

PUBLIC PRIVATE PARTNERSHIPS – A SOLUTION WORTH PURSUING DESPITE THEIR COMPLEXITY

DRAGI KOZAROVSKI*

I INTRODUCTION

Despite any inference which may be drawn from the name, public private partnerships ('PPPs') are not legal partnerships. They are long-term risk allocated agreements entered into by government with the private sector, and regulated by contract. These contracts outline the roles and responsibilities of each of the parties over the concession term.

Over the next decade, the New South Wales ('NSW') Government has planned an average annual increase of 4.6 per cent in infrastructure funding, totalling more than \$110 billion, in order to meet the future challenges facing the State of NSW.¹ Throughout this period, PPPs are expected to contribute to around 10 to 15 per cent of the total NSW infrastructure spend.

The aim of the PPP procurement model is to deliver improved services and better value for money through appropriate risk transfer, encouraging innovation, greater asset utilisation and an integrated whole of life management approach. For these reasons, governments all over the world have turned to the innovative PPP model to finance public infrastructure.

This article will examine the way PPPs are organised and formed with a focus on the types of issues that face government parties.

II PPP ARRANGEMENTS

In NSW, a privately financed project ('PFP') is an arrangement which refers to a specific form of PPP, involving the creation of an asset through private sector financing and ownership control over a long term concession period. The NSW

* Senior Financial Analyst in New South Wales Treasury's Private Projects Branch. The assistance of Matthew Dunn in preparing this article is gratefully acknowledged. The views expressed are those of the author and not necessarily those of the New South Wales Government. Further details on New South Wales' private financing policy and guidelines are available on the Working with Government website: <<http://www.treasury.nsw.gov.au/www/>> at 16 October 2006.

1 New South Wales Treasury, *State Infrastructure Strategy: 2006–07 to 2015–16* (2006) <http://www.treasury.nsw.gov.au/sis/sis_final.pdf> at 16 October 2006.

Government's 2001 *Working with Government Guidelines* holds that the principal features of a PFP are:

a service normally provided to the public by government involving the creation of an asset through private sector financing and ownership control [and] a contribution by government through land, capital works, risk sharing, revenue diversion or other supporting mechanisms.²

The PPP model is essentially a form of non-recourse project financing where the cash flows of a single asset (the project) provide the main source of return on equity and debt repayment.³ In such a model, each project is treated as an organisational entity.

Traditionally, all general government expenditure is funded out of the Consolidated Revenue Fund.⁴ Government agencies looking to supplement their budget allocation with additional borrowed funds are constrained in that they may only obtain financial accommodation from the NSW Treasury Corporation, and this normally requires revenue that can be pledged towards its repayment.⁵

Value for money is achieved through a competitive tender process for the concession of a monopoly right. This is a form of ex ante competition, in that it is competition for the market as opposed to competition in the market. The tender process for a PPP tends to be costly for both the government and the private bidders. Bid costs as high as \$10 million have been claimed for a typical toll road. A large proportion of bid costs can be attributed to legal fees, with estimates as high as 40 per cent. The legal structure and complexity is, therefore, an important consideration in trying to reduce bid costs.

The typical PPP structure comprises a complex web of relationships between several parties. In order to facilitate the infrastructure investment, a 'special purpose vehicle' ('SPV'), a separate legal entity, is created for each specific project. This private entity contracts directly with government and undertakes the activity defined in the concession contract between the SPV and its client, the public procurer. The SPV is responsible for meeting its contractual obligations, including:

- producing and delivering the defined services to the required standard;
- designing and building or upgrading the infrastructure asset;
- raising funds for the capital needs of the project;
- focusing on government's objectives, while responding in cooperation with the public procurer to variation in the project environment; and

2 New South Wales Government, *Working with Government: Guidelines for Privately Financed Projects* (2001) New South Wales Treasury 3 <<http://www.treasury.nsw.gov.au/www/pdf/wwwguidelines.pdf>> at 16 October 2006. See also *Public Authorities (Financial Arrangements) Act 1987* (NSW) s 5A.

3 Non-recourse finance means a loan where the repayment is from the profits of the project the loan is funding and not from other assets of the borrower.

4 *Constitution Act 1902* (NSW) s 39. This provision essentially requires that all Government revenues, unless the Treasurer makes an express agreement to the contrary, are to be gathered in one place for the annual appropriation by Parliament.

5 *Public Authorities (Financial Arrangements) Act 1987* (NSW) s 10. For exceptions, see also *Public Authorities (Financial Arrangements) Act 1987* (NSW) ss 9, 10(3).

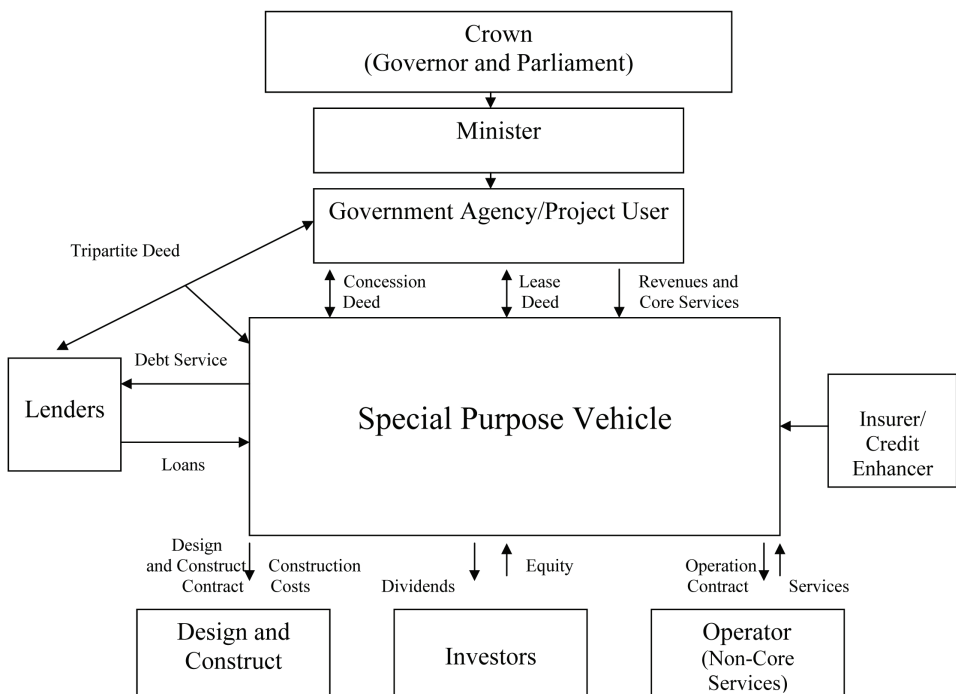
- sometimes, returning the assets in a specified condition at the end of the contract.

In order to manage the risk of the project, the SPV enters into a number of additional contracts typically with a constructor and a facilities maintainer/operator. These contracts tend to be back-to-back agreements reflecting the obligations of the primary concession agreement between the SPV and the government agency.

Other parties to the PPP relationship include:

- the public sector procurer;
- the sponsors, who as equity investors normally create a SPV through which they contract with the public procurer, and the principal subcontractors;
- financiers;
- subcontractors; and
- advisers, insurers, rating agencies, underwriters etc.

Figure 1: Typical PPP Arrangement



There are two primary agreements between the contracting government agency and the SPV, one being a lease over the land, and the other being a project deed outlining the obligations and services to be provided by each of the parties.

The lease is a critical agreement granting a leasehold estate to the private sector for a specified period. This transfer enables the private sector to claim any tax deductions in accordance with the *Income Tax Assessment Act 1936* (Cth) ('*ITAA*'). However, the *ITAA* contains specific anti-avoidance provisions that can be particularly problematic for PPPs, in particular Division 16D and section 51AD. The effect of these provisions, if triggered, is to deny the owner of an asset certain tax deductions, reducing the income from the project.

Section 51AD treats the owners of the property as not having used it for the purpose of producing assessable income or carrying on a business for that purpose. As a consequence, the owner (the SPV) is denied deductions attributable to the ownership of the property, including depreciation, repairs and interest on borrowings. If section 51AD applies to a privately financed project, it is *tax disadvantaged* compared with a conventional public sector delivery option. It is, therefore, virtually impossible for the Government to obtain value for money from a privately financed project subject to section 51AD. The Government has managed this risk by requiring a binding tax ruling with the Australian Tax Office as a condition precedent to financial close.

Similarly, Division 16D of the *ITAA* treats certain non-leveraged finance leases and similar arrangements as loan arrangements. The Division applies to arrangements where the owner transfers substantially all the risks and benefits associated with the ownership of the property to the lessee. Where a Division 16D arrangement is found to exist, deductions will be denied if the use of the property or its effective control is in the hands of a government or tax-exempt government authority.

III PARTIES TO PPP ARRANGEMENTS

A The Public Sector

In NSW, there are three different classes of State Government authorities involved in PPPs. The first type is the general government agency. The general government sector provides public services such as health, education, justice and police, and is funded in the main either directly or indirectly by taxation. Within this general government sector, there are budget dependent and non-budget dependent agencies, with budget dependant agencies receiving their funds via an appropriation from the Consolidated Revenue Fund.

The second type of government authority is a Public Trading Enterprise ('PTE'). PTEs charge for the services they provide, typically by a 'user-pays' arrangement, giving them a broadly commercial character.

The State Owned Corporation ('SOC') is the third type of government agency. SOCs are agencies (mostly PTEs) which have been established with the governance structure mirroring, to the best extent possible, that of a publicly listed company. NSW SOCs are listed in Schedule 5 of the *State Owned Corporations Act 1989* (NSW).

Generally, it is the individual government agency who initiates the need for the investment to take place, and, depending on the government contracting agency, on whether a Minister executes the agreements or if an agency Chief Executive Officer may.

In a PPP, the government retains a permanent interest in the delivery of an asset and/or service. The government is ultimately responsible for determining the project objectives, selecting the private party who will be its agent, seeing that the delivered services are in accordance with specified standards, and ensuring that the public interest is safeguarded. As a result, the public sector remains accountable for many aspects of a PPP, including:

- defining the business and the services required, and the public sector resources available to pay for them;
- specifying the priorities, targets and outputs;
- executing a carefully planned procurement process (which includes the selection of the agent);
- determining the performance regime by setting and monitoring safety, quality and performance standards for those services;
- governing the contract by enforcing those standards and taking action if they are not delivered;
- managing community expectations;
- providing the enabling environment; and
- reacting, in cooperation with the private sector, to changes in the project environment while remaining focused on predefined objectives.⁶

B The Financiers

The financing of a PPP utilises a combination of debt and equity, with the debt-equity ratio being highly dependent on the revenue risks inherent in the project. Arrangements for financing the SPV are usually entered into at the same time as the project agreements are executed between the government agency and private sector and are normally non-recourse. Social infrastructure projects tend to have a high debt-equity ratio, with the government making the unitary payment to the SPV on the basis of an availability charge. In contrast, the revenue of economic infrastructure projects is reliant on third party usage. Given the uncertainty associated with the revenue stream, these projects normally have a much lower debt-equity ratio.

The PPP structure is useful for facilitating capital intensive infrastructure transactions due to project risks being allocated amongst the parties who are best equipped to manage them. Financiers have incentives to make sure that services are supplied on time and to the required standard, as financiers are fully aware of

6 Darrin Grimsey and Mervyn K Lewis, *Public Private Partnerships: The Worldwide Revolution in Infrastructure Provision and Project Finance* (2004) 112.

the positively correlated relationship between the repayment of their funds and future cash flows generated from the operation of the project.

With the financier being fully aware of the possibility of project failure, they insist upon, and are granted, first 'step-in' rights in the event of operator default, which has provided financiers with the opportunity to find a replacement operator.

C Subcontractors

Typically, the SPV will enter into various subcontracts including:

- a contract with a constructor for design and construction of the asset; and
- a contract with an operator (facilities maintenance contract) for the ongoing operations of any non-core services that need to be provided, incorporating the whole of life maintenance for the facility.

The contract with the facilities maintenance provider is usually a back-to-back contract imposing the obligations of the SPV, under the concession agreement, on the operator, under the operator agreement. This contract includes the possibility of abatements for non-performance in accordance with the service specifications as prescribed in the concession agreement.

D Rating Agencies and Insurers

When projects are financed through the public issue of bonds, rating agencies are consulted to provide credit ratings for the entire project, in preparation for the open market bond issue. Insurers can mitigate the risk of the project, working to produce an insurance package that limits the risk of the project, a process which is an additional cost to the SPV. Recently, a new sub-sector of insurers covering the credit risk of debt issues has emerged. These 'monoline' insurers are involved in credit risk arbitrage, creating value for the project where the market would otherwise overestimate risk.⁷

IV CONTRACTING WITH GOVERNMENT

As Figure 1 depicts, a PPP project encompasses a web of contractual relationships, all combining to form the basis of the modern PPP. In recognising this, in conjunction with the diverse nature of the public sector, a potential private contracting party must consider the specific government authority it is contracting with. For example, the latter could be a general government agency, a PTE or a SOC. Each agency has its own unique legislative basis and prescribed means for contracting. Thus, when contracting with government, the fundamental questions that parties need to consider include:

- (a) Is the contracting party the State of NSW or an entity created by legislation with a legal personality separate from the Crown?

7 Ibid 114.

- (b) Does the person who will sign the project agreement for the government party have the requisite authority to bind the State?
- (c) Is the project agreement enforceable against the Crown?
- (d) What can reasonably be expected of government in the exercise of its wide statutory powers and discretion which may impact on the project?

The issue of whether or not a public agency entering into a contract represents the Crown has been a topic of conjecture for past PPP projects in NSW. Private sector parties have felt that some government authorities enter into contracts in their own right, and not as a representative of the Crown. The Crown Solicitor's opinion is in direct conflict with this line of reasoning. As the aforementioned illustrates, entering into contractual relationships with the government involves a large amount of complexity, primarily as a result of the diverse nature of legislation prescribing differing means of contracting for different government authorities.

In light of this complexity, and as a means of overcoming this conjecture, the legislature has acted in order to facilitate PPP transactions. One obvious legislative avenue is to introduce an enabling bill to regulate each transaction. The first NSW PPP, the Sydney Harbour Tunnel, negated the complexity of contracting with government by enacting the *Sydney Harbour Tunnel (Private Joint Venture) Act 1987* (NSW), which as the long title suggests, was created as 'an Act to facilitate the construction, maintenance and operation of the Sydney Harbour Tunnel'. The most significant provision for current discussion is section 3 of the Act, which is a practical response in light of the complexities associated with contracting with government in 1987. Section 3 states that '[t]his Act binds the Crown in right of New South Wales and, insofar as the legislative power of Parliament permits, the Crown in all its other capacities'.

However, entering into arrangements through legislation increases the political risk of a project, with parliamentary debate having the potential to be time consuming. Furthermore, the project may be stopped or further stalled in the case of Parliament instigating a public inquiry into it. For example, during the tender process for the construction of the Eastern Distributor Road, a public inquiry into the project delayed its execution.

Aside from individual legislation, another approach and the chief method used in NSW, is to delegate Parliament's authority to the Treasurer. Using this authority, the Treasurer can declare a 'joint financing arrangement', where the authorities entering into agreements do not fall within the definition of a joint financing arrangement under the *PAFAA*.⁸ This enables a government to commit and incur expenditure beyond one year, a period which is over and beyond that usually specified in the annual Appropriation Act.

The *PAFAA* is a key piece of legislation for PPP arrangements. Importantly, it is only under the *PAFAA* that an authority can enter into a joint financing arrangement.

8 *Public Authorities (Financial Arrangements) Act 1987* (NSW) s 5A(d).

Sections 5A, 20(1), 20(5), 20(6), and in certain instances Part 2C of the *PAFAA*, are the core legislative bases of modern PPPs in NSW. These provisions have had the effect of reducing the complexity of contracting with government, creating an environment which aids parties in identifying the legislative authority for entering into these long-term contractual arrangements.

Although the Treasury's policy is not to offer guarantees as a general starting position, providing a guarantee is a possibility and is assessed on value for money grounds. The Crown is often called upon to provide a guarantee of the contracting agency's performance and obligations under the project deed to the private parties. The guarantee is given by the Treasurer in accordance with Part 2C of the *PAFAA*. Sections 22A, 22AA and 22B provide the option for the Treasurer to grant a State guarantee to a private sector party for the performance and obligations of the authority under the project deed.

In the case of Sydney Water entering into a 'build, own, operate' contract, for example, on its water treatment plants, the private sector argued for a guarantee in respect of the ongoing credit worthiness and payment from the corporation. They recognised that there was a real risk that the corporation may be privatised in the future, leading the private sector to have a contract with an organisation with an overall lower credit rating than Sydney Water had when it signed the contract. To manage this risk, the Government agreed to the requests of the private party and granted a guarantee. The guarantee provides that in the event of Sydney Water's credit rating falling below an agreed rate, the Government will make up the difference of the increase in credit risk.

A similar circumstance was encountered for the Olympic Games facilities, where the contracting authority was the Olympic Coordination Authority ('OCA') which had a finite life. The Government issued a guarantee, which provided that in the event of the authority failing to exist, the Government would be responsible for any continuing obligations existing under the contracts between OCA and private parties. The Sydney Olympic Park Authority was created and took responsibility for the ongoing State obligations under the contracts, with the issued guarantee not needing to be called on.

The United Kingdom ('UK') has developed a standard contract for private finance initiatives pursued in the UK. NSW has been conscious of global developments in the PPP market, and has tailored its contracts and commercial principles for social infrastructure projects to the UK model. This has given increased certainty to transactions, in particular to government, as it is aware that the product going out to the market has already been accepted by others and is able to be properly priced by the market.

V THE ROLE OF GUIDELINES IN PROVIDING DIFFERENT PPPs

Prior to the release of the current *Working with Government: Guidelines for Privately Financed Projects* in November 2001, projects entered into were predominantly economic infrastructure projects, including toll roads, water

treatment plants, and the Olympic Games facilities. Since the release of the Guidelines, NSW has experienced a number of social infrastructure projects.

NSW currently has a number of social infrastructure projects being delivered under the PPP model including, the redevelopment of the Newcastle Mater Hospital, Long Bay Prison and Forensic Hospitals, and the New Schools and New Schools 2 projects. The replacement of Railcorp's rolling stock, Bonnyrigg Social Housing redevelopment, the redevelopment of the Orange Hospital, and the redevelopment of the Royal North Shore Hospital projects are currently in the market.

To date, PPPs have delivered value for money on each of the transactions. Government has been able to effectively and efficiently pass on the cost risks associated with the delivery of an asset and whole of life maintenance over the concession term. It has been assessed that for the New Schools and New Schools 2 projects, the Government has managed to obtain savings in the order of 7 per cent and 23 per cent, respectively, when compared to the Public Sector Comparator.⁹ Importantly, the projects thus far have been able to be delivered on time and on budget to taxpayers.

As one can appreciate, contracts over a 25 to 30 year term are subject to an inevitable amount of uncertainty since not all future events can be foreseen. Unpredictable events such as changes in government, adverse changes in law, default under the concession deed and force majeure events add to the uncertainty. In addition, there is the very real threat that the public authority, which the private sector has contracted with, may cease to exist. These issues allude to additional stress factors confronting the parties to a PPP, which all need to be mitigated to the best extent possible, under the concession contract.

The NSW Government is currently developing a commercial principles framework, based on recent experiences, that social infrastructure project agreements will be based on. This will hopefully lead to lower bid costs for future projects. The strength and resilience of PPP projects rest with the various arrangements forming the basis of a PPP. This not only includes the main concession agreement between the government authority and the SPV, but also all of the subsidiary contracts entered into by the SPV, rendering the back-to-back risks a common complication for these projects.

VI CONCLUSION

In theory, as well as in practice, PPPs have led to improved risk management, an improved alignment of risk between the private and public sectors, and projects being delivered on time and on budget without compromising any accountability for providing services. In the UK, Her Majesty's Treasury has shown 88 per cent of PFI projects were delivered on time compared with only 30

9 New South Wales Auditor-General, *Performance Audit: The New Schools Privately Financed Project* (2006) <http://www.audit.nsw.gov.au/publications/reports/performance/2006/schools_ppp/Schools_ppp_march2006.pdf> at 16 October 2006.

per cent of conventionally procured projects.¹⁰ In NSW, PPPs have delivered savings ranging from 7 per cent to 23 per cent for the new schools projects and have been delivered on time. The improved services and savings achieved through the PPP model demonstrate that it is worth pursuing, despite the increased transaction costs and complexity in comparison to traditionally delivered projects.

10 Her Majesty's Treasury (UK Government), *PFI: Meeting the Investment Challenge* (2003) <http://www.hm-treasury.gov.uk/media/648B2/PFI_604.pdf> at 16 October 2006.