs to be on government balance sheets. However, there is not necessarily any correlation between the balance sheet treatment and the risk allocation between the government and the private sector party, which is governed by the contract.

Risk transfer in Partnerships Victoria projects is not real or effective.

A common view is that value for money is compromised through risk transfer not being real or not being any more effective than the traditional delivery of infrastructure.

Partnerships Victoria projects assign risks to those best able to manage them, avoiding excessive premiums for inappropriate risk transfer, and in reality, what is transferred is the financial consequences of risk occurring.

Construction costs are just one example where Victoria has significantly benefited from transferring the risk of cost overruns to the private sector. However, there are many other areas where the risk transfer is real, including maintenance and fit-for-purpose design.

An example is the Southern Cross Station project, which experienced significant cost over-runs. However, the private sector met most of these costs whilst government met costs related to additional work requested and contamination clean-up, which was a shared risk in the contract.

Won't long-term PPP contracts unduly lock-in future Governments?

Most infrastructure, by its very nature, is built to last for 20 years or more. No matter what mode of delivery, the government is making decisions that have long-term consequences. The benefit of a partnership approach is that the government will need to consider more fully the whole-of-life issues before entering into partnership arrangements and incorporate sufficient flexibility into the arrangements to take advantage of improvements in service delivery quality and efficiency over time.

Partnerships Victoria projects have a higher cost because of higher private sector borrowing costs

Partnerships Victoria is about packaging projects in a way that ensures lower overall cost to the State and improved services to the community. Competition between bidders for a whole of life asset and related services provides scope for innovation and other factors to achieve efficiency savings above those achieved under equivalent public sector delivery and financing.

It is a myth that the value for money outcomes achieved in *Partnerships Victoria* projects are compromised by higher private sector borrowing costs.

The Government's ability to borrow more cheaply is purely a function of its capacity to levy taxes to repay borrowings. Credit markets perceive this power as reducing the risk of their investment and therefore will lend to government at lower rates. However, when it comes to raising finance for a project, it is the risk of the individual project that determines the real cost of finance. The difference between the private and the public sectors is that private sector capital markets explicitly price in the risks of a project into its sources of finance. This is not the case in the public sector. Instead, taxpayers implicitly subsidise the cost of the project by bearing the risk of cost overruns, time delays or performance failures, which are not priced into the Government borrowing rate.

The importance of the finance element of privately provided infrastructure lies in the incentive it can provide for the performance of that infrastructure, and the disciplines external financiers can provide on the delivery of projects to time and budget. While a key objective of Government is to achieve a more comprehensive upfront consideration of risks in conventionally financed projects, it is difficult to replicate the strength of private financing incentives within a conventional financing process where all risks of delivery reside with Government.