FRONTIERS IN INFRASTRUCTURE CONFERENCE

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INTRODUCTION

This morning I will review the substantial contribution PPPs have made to Australia's economic development over the past 20 years. I will then look at the very real question as to whether PPPs can continue to contribute in the current turmoil in financial markets. Lastly, I will give my views on what government might do to encourage and facilitate private sector investment in infrastructure particularly in the current environment. In this case I am referring to those Greenfield projects which are largely funded by the private sector.

CONTRIBUTION OF PPPs

It's difficult to get entirely accurate data on the value of PPP investment over the past 20 years. Infrastructure Partnerships Australia estimates that some $60bn has been invested by the private sector over this period.

Although the greater majority of this investment has been in toll roads, there has been considerable investment also in power generation, water treatment, court and prison facilities, public and defence housing, schools, hospitals, property and public transport.

ECONOMIC IMPACT

The economic impact of this investment has been significant both directly and indirectly.

In a direct sense it represents some $60bn of investment which would not have been made or which would have been delayed if paid for from the public purse.

An Ernst & Young study of the Sydney toll roads network found they are delivering an economic benefit of $22.7b which is 15% higher than the cumulative original estimates for these projects.

The other direct economic benefit is that despite the mythical difference in the cost of capital between the private and public sectors, surveys in the UK and here have demonstrated that the private sector can generally deliver and operate infrastructure cheaper than the public sector. I emphasise 'generally' as there have been some very successful traditional deliveries.

A study by The Allen Consulting Group and the University of Melbourne for Infrastructure Partnerships Australia of 21 PPP projects and 33 traditional government projects found that:

- PPPs were completed 3.4% ahead of time on average and traditional projects were completed 23.5% behind time on average.
- On a contracted $4.9b of PPP projects the cost over-run was only $58m. For $4.5b of traditional projects, the cost over-run was $673m.

Why is this so? Will Rogers, the American humorist, summed it up very nicely many years ago when he said …

If you want to get rid of traffic congestion
get the government to build all the cars
and the private sector to build all the roads.

The message is simple. Governments are generally not as efficient in the operational environment. From years of operating in both sectors, I believe government processes and the absence of bottom line pressure are the biggest differences between the two sectors.

Under the evolved PPP model, where greater emphasis is placed on the owner/operator, the focus is on optimising the long term returns while satisfying the increasing, and appropriate, government requirements in terms of service quality.

The indirect benefits of PPPs are also very significant. Firstly, the use of PPPs has broken the Public Sector's monopoly in the provision and operation of infrastructure in Australia. Like all monopolies, both public and private, the public sector was exhibiting all the signs of inefficiency and lack of competitiveness when micro and macro economic reform was introduced to Australia in the 1980s. These were vital reforms which have served Australia well in a globalised economy.

Governments now have competitive benchmarks for delivery and operation of infrastructure. Although the public sector monopoly still exists in big slabs of our economy the monopoly is now more likely to contract than expand.

PPPs have demonstrated effective risk transfer to the private sector. One of the great myths is that the public sector can do it cheaper because it has a lower cost of funds. Treasury's borrow at the "risk free" rate but we know these projects are anything but risk free. The difference between the Treasury risk free rate and the private sector weighted cost of capital for a PPP is the value of the risk. Governments can talk about "risk free" because when they make a mistake on a project they can raise taxes or defer expenditure elsewhere. We in the private sector get whipped. I will come back on government debt which I think could have a role.

If you do not believe the risks are real and effectively transferred, ask the investors in the :

- Perisher Ski Tube,
- Cross City and Lane Cove Tunnels, and
- The Airport Rail Links in Sydney and Brisbane

The other indirect benefit of PPPs is that it has lifted the standard of government procurement. Although PPPs are expensive to bid and to contract, the non-recourse finance which is traditionally used, the single purpose nature of the project vehicles and the tight terms of the Concession Deed mean that there is enormous preparation up front. Risk assessment and allocation are thorough and planning and programming are essential. We can't be sure of the cross-fertilisation back to traditional government procurement but my guess is that it has had a significant impact.

PPPs IN ROCKY FINANCIAL MARKETS

We have entered a period of instability and loss of confidence in financial markets. We have had a debt binge where risk was priced too cheaply and returns on equity reached unrealistically low levels. We are going through a painful correction and like most corrections there has been overreaction and the good have been lumped in with the bad. We have no real idea when markets will start to realistically value risks and assets or when all the bad stuff has been written off or absorbed and reasonable liquidity returns to markets.

Fundamentally, Australia is still in pretty good shape. Strong terms of trade, full employment and most of the Top 200 companies have strong balance sheets and good management. Our trading banks (which are also a monopoly) are in pretty good shape. WA and Queensland are booming.

Is there a continuing appetite for investment in PPPs? The evidence is positive. BrisConnect may be the last publicly floated SPV for some time but although the unit price is down we cannot ignore the fact that this huge $4.8b project has been fully funded despite the markets.

The Royal North Shore Hospital which is worth over $1bn is being competitively bid by major corporations which have the funding. In my own company, I know that TSIF, the Fund we manage, has no difficulty in finding partners interested in co-investing in the development of projects such as wind farms.

Why is this so? Getting beyond the headlines, infrastructure, whether economic or social, makes good investment sense. The services are generally "essential". The revenue streams are generally linked to inflation and are very long term. Infrastructure is still a great asset to match the long term obligations of a super fund.

There is money available. Hundreds of millions continue to be put into super every year in Australia. Hundreds of billions go into global pension funds. This money must find a reliable and safe home.

The big difference going forward, and for the foreseeable future, is that many of the vehicles will be unlisted. Why expose yourself to the current vagaries of the listed market?

From the debt perspective, we can expect the banks to become more conservative and more expensive. This will not kill the deals and probably means a return to more realistic pricing and risk allocation. Capacity will also be an issue.

ENCOURAGING PPPs

What can government do to encourage PPPs in this environment? In my view Government facilitation and encouragement falls into a number of categories:

1. Bid costs and time
2. Risk allocation
3. Financial support and
4. a true long term partnership

The cost of major PPP bids is getting out of hand when two or three pre qualified bidders spend $35m each for a bid. The losing bids (i.e. $35m to $70m) go into the waste paper basket or should I say the skip given the size of the bid submissions. I will come back to this issue with a suggestion as to how to mitigate it. The PPP bidding process adds considerably to the time it takes to get into construction. Two years is not unusual.

Governments have enjoyed the benefits of the remarkably favourable debt and equity markets over the past 10 years in terms of both price and terms and conditions. The risk allocation on many PPPs has shifted too far in favour of government. On issues such as existing but unidentified contamination on government-owned sites, government planning and other approvals, change of law, ownership of the construction float, facilitation, network enhancements and future upside sharing, the pendulum has swung too far towards government.

These are not deal stoppers but they do impact on market response and they do add to the cost of projects.

As funding gets more difficult and expensive, there is no reason why government cannot make a contribution to assist projects which are struggling to be commercial or, for policy reasons, to reduce the toll or charge. The government's contribution can be in the form of :

- a grant, either general or for specific works (the Queensland government made a substantial contribution to the Airport Link Project);
- as a loan to the project vehicle;
- or even equity in the project vehicle.

However, the equity solution is not recommended as the government ends up in a significant conflict of interest being the host authority and part owner.

The loan option is interesting. Governments can borrow more cheaply and longer than the private sector but if the private sector is taking the first tranche of risk through equity and some of the second tranche of risk through debt, there is no philosophical or practical reason for the government not to lend to a project taking advantage of its cheaper and longer term debt. Of course, I cannot have it both ways and the government should charge an appropriate premium for risk. In this way we get the best of both worlds. Private sector investment means we have true risk transfer to the private sector. The inclusion of a tranche of government debt reduces funding costs without the inefficiency of public sector delivery. A 25 year CPI linked government bond would be a welcome addition to this market. A real yield of 2.0 to 2.5% is possible in this market. In the Queensland Schools PPP the State is providing the debt.

The “partnership” part of the term PPP is often overlooked in Australia. The “winner takes all” approach does not encourage positive long term relationships. It’s at odds with modern contracting also which has more emphasis on all parties achieving their goals for the common good. PPPs need to provide greater flexibility for both parties to cover future seen or unseen events.

There are many current and recent examples of major variations on PPP projects including the Exhibition Street extension, the Calder Interchange and the Westgate and Monash widening on City Link. The widening of the M2 and the Bridge on the M5 in Sydney are examples also.

A NEW MODEL

Governments could encourage and facilitate PPPs by adopting an evolved model which helps solve the problems of bid costs, risk allocation, availability of finance and long term flexibility. Greater emphasis should be placed on the “Partnership” aspect of PPPs.

This new model would embrace the concepts of modern alliancing contracts with pain share and gain share and attainment of shared goals.

The owner/operator could be selected in a competitive process based on returns, expertise, operating model, design and compliance. The winner could then compete the construction and the debt, transparently to Government, with the results passed through to the project.

In this way, we would save having two or three bidders all trying to raise debt for the same project in a difficult market and all producing complete design and construction bids. It would reduce the time and cost of bidding for both the private and the public sectors. It would also lift the level of competition in finance and construction. In debt provision this would help solve current problems with maintaining long validity periods on debt.

A government contribution by grant or loan will not only improve project economics but will also boost the confidence of the private sector as a sign of government support. It enhances the “partnership” concept.

Alliance principles could then be incorporated in the concession itself. The risk allocation would be more properly balanced and provision would be made for future variations.

The principles and method of valuing variations would be agreed upfront. Recognition would be given to the fact that the situation will inevitably change for the government and the concessionaire over the long life of the concession and flexibility would thus be built into the concession.

It would open the construction field to more bidders including foreign companies which ……

The government's role as a facilitator should be enhanced. Until you have dealt with government on a major project, you don't realise that in many cases you are not dealing with a monolithic structure, but rather a series of warring tribes. The use of a Co-ordinator General in some States has been an effective means of co-ordination across the many agencies involved in major projects. When we did the Walsh Bay Project, we would not have got the project up without the Head of Premier's effectively fulfilling the Co-ordinator General role. The government needs also to take the lead in publicly promoting PPP projects. Political leadership in Victoria and Queensland is a great incentive to the private sector.

Governments should have clear public policy outcomes and reflect these in the concession whether it be lowest tolls, highest utilisation, quality of service or speed of throughput. As part of its facilitation role, government should work constructively to ensure a PPP project is a long term success.

We have been doing modern PPPs for 20 years. They have been a great success despite some problems along the way. Australia has one of the best PPP models in the world but it is time to refresh the model based on the lessons we have learnt and in response to current market conditions.