SUCCESSFULLY ALLOCATING RISK AND NEGOTIATING A PPP CONTRACT

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1. INTRODUCTION

The delivery and operation of public infrastructure is a risky business, and the track record of the public sector in assessing and managing these risks is mixed. PPPs provide an opportunity for the public sector to:

•harness the private sector's expertise and skills in managing these risks; and

•by doing so in a competitive environment, achieve better value for money outcomes for taxpayers in the delivery of public infrastructure and the provision of public services.

One of the key value for money drivers in a PPP transaction is the transfer of risks to the private sector. But this transfer of risk comes at a price, and attempts to transfer risks which the public sector is better placed to manage than the private sector can damage the value for money proposition of a PPP deal. The transfer will only improve value for money if the price charged by the private sector to manage the risk is less than what it would cost government to manage the risk itself.

The efficient or optimal allocation of risk, that is the allocation of risks to the party that is able to manage the risk at the least cost, is clearly an essential ingredient to the achievement of best value for money outcomes—this much is agreed by all parties involved in the delivery and operation of public infrastructure. However, the achievement of best value for money outcomes requires more than just the efficient allocation of risks.

Government must also consider which project delivery procurement model for engaging with the private sector is likely to deliver the best value for money outcome—which involves the consideration of both publicly and privately financed delivery models. In addition, careful consideration should be given to the development of effective market engagement and negotiation strategies to ensure that those risks which government is seeking to transfer are priced by the private sector within a competitive environment so as to deliver the best value for money outcome for taxpayers. This paper considers all of these issues.

2. CHOOSING THE RIGHT DELIVERY MODEL FOR THE PROJECT

Most of the PPPs which will be discussed [in this paper] will be privately financed Build, Own, Operate and Transfer (BOOT) transactions (with a user pays revenue stream), or Design, Build, Finance and Maintain (DBFM) transactions (with a government payment revenue stream). These are referred to collectively in this paper as Privately Financed Projects (PFPs) or PFIs (to use the UK term).

You only have to look at the lists of current and potential PPP transactions published by the NSW, Victorian and Queensland Governments to see that the PPP label is generally used in Australia as a synonym for a PFP.

When we think of recent NSW PPP transactions, we think of deals such as:

•the recent Sydney tollroad deals—being the CCT, M7 and LCT projects (and before them, the M2, M4, M5 and Easter Distributor (M1) projects);

•the NSW New Schools Projects—1 and 2;

•the Mater and Long Bay Hospital projects; and

•the RailCorp Rolling Stock PPP.

All of these deals are privately financed BOOT or DBFM deals.

The same applies if you consider recent Victorian and Queensland PPP transactions such as EastLink, Royal Women's Hospital, Melbourne Convention Centre, North South Bypass Tunnel and the Southbank TAFE.

Whilst the privately financed BOOT or DBFM transaction is certainly a core member of the PPP family, it is not the only member.

The first and most important step which governments must take on a major infrastructure project, in order to successfully allocate risk and achieve the best value for money outcome for taxpayers, is to thoroughly consider all of the delivery models under which government can engage with the private sector for the delivery and through–life support of infrastructure and the provision of associated services.

The PPP policies of the NSW, Victorian and Queensland Governments refer to the need to consider alternative delivery models during the business case development stage of a PPP transaction. However, this consideration is often limited to a comparison of a privately financed BOOT transaction against a 'traditional government procurement model', which in most cases will be where the government agency separately engages designers and then contractors to design and construct the facility, which the government agency then maintains itself or engages a separate FM contractor to maintain.

This approach is too narrow, and does not give sufficient regard to the whole–of–life value for money outcomes which alternative delivery models for the engagement of the private sector—whether they be publicly or privately financed—could deliver.

The value for money drivers for PFPs are typically stated to be the following:

Risk transfer

PFPs allow government to transfer risks to the private sector which the private sector party is better able to manage at a lower cost than government, thereby reducing the overall cost of the project to government. Historically, the private sector has managed delivery risks better than the public sector. This is not surprising (or indeed meant to be a criticism of the public sector) given the different drivers of the private sector and the public sector. It may be trite to say it but the key driver for the private sector is the profit imperative, which essentially means controlling the costs of delivery by managing the risks appropriately. On the other hand, the key driver for the public sector is risk mitigation which usually leads to more expensive cost outcomes on delivery.

Whole–of–life costing

The long term nature of PFPs often requires the private sector party to assume responsibility not only for the design and construction of a facility, but also for its operation, maintenance and refurbishment. This provides a commercial incentive for the private sector to adopt design and construction methodologies which will minimise the overall cost of building, operating and maintaining the facility through life. In other words, the private sector is incentivised to deliver a more efficient operational outcome by capturing operating efficiencies at the development phase.

Innovation

PFP projects focus on output specifications, thereby providing private sector bidders with the opportunity to develop innovative design and other solutions so as to meet government's requirements at lower cost. Further, the private sector is incentivised to create innovative solutions to unforeseen risks as they emerge (for example on the Melbourne City Link project, unforeseen construction risks which crystallised with possible timeline implications were imaginatively overcome through innovation).

Asset utilisation

Some PFP projects provide opportunities for third party use of the facility, thereby generating revenues which would not be derived if the facility were built, owned and operated by government (due to the absence of commercial motivation). These third party revenues can reduce the cost government would otherwise pay as sole user of the asset or alternatively open up opportunities for upside revenue sharing.

To this list should also be added the benefits of earlier project delivery. The use of private finance can enable certain projects (and their associated economic and social benefits) to be delivered to the community much earlier than would be possible if the project had to wait its turn for the allocation of government capital funds. In the case of economic infrastructure, where user charges can be imposed, PFPs can also enable government to expand its available finance and thereby allocate its limited capital expenditure budget to other projects such as schools and hospitals. However, this benefit also brings with it the risk of distorting government project priorities in favour of those projects which are capable of being delivered as a PFP.

For a PFP to represent best value for money, the benefits derived from utilising the PFP model need to outweigh the higher cost of private sector finance and any

other potential disadvantages of the PFP model (such as the inflexibility of a long term contract).

So are the above value for money drivers (particular the first four) limited to privately financed PPP projects? Put another way, is it possible to develop a project utilising a project delivery model which captures the above value for money drivers, but which uses public sector funding instead of more expensive private sector finance, thereby further reducing the overall cost of the project to government?

The answer, for some projects, will be yes.

The following table shows the different delivery models used for both publicly financed and privately financed partnerships.

AUSTRALIAN PPP FAMILY

PUBLICLY FINANCED PROJECTS

PROJECT ALLIANCE	DCM/O	STRATEGIC ALLIANCES	LTS AGREEMENTS
• Lawrence Hargrave Drive • Sydney Water SewerFix and PSP Programs • National Museum of Australia	• Pacific Highway Upgrades • Millennium Train • M5 East • Gateway Bridge	• Collins Class Submarine Through Life Support • ARTC Rail Infrastructure Improvement Alliances	• RTA/QLD DMR Road Maintenance Contracts • Defence Comprehensive Maintenance Contracts

PRIVATELY FINANCED PROJECTS

BOOT	DBFM	OPERATING FRANCHISE
• Sydney Tollroads • Telstra Stadium • Alice–Darwin Railway	•RailCorp Rolling Stock PPP • Mater Hospital • NSW Schools Projects • Royal Women's Hospital	• Victorian Train and Tram Franchises

Consider, for example, the $2.2 billion Pacific Highway Upgrading Program, which has been in place since 1996, on the Central and Northern coasts of New South Wales. These upgrades are being delivered using a Design, Construct and Maintain (DCM) delivery model.[1] The NSW Roads and Traffic Authority (RTA) enters into a single contract with the private sector for the design, construction and, for a 10 year period, maintenance of the upgrade. This delivery model has enabled the RTA to:

• transfer most risks associated with the design, construction and maintenance of the upgrades to the private sector, being risks which the private sector is able to manage at lower cost than the RTA, thereby reducing the overall cost of the projects to the RTA;

• provide the commercial motivation (via a lump sum maintenance fee) required to encourage the private sector to adopt a whole–of–life approach to the design, construction and maintenance of each project; and

• provide the private sector with an opportunity to develop innovative solutions which satisfy the RTA's output focused requirements for each project.

Furthermore, all of the above value for money drivers are being achieved without the utilisation of private sector finance.

There is also no reason why a DCM or Design, Construct, Maintain and Operate (DCMO) delivery model cannot be applied to many other forms of public infrastructure in order to facilitate value for money outcomes through whole–of–life costing, risk transfer, innovation and, in appropriate cases, third party asset utilisation.

Of course, a key difference between a DCM/O and a PFP is that with a DCM/O it is only the contractor's operation and/or maintenance fee which is effectively at risk during the operational phase of the project. With a PFP, the private sector's investment in the capital cost of the project is also 'at risk' during the operation phase of the project since payments are typically only received when the public services commence following construction completion and continued payment depends upon performance against specified performance criteria. Placing the capital cost of the project at risk clearly provides a very strong incentive for the private sector to identify, allocate and manage those risks which are allocated to it, and to achieve the optimal balance between design and construction costs on the one hand, and operation and maintenance costs on the other. Indeed, one of the desirable features of the private sector financing of a project is the due diligence work which the financiers and equity investors carry out on the project. However, it is suggested that the same incentives can be created, albeit with less money at risk,[2] under a DCM/O model, particularly if some of the payments for construction work are 'back ended' and made contingent upon the operational performance of the facility. Also, these outcomes can be achieved under a DCM without some of the other

disadvantages of a PFP such as the lack of flexibility which comes with a long term privately financed contract.

Consider also recent projects delivered under a publicly financed project alliance delivery model such as Lawrence Hargrave Drive, the Sydney Water SewerFix and Priority Sewerage Programs and the National Museum of Australia. Under the project alliance delivery model the parties embrace a 'no blame' culture, which allows the parties to adopt cutting edge innovative solutions in the pursuit of cost/time savings and enhanced project outcomes without fear of legal claims in the event they fail. This, coupled with a remuneration structure which rewards or penalises the participants depending on their performance against the client's Key Performance Indicators (KPIs), has resulted, by most accounts, in these projects achieving high levels of innovation, with resultant time and cost savings for government which would not have been achievable under traditional delivery models.

The above examples demonstrate that a project does not necessarily need to be privately financed in order for government to capture the benefits which a PPP can deliver. To ensure the best value for money outcome for taxpayers is achieved, all possible PPP delivery models, including publicly financed ones, need to be considered.

The message here, however, is not that privately financed PPP transactions cannot deliver best value for money outcomes, or that all projects should be publicly financed because government can borrow money at a lower cost of finance than the private sector. There are many projects for which a PFP will represent the best possible value for money delivery model, notwithstanding the higher cost of finance. This is why the BOOT model has been the backbone of the Australian PPP family. Further, the capacity of government to borrow the funds needed to build and maintain the infrastructure which communities require is not infinite, and the economic and social benefits of accelerating the delivery of high priority infrastructure projects through the use of private finance must not be overlooked.

That said, if PPPs are truly about delivering best value for money outcomes for taxpayers, then we ought to be ensuring that the full range of PPP delivery models are considered during the early planning phases of each project to ensure that the delivery model adopted is the one which is most likely to deliver the best value for money outcomes, having regard to the particular characteristics of the project and the outcomes which government is seeking to achieve.

SUCCESSFULLY ALLOCATING RISK ON PFPS—A QUESTION OF PERSPECTIVE?

As PFPs currently dominate the Australian PPP scene, it is appropriate to now consider how to successfully allocate and negotiate risk in the context of this form of PPP.

So, from whose perspective are we considering this issue? Privately financed PPPs involve many stakeholders, all of whom will bear some level of risk in relation to the transaction. Indeed, the large number of stakeholders involved is one of the features of PFP which distinguishes it from other forms of procurement, and which makes the task of risk allocation so challenging.

Below is a contractual structure diagram for an accommodation facility PFP (such as a hospital, school or prison).

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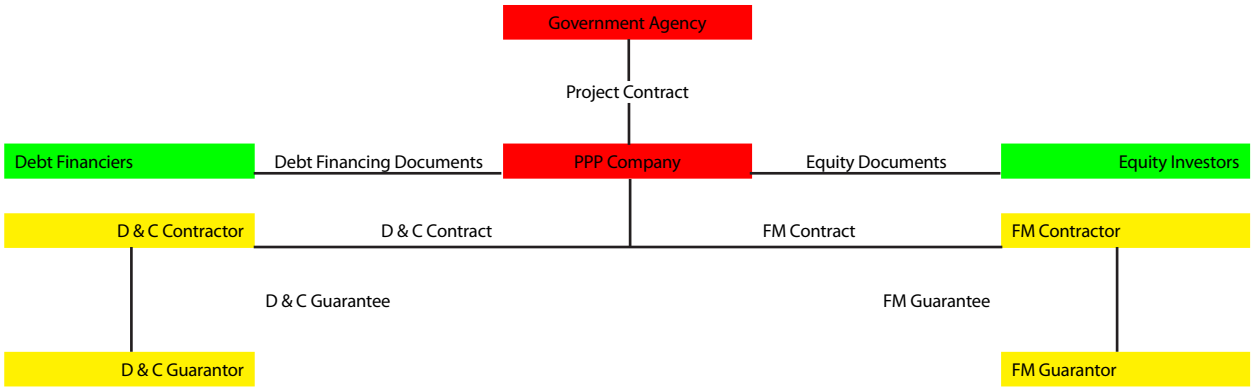


It shows the main players in the transaction, amongst whom the project risks will be allocated.

They are:

• the government agency;

• the PPP company, and as a consequence, the equity investors;

• the debt financiers (or the bondholders and the credit wrapper if the finance is raised from the capital markets);

• the D&C contractor, which will typically be a joint venture of two or more contractors on the larger PPPs, and their parent company guarantors; and

• the FM contractor and its parent company guarantor.

In addition, there will be:

• insurers to whom the concessionaire and its contractors will transfer certain risks; and

• subcontractors, to whom the D&C contractor and FM contractor will transfer certain risks and obligations.

So, the question of how to successfully allocate risk in a PPP transaction really applies at many levels, and the outcomes which the different parties are seeking to achieve are in many respects fundamentally different, such that what constitutes a successful allocation of risk for one would not necessarily be considered a successful outcome by the others.

Compare, for example, the interests of government, the concessionaire and the equity investors on the one hand, and the financiers on the other hand.

Each of government, the concessionaire and the equity investors are interested in delivering the project at the lowest overall cost and thereby achieving the best value for money outcome. Accordingly, it is generally in the interests of these parties to allocate risk in the most efficient manner possible, which will generally be to the party which is able to manage the risk for the least cost.

The debt financier, on the other hand, is predominantly interested in ensuring that its loan will be repaid, and that the risk of default under the financing documents is minimised. It is not particularly interested in its borrower (PPP company), taking on more risk in the pursuit of better value for money outcomes (and thereby a lower cost to government and/or a higher return to the equity investors), if this will increase the risk of PPP company falling into default on its loan repayments. It is for this reason that we do not see, on privately financed projects, the PPP company entering into an alliance contract with the D&C contractor. Rather, the financier will require that PPP company enter into a lump sum D&C contract which allocates most risks associated with the construction of the project to the D&C contractor and which requires the D&C contractor to pay sufficient liquidated damages to enable PPP Company to meet its debt service obligations in the event construction is not completed on time.

Similarly, whilst the interests of the D&C contractor, PPP company and the equity investors might generally be aligned when it comes time to negotiating the terms of the project contract with government, the same cannot be said when it comes time to negotiate the terms of the D&C contract (although as mentioned above, the financier will also have a significant influence over the terms of that document).

Accordingly, the answer to what constitutes the successful allocation of risk in a privately financed PPP will depend on who you ask. That said, it is in the interests of all parties to devise a risk allocation which:

• is consistent with market expectations, and thereby enable the transaction to proceed to financial close swiftly and minimises tender and deal closure costs;

• will survive the risk 'bumps' which will inevitably occur during the life of the project; and

• has within it sufficient flexibility to enable the parties to deal with external changes and events the effects of which cannot be

predicted with certainty at the time the deal is signed (such as possible changes to the public's service expectations over the life of the project).

In this regard, the 'centre piece' of any privately financed PPP, in terms of risk allocation, is the project contract between the government agency and PPP company. The main architect of this document is, of course, the government agency. Accordingly, the balance of this paper will generally consider the issue of how to successfully allocate risk and negotiate a project contract from the perspective of government.

4. DEVELOPING A RISK FRAMEWORK FOR THE PROJECT

4.1 Risk framework precedents

Whilst every project is different, there is nothing like market precedents as a starting point for the development of a risk framework which will meet the objectives mentioned above. For example, there is now a well established 'core' risk allocation for privately financed tollroad projects in Australia. That said, with each successive tollroad project the risk allocation has 'evolved' around the edges having regard to:

• lessons learned from previous projects—both tollroads and non–tollroads, in Australia and overseas;

• changes in general market conditions and the level of competition and market appetite for these projects;

• the unique characteristics of each project—for example with the Cross City Tunnel had some characteristics which were quite different to those associated with the M7 which achieved financial close just a few months afterwards and even the LCT which achieved financial close less than 12 months after the M7. This resulted in subtle differences in the risk allocation which the RTA put to the market in its tender documents for each project. A good example here is the additional provisions which were included in the M7 Project Deed for the future connection of new roads to the M7, and the possible future provision of public transport services (such as light rail or dedicated bus lanes) in the median between the M7 carriageways; and

• the public's desire for continuous improvement.

The benefits of following market precedents in terms of reducing tender and negotiation costs can also be seen on the North South Bypass Tunnel deal in Brisbane. The speed with which the Brisbane City Council is likely to close the NSBT deal—just 14.5 months after calling for expressions of interest—is a direct reflection of its decision not to 'reinvent' the risk allocation and commercial terms for a privately financed tollroad deal, but instead largely adopt the form of tender and contractual documentation most recently used by the RTA whilst at the same time picking up some of the latest thinking from the EastLink transaction as well as some fresh thinking to deal with project specific issues (such as the future Airport link) and lessons learned on the recent NSW tollroads.

Similarly, if you are looking at a hospital project, or a school, prison or stadium project, then there are plenty of good market precedents which you can draw on to develop a risk framework for your project. Indeed, it is these precedents which have informed the Partnerships Victoria Standard Commercial Principles and the 'generic' risk allocation tables which you can find in the PPP policy documents published by other governments.

One of the dangers, however, in using a 'checklist' method to risk allocation is that it may lead to a 'blinkered' approach to the identification of risks. As stated above, each project has its own unique set of risks and market conditions that must be dealt with. As such, the formulation of a risk framework must take into consideration the unique characteristics and risks of the project. Thus, although precedents and the risk allocation tables are useful in drawing on previous experiences, they should only be used as a starting point when developing a risk framework for the project.

Further, for some projects, there will not be a close precedent which government can draw on when developing a risk framework. A good example here is the RailCorp Rolling Stock PPP. On this deal, many of the risks are unique and it has been necessary to go back to first principles to identify all relevant risks and devise a risk allocation which will achieve all of the key objectives mentioned above and also deliver the best value for money outcome for NSW taxpayers. This has involved a variety of techniques to ensure all relevant risks are identified (such as brainstorming workshops, reviews of previous projects, interviews with internal and external stakeholders, site visits and the use of generic risk matrices and previous rail sector and rolling stock procurement contracts as checklists). A risk matrix was then developed which has informed the development of the project contract as well as various internal risk management plans to assist RailCorp to manage those risks which it will bear. Bidders have also been required to prepare risk management plans which

demonstrate how they will manage risks allocated to them and which are capable of interfacing with RailCorp's risk management plans.

4.2 Efficient risk allocation—principles vs practices

The risk allocation principles of the various PPP policies are easy to state but more difficult to implement. The objective of the policies is efficient/optimal risk allocation, that is that risks should be allocated to the party that is best able to manage the risk at the least cost.

Whilst the principle of efficient risk allocation appears to be generally agreed by both government and the private sector, the proper application of the principle to specific risks on various projects continues to be the subject of considerable negotiation. The reasons for this include the following:

Subjective Views
Each party comes to the transaction with its own subjective views as to:

- the respective abilities of the parties to manage various risks;
- the likelihood of certain risks occurring and their consequences; and
- the costs which the other may incur in managing risks.

These subjective views, even if reasonably and honestly held, often differ.

Complexities
Many risks are not wholly within the control of one particular party. For some risks the ability of a particular party to manage the risk, and the costs which it will incur in doing so, will depend to a large extent upon how the other party conducts itself. In these cases, risks need to be shared, and obligations or restrictions need to be imposed on the party that is not best able to manage the risk in order to assist the party responsible for managing the risk. There are often many ways in which such risk can be sliced, diced and allocated and hence considerable scope for debate and brinkmanship.

Difficult Risks
Similarly, for some risks (such as uninsurable force majeure events) neither party is particularly well placed to manage the risk. In a 2001 survey conducted by the Chamber of Commerce and Industry of Western Australia and the Institution of Engineers Australia on risk allocation in major West Australian construction projects, 35% of respondents said that risks which had been allocated to them were 'impossible to manage'. This figure rose to 67% of contractor respondents (as opposed to principals or consultants).[3]

Other Influences
The principles of efficient risk allocation do not operate in a vacuum—there are other important influences on risk allocation which are also at play. In a 1999 survey of participants in infrastructure projects conducted by the Victorian Department of Treasury and Finance, it was found that the three most influential factors on risk allocation were:

- commercial requirements (linking risk and return);
- bargaining power; and
- debt financiers' requirements.[4]

In the context of PPPs, the risk allocation underpinning the PSC and the dollar values attributed to retained and transferred risks can also have a bearing on the willingness of government to depart from its preferred risk allocation.

These influences dictate that, inevitably, risks will not always be allocated in accordance with the principles of efficient risk allocation. The reality is that sometimes risks will be allocated to the party least able to refuse the risk rather than the party best able to manage the risk. This is of course heightened at the time the government is maintaining maximum competitive tension, i.e. just before the announcement of preferred proponent (see section 5.2 below).

4.3 How can the challenge of risk allocation be better managed?

Measures which government and other PPP participants can take to better manage the challenge of risk allocation include the following:

Don't Lose Sight of the Basic Principles
Firstly, government agencies need to be careful, when drafting the contractual documentation on which bids will be based, not to lose sight of the principles of efficient risk allocation. There is often a strong temptation to start with an aggressive draft and see how the market responds before making the difficult calls on the difficult risks. The fact that government is often in a strong bargaining position at the start of the tender process exacerbates this temptation. One of the risks which government agencies run when they adopt such an approach is that bids will incorporate pricing that reflects the allocation of unmanageable risks to the private sector.

Price the Risk
Where a party considers the allocation of a particular risk to it offends the principles of efficient risk allocation it should be prepared to separately price the risk and advise the other party of the price. This would enable the other party to make an informed value for money assessment. Too often it seems that bidders are unwilling to separately

price government's preferred allocation of a particular risk, making it difficult for government to assess whether the bidder's preferred risk allocation does, in fact, represent a better value for money outcome.

More Precise Drafting
More precise drafting (i.e. avoidance of the 'catch–all') can often turn the objectionable into the acceptable, thereby reducing negotiating time and costs. This is particularly the case with the government tendency to include broad indemnities at the back end of the project agreement—potentially undoing the carefully negotiated risk allocation contained in the balance of the agreement, and introducing the unpriced unmanageable risk element.

Alternative Risk Transfer
Effective risk management requires smarter thinking and investigation of alternatives to what usually happens with delivery risk—loading it on the balance sheet of the D&C contractors, or chasing ephemeral insurance options in a market currently characterised by volatility. The usual approaches to risk allocation will also become historical if the proportionate liability legislation which was enacted by Australian governments as part of the tort law reform has the (possibly) unintended effect of allowing the judicial process to determine the allocation of risk after the event. So if a deal has been done to lay off a particular risk against a D&C contractor balance sheet, but a court later decides that the D&C contractor was only responsible for 10% of the crystallised risk, that leaves the carefully negotiated risk allocation in tatters, with the party suffering loss being required to pursue the other 90% against a third party with which it possibly has no contractual relationship. But what are these alternative risk mechanisms? The reinsurance market has been developing for some time the concept of catastrophe bonds, which allow parties wishing to lay off risk to access a much broader capital market than the reinsurance market alone. This will need to be the subject of much greater focus as there is an enormous pool of international capital which might be accessed via these alternative risk transfer mechanisms.

However, as previously stated, whilst the principle of efficient risk allocation appears to be generally agreed by both government and the private sector, the proper application of the principle to specific risks on various projects continues to be the subject of considerable negotiation. It is for this reason that an effective negotiation strategy must be implemented as many risks will be allocated based on the negotiation process.

5. DEVELOPING AN EFFECTIVE MARKET ENGAGEMENT AND NEGOTIATION STRATEGY

5.1 Effective market engagement

An important process challenge in negotiating a PPP contract is effective market engagement, i.e. ensuring bidders bid what government wants. It is in the interest of all parties, particularly government, that bidders have a clear understanding of government's objectives, requirements and priorities.

A complicating factor to effective market engagement in the Australian context is the tension between:

- a more frequent, informal and effective dialogue between the government agency and bidders; and
- the risk of statements made during such discussions giving rise to legal claims by unsuccessful bidders alleging unfairness or impropriety in the tender process.

It is clear from cases such as Cubic,[5] that informal discussions between the government agency and bidders involving unplanned (as opposed to planned) dialogue increases the risk of misleading and/or inappropriate statements being made (albeit perhaps unintentionally) which can subsequently give rise to claims and court proceedings which can adversely affect the procurement process and the project. It is clearly in the interests of both government and bidders that the need for effective dialogue between the parties during the bidding process is supported and balanced by appropriate levels of probity so as to avoid such situations and ensure the high levels of accountability and transparency which all parties (including taxpayers) are entitled to expect.

The practical steps which government can take to promote effective market engagement include the following:

Market Sounding
Government agencies should always engage in a market sounding process prior to EOI release to assess market interest and the likely level of competition.

Clear Articulation of Requirements
Government agencies should think long and hard about their objectives and requirements before calling for bids so that they can clearly articulate their requirements in the tender documents. Agreement should be reached between all internal government stakeholders before the tender documents are released. Priorities between competing objectives, such as

time, quality and cost, should be specified to the extent possible.

Feedback
Ensure there are opportunities for bidders to receive feedback, particularly on the technical aspects of their proposals, before final bids are to be submitted. Whilst there have only been limited opportunities for such feedback in the past, more recent projects, such as the RailCorp Rolling Stock PPP and the North South Bypass Tunnel project have seen numerous technical, commercial and financial workshops prior to submission for bids which enabled bidders to clarify government's requirements and seek input and feedback on key aspects of their proposals prior to their submission.

Similar processes were also adopted on the Eastlink project, the Victorian New Prisons Project and the New South Wales New Schools Project. Indeed on the latter project, the two bidders selected to submit fully documented BAFOs were provided with a summary of issues to assist them in improving their proposal. Each party was also advised that they could submit draft proposals prior to the submission of their BAFO.

These opportunities need to be properly planned and structured to ensure bidders are treated equally and the content of the feedback is properly thought through.

Disclosure of PSC
Disclose the raw PSC to the market to assist in quickly identifying any mismatches in expectations, unless special circumstances requires otherwise.

The implementation of such measures should also reduce the need for Best and Final Offer (BAFO) processes.

5.2 MAINTAINING COMPETITIVE TENSION TO PREVENT DEAL CREEP

Competitive tension and deal creep

Once the market has been effectively engaged, government must maintain competitive tension to prevent deal creep.

Competitive tension is the key to a successful outcome that delivers value for money to government. It follows that this competitive tension needs to be maintained for as long as possible. However, it is difficult to maintain competitive tension once a private partner has been publicly announced, and this becomes a problem when there are unresolved issues to be negotiated in the period between the announcement of the preferred private partner, and the execution of contracts. Experience shows that in some cases the private partner may attempt to introduce new issues late in the process when the government is in a weaker negotiating position and under pressure to conclude the deal.

There are a number of methods by which government can enhance the competitiveness of the process. One method is for government to select a second preferred bidder as a standby, following the announcement of the preferred proponent. This strategy was employed by the NSW government on the Long Bay Prison and Forensic Hospital project. Novacare was initially appointed as a 'reserve proponent' but was later elevated to preferred proponent when negotiations with the initial preferred bidder stalled.

Another method is to have a number of bidders develop their proposals, and provide full documentation, before final selections are made. This was the method selected for the recent procurement of the EastLink project in Melbourne. Two bidders submitted tenders for the project, both of which subsequently engaged in detailed negotiations and clarification discussions with the government over a period of several months before the project was ultimately awarded to ConnectEast in October 2004. In fact, both bidders were required to submit fully committed and signed project documentation at various stages of the bidding process, without knowing when the award would be made—thus maximising competitive tension throughout the process.

In a speech delivered at an address to the Committee for Economic Development in Australia (CEDA) in Melbourne the week following the award, Janet Holmes à Court, Bid Chairman of the successful consortium, acknowledged the tension maintained during the bid process as 'unbearable right to the end'. Certainly it was this tension that enabled the government to arrive at a comprehensive and competitive result, achieving clarity of outcome without weakening their bargaining position by making a commitment to either consortium prior to the award.

Bid costs

Of course, these methods do have the potential to increase the costs of bidding for a project, and despite the obvious advantages of an extended period of pre–award negotiations for the government party, the desire to maintain competitive tension must be weighed against the desire not to discourage private parties from bidding for projects. Thus, whilst this level of detail and documentation may be suitable for a multi billion dollar PPP

project like EastLink, it may not be suited to smaller and less costly projects. It is therefore critical that the scale and complexity of the proposed project be taken into account by the government when determining the most effective way to attain a competitive bid from a competitive market.

Not always appropriate

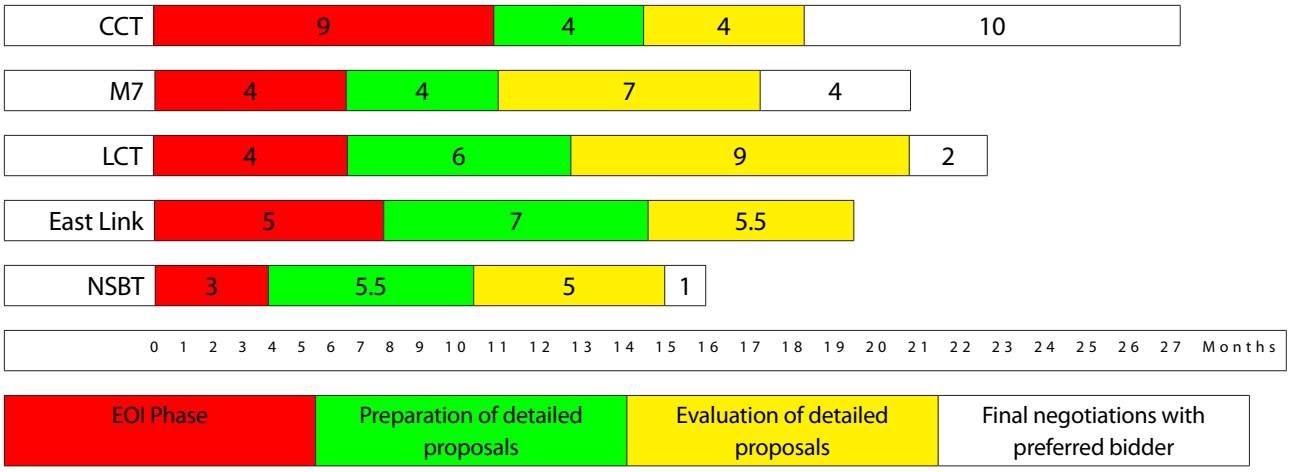
Also, it may not always be practicable or appropriate for government to advance the legal documentation with two or more bidders in a competitive environment. For example, if a clear stand–out winner is identified early in the evaluation process and it is not considered likely for the second–placed bidder to catch–up, even if it was to accept government's preferred risk allocation without qualification, then it may not be sensible to put the second–placed bidder to the expense of advancing its contractual documentation simply to create a competitive environment within which the contractual documentation with the first–placed bidder can be progressed.

Closure times

It should also be borne in mind that while tender costs for unsuccessful bidders may be higher under some procurement methods, a shorter process overall may actually reduce tender costs incurred by both government and private sector participants in the long run. Thus, as long as there is sufficient deal flow, and unsuccessful tenderers win their fair share of projects, all parties stand to benefit from a shorter bidding process.

Some early PPP projects experienced lengthy negotiation phases following the appointment of a single preferred bidder—in some cases, over 18 months. However, as demonstrated by the recent toll roads experience in Sydney and Melbourne, it is possible to develop quick, certain and effective processes that discourage deal creep.

The following diagram compares the length of the various stages of procurement, from the call for expression of interest (EOI Phase) up until deal close, of five of the largest and most recent Australian toll roads: the Cross City Tunnel (CCT), the Westlink M7 (M7) and the Lane Cove Tunnel (LCT) in Sydney, the EastLink project in Melbourne, and the North South Bypass Tunnel (NSBT) in Brisbane.



In the Cross City Tunnel project, the first in the latest generation of Sydney toll roads, the NSW Minister for Roads announced the Cross City Motorway consortium as the preferred proponent in February 2002, and negotiations were concluded by December 2002. This reasonably short negotiation period is even more impressive when it is considered that negotiations were conducted in tandem with a series of changes to the proposed project.

An even shorter period of negotiation was conducted during procurement of the $1.5 billion Westlink M7 project (formerly the Western Sydney Orbital). The WestLink Motorway Consortium was announced as the preferred proponent in October 2002, and negotiations were concluded in February 2003.

Similar processes were adopted in the recent Lane Cove Tunnel project, which led to the Vice President of the Australian Council for Infrastructure Development and the chairman of the successful Lane Cove Tunnel consortium, Mr Tony Shepherd, publicly praising the efforts of the RTA in tackling 'deal creep'.

On EastLink, proposals were received by the State in late April 2004 and contract close was achieved on 14 October 2004, resulting in a process comprising evaluation, negotiation and award lasting just over 6 months in total, with financial close a little over a month later.

It is in [a] relationship of trust that risk can be effectively allocated and managed, that the government will achieve value for money and ultimately that the project will be delivered.

The NSBT process is the latest example of a streamlined Australian toll road procurement process. On 27 April 2006, the Brisbane Council announced the appointment of a sole preferred proponent after negotiating and finalising all commercial terms in a competitive evaluation process which concluded just 13.5 months after the initial call for expressions of interest. Contractual close is expected to occur this month.

5.3 Negotiation strategies

The key to successfully negotiating a PPP contract is the development of sound negotiating strategies.

The first step to a successful negotiation is thorough preparation. This preparation should begin during the tender documentation preparation phase. The more issues that are appropriately covered in the tender documentation means fewer items will be subject to the time consuming and costly negotiations after bids have been received. The tender documentation needs to clearly and precisely set out government's requirements and preferred risk allocation, which should be set having regard to the risk allocation principles discussed above. The thinking which influenced government's preferred risk allocation should be recorded for later reference and, where appropriate, communicated to bidders.

On the private sector side, bidding consortia should seek to present a unified position. Bidders sometimes seek to distance themselves from risk allocation changes proposed by their financiers or contractors. This practice should be avoided as it only serves to complicate the negotiations from the government's perspective and raise questions about the ability of the consortium to effectively do a deal as between its members. A bidder that is able to effectively manage its internal negotiations and present a unified position is a much more attractive proposition to government than one that can't.

Once bids are received, the parties should set out isolating the issues which are not agreed from those which are. Each party should be encouraged to explain not only its position, but the objectives which it is seeking to achieve by adopting that position. This will facilitate the identification of potential solutions which satisfy the objectives of all parties.

Closing the gaps to produce a deal requires momentum. Try to take tackle the smaller issue first and build a relationship of trust. Once momentum has been generated, try to maintain controlled momentum as you progressively work through the issues. If you hit an impasse, move on to the next issue and come back to the more difficult issues later.

As you move towards the end game, you need to create and work to deadlines. There is nothing like a credible deadline to bring negotiations to a close. Also, as you reach the end game, try to make the other side feel good about the deal. If you think you have 'won', act graciously. Contractual close is just the start of a long term relationship in which trust and respect will be crucial.

Unfortunately some contractual negotiations become bogged down in an atmosphere of distrust where points are not made or conceded on the basis of the commercial requirements of the parties but rather as part of some rather unwieldy game of chess where brinkmanship is more important to see who blinks first.

This inevitably leads to protracted negotiations and bad blood.

This style of negotiation can really only be constrained by the commercial parties themselves developing the necessary relationship of trust and making decisions on the hard issues (with advice no doubt from legal and commercial advisors) instead of relying on their advisors to run the negotiations and make the decisions. After all, it is the commercial parties who will be in the long term relationship and not the advisors, and they will need to begin developing the trust and problem solving mechanisms which will be required to see them through the long haul.

It is in this relationship of trust that risk can be effectively allocated and managed, that the government will achieve value for money and ultimately that the project will be delivered.

6. CONCLUSION

The foregoing discussion demonstrates that the first and most important step which governments must take on major infrastructure projects, in order to successfully allocate risk and achieve the best value for money outcome for taxpayers, is to thoroughly consider all of the delivery models under which government can engage with the private sector for the delivery and through–life support of the infrastructure, and the provision of the associated public services. It is vital that governments not approach PPPs from the blinkered perspective of the PFP model. Rather, they should evaluate each project and all possible private sector involvement on the merits of each particular case, in order to determine which member of the Australian PPP family will best allow government to achieve value for money in that instance. The second step to achieving value for money is to effectively allocate the risk. It is in the interests of all parties to devise a risk allocation which is consistent with market expectations, will survive risk 'bumps' and has sufficient flexibility to deal with external changes which will occur over the life of the project. Market precedents are a useful starting point for the development of a risk framework which will meet these objectives.

Further, sufficient competition must be maintained to ensure that those risks which the government is seeking to transfer are priced by the private sector within a competitive environment so as to deliver the best value for money outcome for taxpayers. This can be achieved by effectively engaging the market and maintaining competitive tension to prevent deal creep. However, although strategies can be utilised during the bid process to maintain this competitive tension, for example having a number of bidders develop their proposals and provide full documentation before a final selection is made, this must be weighed against the desire not to discourage private parties from bidding for projects. In addition, it is important that a relationship of trust be developed during the contractual negotiation process to see the parties through the life of the project.

REFERENCES

1 Although the NSW and Commonwealth Governments are presently exploring the use of the PFPs to accelerate the delivery of future upgrades.

2 With less money at risk, the 'risk premium' changed by the private sector will also be reduced, resulting in a lower cost to government.

3 Institution of Engineers, Australia and Chamber of Commerce and Industry of Western Australia Effective Risk Allocation in major projects: Rhetoric or reality? 2001 http://www.ieaust.org.au/policy/publications_by_year3.html

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