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CONSIDERATION OF CRITICISMS OF PPPs

A number of Australian newspapers and magazines have recently published articles attacking the use of public private partnerships (PPPs). Considered below is the validity of some of the more frequent criticisms of PPPs.

Duration of Contracts

One criticism is that the government is binding itself to contracts of 20 or 30 years duration, when society's needs may dramatically change within that time. While it is obviously true that society will change over time, this consideration is equally correct for traditional public sector means of procurement. In fact, correctly prepared PPP contracts should address this concern better than traditional methods of procurement in that they should be drafted so as to permit flexibility when responding to a change in public needs. This can be done through ensuring the PPP contract contains provisions which enable the government to alter the scope of services the private sector partner is providing, once the parties have negotiated an adjustment to the service charge.

PPPs are more expensive

Another argument is that because the government's cost of borrowing is cheaper than the private sector's, PPPs will always be more expensive than public provision. It is undoubtedly true that PPPs involve considerably greater transaction costs than most other means of procurement. This is because PPPs are complicated and require a great deal of preparatory work. While financing costs represent approximately one third of the total cost of PPP projects, given that the purpose of the government establishing a public sector comparator is to ensure that a PPP represents value for money over the whole life of the asset, this factor should outweigh the additional cost of borrowing. An illustration of this can be given by comparing PPPs with the Federation Square project (considered below). While PPPs are more expensive to establish, none have experienced the cost blow-outs still being encountered on that project.

Money not spent on PPPs could be used to build more social infrastructure and accelerate the rate of the reduction of State debt

This criticism assumes that PPPs are more expensive than public sector procurement. The argument is that money "lining the pockets" of the private sector would be better spent on building more infrastructure or even accelerating the rate of State debt reduction.

In response to this criticism, it should be noted that by allowing the government to pay a service charge rather than pay up front construction costs, PPPs free up government capital expenditure. In doing so they enable the public to have access to a broad range of state of the art and well maintained infrastructure which might not otherwise be available. PPPs also encourage state and local governments to undertake a strategic long term view of their service requirements, enabling government to undertake a far more substantial development than they could otherwise manage to finance.

PPPs just shift government debt off the balance sheet

As critics of PPPs have correctly pointed out, PPPs sometimes give the appearance of reducing government debt. However, this is not the case since, in a PPP, the public sector either commits itself to a stream of payments for 20 to 30 years or means such as tolls need to be utilised.

As stated above, however, by freeing up government revenue from projects which can be appropriately procured by way of a PPP, governments should be left with sufficient resources to finance other infrastructure which is not susceptible to delivery by this method of procurement.

PPPs lead to creative accounting

An allegation raised currently in the United Kingdom is that local governments, in particular, are engaging in creative accounting to ensure that a project can proceed as a PPP. This is because the reality appears to be that if this method of procurement is not available, the project will not be able to be instigated.

While this represents a strong argument, it is not a criticism as to the viability of PPP projects. Rather, it is an indicator of potential ramifications if this method of procurement is inappropriately used.

PPPs have not demonstrated improved value for money

The United Kingdom National Audit Office responded to this allegation by releasing its findings that lifetime cost savings of 20% or more were realised in most PPP projects. These savings were made through private sector efficiencies in design and management, a focus on whole of life costing (leading to the integration of various design, construction and operational aspects of the project) a focus on output specifications permitting innovation, efficient risk allocation and obliging the public sector to focus on strategic approaches to procurement rather than on short term solutions.

PPPs Cannot Genuinely Transfer Risk

One of the more damning criticisms of PPPs is that in relation to essential infrastructure, risk cannot be genuinely transferred to the private sector, given that the government will have to step in if such projects fail, especially if this is necessary to ensure public safety.

This concern again raises the point that PPPs are not a suitable method of procurement for all projects. Indeed this is recognised in the Partnerships Victoria guidance material which stipulates that a project should only proceed when it is both in the public interest to do so and where the government can genuinely achieve value for money through an efficient and realistic transfer of risk.

FEDERATION SQUARE

When construction of Federation Square, the first block in Melbourne which will connect the central business district with the Yarra River, first commenced in 1998 hopes were high. However, persistent cost and time overruns continue to blight the project.

In May 2002 the Victorian Government allocated an additional \$55.6m to complete the Federation Square project. This brought the budget for the project - originally estimated at the project's inception in 1996 to be \$110m, to \$394m (of which \$280m is to come from the Victorian Government, \$64m from Melbourne City Council and \$50m in federal funds). Moreover, not all State costs associated with the development of the

BREAKING NEWS

- The Victorian government has named Civic Nexus as the preferred bidder for the Spencer Street Station precinct redevelopment. The consortium, made up of Leighton Constructions, ABN Amro Australia and the architects Daryl Jackson and Nicholas Grimshaw, will provide approximately \$450m to build and operate the \$350m station for 30 years. In return the Government will pay the consortium \$34m a year for 30 years (allowing inflation) and allow it to build a retail plaza, two apartment towers and a 36-level office tower on the site.
- Queensland business group, Commerce Queensland, has questioned the ability of the Queensland government to deliver on PPPs following the government's apparent bowing to union pressure to extend the deadline on draft PPPs Guideline submissions by 3 weeks.
- On 24 May 2002, the Adelaide Advertiser reported that the Rann government has set up a cabinet subcommittee to examine future projects and to ensure no bureaucratic red tape holds up plans for private enterprise to build major infrastructure projects in a partnerships deal. The South Australian government has complied some guidelines for the plan with Treasurer Kevin Foley saying on 23 May 2002 that the details would be released soon. It appears that the most likely projects being considered at this stage are the upgrading of the Glenelg tram, the construction of regional hospitals, suburban and county police stations and a new aquatic centre and women's prison.
- The Bracks' government's synchrotron research project has a \$57 million funding shortfall on its construction costs according to a new report by the State Auditor General. The Auditor General reported on 5 June 2002 that the cost was \$157 million whereas the government had pledged total funding of \$100 million. Premier Bracks defended the shortfall stating that the government was working to secure the \$57 million from the private sector. It is unclear at the present point in time where such private investment will come from and how it will be structured.
- Challenger International through its subsidiary, The Liberty Group, has formally announced its role as owner and manager of Victoria's County Court facility which has now officially been opened by Premier Bracks. The Victorian County Court project represented the first public-private partnership delivered under the Partnerships Victoria policy.

Square are included in this budget. State funded costs incurred in the demolition of the former Gas and Fuel Corporation Towers and Princes Plaza (amounting to \$5.4 million) and part of the fitout costs to be met by the Commonwealth Government and commercial tenants are not included in this latest budget estimate.

For over two years the Government and Opposition have blamed one another for the project's poor track record. The Opposition claims that the cost and time overruns to Federal Square has been caused by:

- the government's intervention on the shards issue (the originally envisaged 22m shard has been replaced by an 8 metre version of the original in order not to obscure the view of St Paul's Cathedral);
- forcing initial project director, Mr Bonice, out of his office;
- loss of potential investors and tenants of the project due to the scrapping of the shard; and
- a six month delay in appointing a Chief Executive Officer to the Federation Square Management Company.

By contrast, the Government has blamed the project's blowout on the previous Government's "reckless" contractual arrangements.

Political point-scoring aside, the key driver of the cost and time increases appear to have been the adoption of a managing contractor procurement strategy in the context of construction work moving rapidly ahead of the detailed design work. A managing contractor procurement strategy is one where the owner appoints a single contractor not to carry out any part of the construction works itself, but rather to administer the construction process by contracting directly with the necessary contractors and consultants.

One ramification of this strategy has been the generation of a large number of variation and prolongation claims. Another ramification was the Government's decision in late 1998 not to novate the Architect's Agreement to the Managing Contractor. This decision was made on the basis that the design was incomplete and that the State was best able to manage the design risk.

The resulting changes to the Managing Contractor's Agreement, together with other variations to works undertaken directly by the Managing Contractor increased the total

estimated payments under that Agreement to \$70 million (compared to the originally agreed total contract sum of \$34.5 million). This has meant that, after having originally contracted to bear the cost, time and design risks for the Square in return for a fixed fee, the Managing Contractor no longer bears these risks.

THE PARTNERSHIP'S VICTORIA CORRECTIONAL FACILITIES PROJECT

In June 2002 the Victorian Government released the expression of interest brief for the development of a 300-bed correctional centre and a 600-bed remand centre. These facilities will be delivered under the Victorian Government's Partnerships Victoria policy.

While Victoria's prison system is designed to accommodate 2,875 prisoners, it is operating at 123% of its design capacity with 3,536 prisoners at 3 May 2002.

The services the successful consortium will be expected to provide include:

- the design, construction, finance and maintenance of the two facilities (this will involve the provision of buildings, security barriers, equipment, fixtures and fittings, information technology enablement, communications infrastructure and plant);
- the "hard" facilities management services such as the maintenance of the two facilities and the maintenance of plant and equipment (including repair and replacement);
- ancillary services such as the provision and maintenance of all electronic security systems, infrastructure and fire systems; the provision of "soft" facilities management such as waste removal, external gardening and ground maintenance; the possible provision of services transporting visitors from local public transport interchanges and the provision of information systems support and management.

The correctional services will continue to be provided by CORE – the Public Correctional Enterprise.

Set out to the right is an illustration of the proposed contract structure. As can be seen, it is envisaged that the key agreements for the Project will be:

- a Facilities Services Agreement between the Contractor and the Minister for Corrections;
- a Ground Lease between the Contractor and the Minister for Corrections; and

- a Tripartite Agreement between the Minister for Corrections, the Contractor and the financiers to the Project (to, among other things, define the rights of the Minister and financiers in the event of a material default by the Contractor).

In addition, irrevocable facility access arrangements will be required to be given by the Contractor to allow custodial and other services to be provided by CORE. This may be by way of a separate Sub-Lease from the Contractor to the Minister for Corrections.

The expression of interest envisages that the concession period will run for 25 years and risk will be allocated as follows:

- the State will retain residual value risk in relation to the Project (since at the end of the concession period the facilities will be handed back to the State at a predetermined value); the risk of site acquisition, availability and obtaining the necessary rezoning; and demand risk (in that payment will be linked to availability not the utilisation of the facilities); and
- the Contractor will be expected to take the risk of allocation of other site development risks; design and construction risk; asset ownership and maintenance risk; industrial relations risk (insofar as that risk relates to the capacity of the Contractor to deliver its services) and tax risk relating to the ownership and funding of the facilities.

The Project Brief is expected to be released to the three or four shortlisted candidates in August 2002 with preferred tenderer(s) announced in February 2003. It is then proposed that the Project Agreements will be executed in mid 2003 with commercial acceptance following in mid-late 2004.

GREG CAMPBELL ATTENDS PPP CONFERENCE IN LONDON

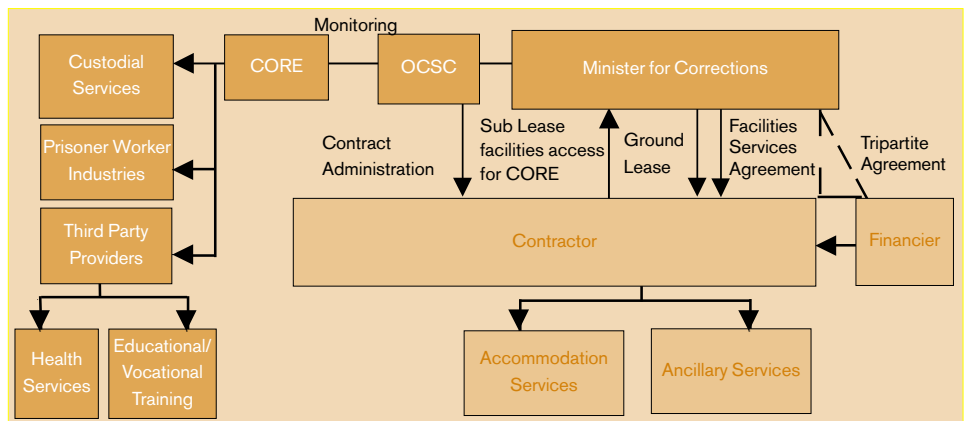
Greg Campbell has returned to Melbourne following his attendance at the Public Private Finance Awards night held on 29 May at the Royal Lancaster Hotel in London. The night was a great success with awards handed out in categories such as Best Operational Project, Best Health Project, Best Defence Project, Best Accommodation/Property project, Best Transport Project, Best Education Project, Best Environment Project, Best Design, Best Strategic Infrastructure Project and Deal of the Year. Many of these awards were divided into two categories: 'above £20 million' and 'below £20 million'.

A two day seminar accompanied the awards ceremony and covered topics as diverse as the global PPP market, assessing value for money, PPPs in the local government context, risk financing and mitigation and standardisation of terms and conditions in PPP contracts.

While in the United Kingdom Greg also took the opportunity to visit the site of several PPP projects. This included an in-depth briefing from Portsmouth City Council who have undertaken the first local government road infrastructure PPP. This project includes not only the maintenance of highways but also the rehabilitation and maintenance of street-lighting, bus stops and street kerbs.

MARK CATCHPOOLE RETURNS TO MADDOCKS FROM SECONDMENT TO TREASURY

In the second week of August Mark Catchpoole returns to Maddocks following a six month secondment to the Department of Treasury and



Finance (DTF). During the course of his secondment, Mark worked with the Commercial and Infrastructure Projects branch of the Commercial Division of the DTF where he has been intimately involved in the consideration of numerous projects for procurement in accordance with the Partnerships Victoria policy. Mark has also been involved in dealing with a number of policy issues raised by such projects.

Mark would welcome any queries in relation to the Partnerships Victoria guidance material or any general issues you have with respect to this method of procurement. From mid-August Mark can be contacted directly on (03) 9240 0868.

AMANDA SHAW JOINS MADDOCKS

Amanda Shaw has joined Maddocks as a Senior Associate in our infrastructure and major projects group. Amanda joins us from CMS Cameron McKenna in London where she spent two and a half years in their highly regarded Energy, Projects and Construction department. Prior to this, Amanda spent six years in the Banking and Finance department of Clayton Utz in Melbourne where she worked primarily in major projects.

Amanda has extensive experience in privately financed infrastructure projects both in Australia and the United Kingdom. This experience has included acting as the lead project lawyer on a number of infrastructure projects being implemented under the United Kingdom's Private Finance Initiative (upon which the Victorian "Partnerships Victoria" policy and procurement guidance is based) across a range of project areas including health, education, transport, police and office accommodation. This United Kingdom experience built upon Amanda's previous Australian experience which included the Melbourne City Link project, the corporatisation and privatisation of the Victorian electricity market and the first round of privately owned public hospitals projects in Victoria. Amanda is well-placed to advise in relation to a diverse range of projects as, in addition to the range of the projects she has been involved in, she has acted variously for project sponsors, government and financiers.

We welcome Amanda to Maddocks' infrastructure and major projects group.

OUR INFRASTRUCTURE AND PROJECTS TEAM

If you would like further information about any of the articles contained in this newsletter, please contact one of our team members below.



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