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A CLIENT'S OWN CONSULTING TEAM

Public Private Partnerships in NZ

What Does the Future Hold?

What is a PPP?

PPPs are gradually becoming more widely used internationally in contracts, but what are they?

“A public private partnership is a legally binding contract between government and business for the provision of assets and the delivery of services that allocates responsibilities and business risk among the various partners.”

British Columbia 2003

What’s special about PPPs?

PPPs:

- Bring private sector innovation;
- Allocate risks to where they can be best managed;
- Can minimise the whole-of-life cost, viz:
  - Procurement;
  - Construction process;
  - Operational cost;
  - Maintenance costs.
- Historically, deliver on time or ahead of time, and to budget;
- Are very large in scale – Treasury looks for >$50m and funders look for $50-75m or more.

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Is PPP a proven procurement methodology?

- The procurement method has been used around the world (Australia, Canada, Finland, France, Germany, Norway, Poland, Singapore, South Africa, UK and others).

- In the US, about half the states have used PPPs in building nearly 100 transportation projects totalling approx. US$54b.

- In the UK, there are close to 40 street lighting PPP projects currently under way or in place.

What PPPs are happening in NZ?

- Currently, there are two PPPs that the Government has entered into in NZ. They are:
  - Hobsonville Point Schools Project (primary opening in 2013);
  - Wiri Prison Project (opening 2015).

- The Schools project is to design, build, manage, maintain facilities, and finance a new primary school (690 pupils) and secondary school (1,500 pupils) at Hobsonville Point.

- The Prison project is to design, build, operate, maintain and finance a new 960-bed prison at Wiri.

The Role of the National Infrastructure Unit

It is common practice in most countries that use PPPs to establish a specialist PPP unit. Such units are usually located in, or are associated with, the national Treasury or Ministry of Finance. In New Zealand this role is played by the National Infrastructure Unit (NIU) of the Treasury. The unit is:

The focal point for economic and financial assessment and advice on all PPPs and will assist government agencies more generally. It will ensure application of the NIU Guidelines. The relevant PPP authority will also promote best-practice PPPs by absorbing and disseminating the lessons of experience and consulting with other governments on their experiences and practices.

Guidance for Public Private Partnerships (PPPs) in New Zealand
Prepared by the National Infrastructure Unit of the Treasury
October 2009
Version 1.1

The Role of the National Infrastructure Unit

Cabinet has agreed that:

- The NIU should be involved in the economic and financial assessment and advice on all PPPs;

- Departments and agencies should be required to consult the NIU early in the development of a PPP proposal, and;

- Departments and agencies should be required to give the NIU the opportunity to make an experienced officer available to the project steering and working groups.

The Draft PPP Contract (NIU)

- The draft Contract provides the underlying commercial principles that New Zealand PPPs should adhere to, and Treasury estimates that approximately 80% of the draft Contract would be relevant for operational-focused and user-pays infrastructure PPP contracts.

- The draft Contract is a set of ‘model terms’. It does not deal with matters that are specific to individual projects or sectors. Most project specific matters will be dealt with in the schedules to the PPP contract. The schedules included in the draft Contract provide a framework for the inclusion of project specific material. A number of the schedules are more generic and will be applicable to PPPs generally.

MinEd’s role in the Schools Project

The Ministry of Education plays a number of key roles in the Schools PPP. It:

- Was the procuring authority under the PPP procurement process;
- Specified the detailed, output based, design requirements of the schools;
- Is the actual owner of the new buildings created under the PPP arrangement;
- Provides the ultimate sign-off that the new schools are acceptable prior to occupation;
- Will monitor the private sector’s performance over the contract life (25 years);
- Pays for performance and will apply penalties to the private sector partner for any poor performance;
- Is responsible for all of the education related services provided in the Schools.

Private sector’s role in Schools Project

The private sector partner provides the following services:

- Waste management & cleaning, security, pest control, utilities management;
- Building & asset maintenance (whole of life);
- Information & communication technology backbone;
- Furniture, fittings & equipment management;
- General facilities management & ground maintenance;
- Janitorial and porterage services;
- Telephone based Helpdesk services.

Features of the Schools Project

- ‘*Learning Infrastructure Partners*’ is the name of the experienced private sector consortium.
- Finance has been provided by Westpac and the PIP Fund. The PIP Fund is a group of local investors including the NZ Superannuation Fund, the NZ Social Infrastructure Fund and a number of community trusts.
- *Learning Infrastructure Partners* was selected on the basis of its innovative design, its willingness to underwrite the performance of its schools for 25 years and its price.
- The final fixed cost of the schools is believed to be approximately 1% below budget and delivery risk sits firmly with the private sector. The consortium takes responsibility for the assets it creates.
- The PPP model will free the schools’ principals from the distraction of managing property so that their core focus can be on educational outcomes.
- Hobsonville Point Primary School is expected to open at the beginning of 2013 and Hobsonville Secondary School in early 2014.

Private sector's role in Prison Project

- The private sector (*SecureFuture*) will support the Government in reaching its target of a 25 per cent reduction in reoffending by 2017.
- The 25 year contract is worth approximately $840 million, apparently 17 per cent less than if the prison was procured through conventional means.
- Fletcher Construction will build the new facility which will be operated by Serco and maintained by Spotless Facility Services.
- It will provide a modern prison, with improved facilities and services, and will be strongly focused on rehabilitating prisoners.
- The contract has strong performance incentives, and *SecureFuture* must perform 10 per cent better than Corrections in reducing re-offending rates.
- The consortium will face financial penalties if it fails to meet custodial, rehabilitation and re-integration measures.
- The new prison will still operate within the current Corrections' framework. It will have to comply with all relevant New Zealand legislation and international obligations.

What is the Treasury approach to PPPs?

- Performance regimes must be better than the public sector can provide;
- The project must be of sufficient scale – high up-front costs ($50-100 m);
- The cost of the project cannot be greater than the public sector comparator (PSC);
- Treasury looks for opportunities for:
  - Innovation in asset design and to improve whole-of-life asset management/ costing
  - Innovation in service delivery arising from the assets;
  - Transfer of risk;
  - Potentially bundled services.
- The required timeframe for service delivery needs to be >2-5 years;
- The “project interface complexity” has to be reviewed. (How hard is it?);
- If legislative change is required, it needs to be factored in (e.g., Wiri Prison);
- Market capability is reviewed. (Can strong legal, financial teams be raised?)

A draft standard contract is available on the National Infrastructure Unit website and the Treasury PPP Team provides detailed development guidance.

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Draft PPP Standard Contract (NIU)

"The draft PPP Standard Contract, and the model terms it contains, are a starting point in the development of PPP procurement in New Zealand. In the medium term, once the model terms have been tested across a few live market transactions, our intention is to move to a set of mandatory model terms (in the nature of the UK's SOPC4), so that procurement processes may be further streamlined. Until that point in time, the draft Contract will remain in draft status, however will continue to be adopted as the initial contractual basis for all live PPP projects."

National Infrastructure Unit, The Treasury

20 April 2011

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Public Sector Comparator

"The Public Sector Comparator (PSC) is an estimate of the hypothetical, whole-of-life cost of a public sector project if delivered by the Government."

Infrastructure Australia, National Public Private Partnership Guidelines (2008)

PPPs in local government

- Overseas - institutions, including pension funds, are heightening their interest in infrastructure investment — a growing pool of private capital is becoming available to help finance properly structured public projects.
- Tax increment funding (targeted rates) is gaining in popularity.
- In Scotland, LG is packaging up a range of projects to attract scale. The model, developed by Ernst & Young, has been tested and works well there.
- The streetlight PPPs in UK, where PPP is getting political support, are seen as one of the most successful LG PPP sectors in UK.
- In the US, more states are passing PPP-enabling legislation and reaching out to contractor-funder consortia to achieve workable procurement practices that can deliver projects on time and on budget.
- LGs like PPP because the discipline around them satisfies them they will get cost certainty and contestability.

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The bankers' approach to PPP

- There is "aggressive" interest in NZ from Australian banks – looking for assets.
- Japanese banks are also active in NZ.
- Banks' return on assets is quite stable in NZ at present, but less than 1%.
- Banks see PPPs as attractive because they provide important community infrastructure and (for social infrastructure projects) a low-risk profile.
- Negatives as seen by banks are:
  - Long bidding process;
  - Political uncertainty and "lumpy pipeline";
  - Low product cross-sell;
  - Poor record of some patronage PPPs.
- Australian banks will not take on debt of more than $3B. They are likely to establish onshore/ offshore teams for their funding deals.
- All Australian banks are signed up to the "Equator Principles". These require due diligence in the environmental assessment of a project.

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The bankers' approach to PPP (ctd.)

- Challenges of PPPs as faced by banks are:
  - Bank market liquidity (future crises);
  - Financing costs – future market dislocation;
  - Achieving a longer financing tenure (presently 7 years);
  - Proving the NZ bond market model to allow it to open up;
- The base case cost needs to be conservative as later re-financing will almost certainly have to take place;
- The gearing level banks look for is 85-90%;
- A real focus for banks is the selection of consortia. Because of the up-front costs involved, a lot of effort by the banks is put into consideration of what they believe to be the "best" consortia.
- Government actions that would attract debt to the table are:
  - Strong pipeline;
  - Bundling of projects where possible;
  - LG procurement – national framework set up;
  - Partial debt buy-back by Government.

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Conflict management & dispute resolution

- The "people factor" is a big risk factor in NZ PPPs;
- A-Team being in at the start, then the B-Team later – becomes a risk in disputes if they are of a complex nature;
- Controls on public sector involvement are very low;
- Mandatory procurement rules apply to Central Govt., but not to Crown agencies, e.g., NZTA;
- Overseas, court action has generally been avoided – but this may not happen in NZ.

Conflict management & dispute resolution

- The Auditor General can be involved in NZ;
- Strategy in claims – need to take multiple angles;
- Liability may be higher than the contractual limit;
- Don’t defer claim preparation until project’s end;
- Keep a regular paper trail;
- Hold back money if possible;
- Maintain a single point of contact;
- Get specialist legal advice early.

PPPs – reasons for failure

- Biggest reason – scope creep;
- Delay;
- Over-specification;
- Failure to consider opex implications;
- Inadequate expertise of customer;
- Lack of diversity in the contracting model;
- Optimistic risk transfer v. risk management;
- Legislation issues.

PPPs – reasons for success

- Effective risk transfer on capex and opex;
- Good economics;
- Outside of legislative constraints;
- Integrated with development and transport objectives;
- Regional infrastructure;
- Appropriate contract methodology – separation of capex and opex;
- Effective communication (really critical).

Important things to consider (1)

With PPPs:

- It’s about the ability of the teams (consortia) – skills are needed because project governance is so important and expertise is required in order to be competitive;
- It’s about programme rather than project;
- Don’t do them because money is short – do them because better outcomes are wanted;
- You need the ability to think outside the box.

Important things to consider (2)

- Small TLAs are unable to undertake PPPs because of the scale required;
- The cost of finance in PPPs is higher (Govt. can get lower interest rates);
- What happens if things go wrong? Need to have the guarantee of continuity;
- In setting up your deals, allow a margin for conclusion, e.g., environmental cost, etc.;
- Your detailed business case is best looked at as a 5-case model.

Important things to consider (3)

<u>The 5-case model</u>:

- Strategic:
  - Compelling – strategic fit and meets business needs;
- Economic:
  - Optimises value for money;
- Commercial:
  - Is commercially viable;
- Financial:
  - Is affordable within available funding;
- Management:
  - Is achievable and can be successfully delivered.

Important things to consider (4)

- Information gathering:
  - Market engagement;
  - Expressions of interest;
  - Probity.
- Output specifications:
  - Defining output measures;
  - Design input v. innovation;
  - Unintended consequences.
- Risk allocation:
  - Risk assessment;
  - Risk allocation.

Important things to consider (5)

- **Payment mechanisms:**
  - Incentives v. penalties;
  - Timing;
  - Dispute resolution;
  - Monitoring and reporting.
- **Flexibility:**
  - Future changes;
  - Upside;
  - Downside.
- **Refinancing:**
  - Savings;
  - Additional costs;
  - Guarantees;
  - Currency risks.

Important things to consider (6)

- Termination:
  - Dispute resolution;
  - Early termination;
  - Contractual termination;
  - Handover.
- Contract Duration:
  - Competition;
  - Certainty;
  - Renewal.
- Negotiation:
  - Preferred bidder; or
  - Competitive dialogue.

Creating PPP Contracts (1)

- NZ Treasury has a standard PPP contract. It is based on – design-build-finance-maintain-operate.
- Standard contracts can reduce negotiating costs.
- Market engagement is going on now – "who is in the market, what strengths are there, etc?" (Transmission Gully; radio network; social housing).
- NZ Treasury has a national infrastructure PPP Team.
- Non-disclosure agreements are needed to control who-talks-to-who in a PPP environment.
- A process probity deed is needed to set out a clear structure – but not too early, so that early discussion is not stifled.
- Outputs – need a clear demonstration that things can be built as required – ask for evidence of achieving outcomes.
- Payment may only be based on the delivery of product or services.
- There may be opportunities for obtaining extra revenue – the agreement may specify a split of revenue between the parties.

Creating PPP Contracts (2)

- Risk v. reward profile has to be well considered.
- Value-for-money considerations are from the Business Case onwards. The Business Case needs to be regularly reviewed.
- Innovation is desirable but it must meet quality and affordability criteria.
- Whole-of-life considerations drive the whole value-for-money situation.
- Cash flows must be deliverable and subject to robust modelling and sensitivity analysis. Returns to debtors and equity partners must be met.
- A constraint in NZ is the present inability to “hedge” against other projects. A bigger pipeline of projects is needed.
- The more there is in the pipeline, the more interest there will be in financing.
- Funders will be Australasian banks, Asian banks, infrastructure funds, superannuation funds, sovereign wealth funds, etc.
- Asian banks are currently interested in the Christchurch rebuild.

Creating PPP Contracts (3)

- KPIs have to be clear – will they still be relevant in 5 years time?
- PPP contracts need to be flexible to reflect the user's requirements and the outcomes they are trying to achieve.
- Need a mechanism to re-negotiate if necessary.
- The matters above introduce a degree of uncertainty, hence risk, which needs to be priced for.
- The risk profile will change over the 25-30 year life of the contract, so there is a refinancing risk. (Refinancing will usually occur every 7 years).
- There is a currency risk with NZ PPPs because of overseas funding.
- The public sector may have "step in" rights, i.e., right to step in, resolve an issue and step out again.
- Funders can intervene if things are not going well – but only if an event of real significance occurs.
- In UK, the requirement is to use the competitive dialogue (i.e., dual negotiations) approach following EOI. However, this pushes up the costs. In NZ, the preferred bidder approach is used.

Creating PPP Contracts (4)

- The private sector needs to understand the need for transparent, equitable procedure for those participating in public projects.
- The public sector needs to understand sensitivity around disclosure.
- In the first two NZ PPPs the private sector was able to engage on the outcomes required because of the output specifications that were put up.
- The core Concession Agreement is more than 200 pages long. Changes put forward by the private sector add substantial cost because of time spent in producing (private) and reviewing (public) derogation schedules.
- There will be a review by Treasury of the Concession Agreement with an update. This should be completed prior to the next PPP.
- “Thin capitalisation” rules apply to PPPs to control the amounts of debt foreign-owned equity can incur. (Australia exempts PPPs, however.)
- In NZ the preference has been for bids to be fully underwritten.

Monitoring and evaluation (1)

- Monitoring required for:
  - Governance;
  - Management;
  - Risks;
  - Delivery;
  - Contractual
- Value for Money
  - Economy – wage inflation; training; discount on material costs; recruitment plan; procurement; cost of funding;
  - Efficiency – Output measures, e.g., spend per delivery, earned value, quality, health and safety;
  - Effectiveness – Outcome measures, e.g., levels of service, benefits, wellbeing indices, confidence indicators.

Monitoring and evaluation (2)

- Evaluation required for:
  - Ongoing – audit framework;
  - One-off – investigation;
  - Learnings.

- Reporting required for:
  - Explaining the purpose;
  - Outlining the story.

The reporting frequency should be established in advance and reporting bias avoided.