

LESSONS FROM THE UK

THE PRIVATE PUBLIC PARTNERSHIP (PPP) MODEL IS BACK ON THE DISCUSSION TABLE AS A MEANS OF BOOSTING NEW ZEALAND'S FLAGGING INFRASTRUCTURE. WE EXAMINE THE LESSONS LEARNT IN THE UK WHERE THIS MODEL HAS BEEN USED FOR 12 YEARS.

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For decades New Zealand has under-invested in infrastructure, leaving aspects of its transport and utilities networks in poor shape. And, pressure on its networks continues to grow.

For years, the possibility of using the private public partnership (PPP) model has been hotly debated as a means of developing both economic and social infrastructure, including roading, rail, airports, seaports, water and waste water, hospitals, prisons, schools, housing and other infrastructure facilities.

In February, the Government put this back on the agenda when Ministers Michael Cullen and Annette King announced that a steering committee was to be established to investigate the possibility of utilising a PPP to develop the Waterview Connection, a \$2 billion tunnel project which will complete the western ring route in Auckland.

In a paper, Peter Owles, a banking and finance partner in the Auckland office of Buddle Findlay, notes that there have even been several projects in New Zealand which fall within the definition of PPPs such as the Wellington and Hutt Valley water and waste water projects, Vector Arena in Auckland, Papakura District Council's franchising of its water facilities and several healthcare facilities. There have been other PPP projects planned which have not yet come to fruition, particularly in the roading and land transport arena such as the Penlink PPP Project.

In the past, PPPs earned a bad reputation in some parts of the world and not without reason, thanks to their cost overruns, delays and contractor insolvencies.

"The debate over whether PPPs are an appropriate structure for the development of roading infrastructure in New Zealand has been underway for some years now. There is, unfortunately, a reasonable degree of rhetoric in the debate, some of which is uninformed and misleading. Because of the nature of the projects – the provision of 'public' assets or services – the issues surrounding PPPs appear to be inherently political which tends not to assist in the clarity of the debate," observes Owles.

One way to assess the effectiveness of PPPs is to look at the experience in the UK, where PPPs have been used for about 12 years and to learn from the UK's experiences, especially in the social infrastructure space.

The UK PPP market now has more than 500 projects in operation and some are even nearing completion.

While initially the focus in the UK was on the construction phase – getting something built on time and for a reasonable sum of money – the emphasis has shifted. "A lot of projects have become operational now and there's much more focus now on how they are performing operationally," says Chris Elliott, head of infrastructure investing at Barclays Capital.

He says there is considerably more attention being given to making the operational phase work better, improving flexibility and aligning the interests of the public and private sector more closely.



The drive towards standardisation has taken a lot of the creativity out of the deals.

CHRIS ELLIOT – BARCLAYS CAPITAL

A number of reports have been released recently on the subject of operational Private Finance Initiative (PFI) projects and many of the findings have been surprisingly positive.

HM Treasury and Partnerships UK, a PPP body set up by the Government, found:

- public sector contract managers reported that 96 percent of projects were performing at least satisfactorily, 66 percent to a very good or good standard;
- 83 percent of contracts were described as always or almost always accurately specifying the services required; and
- 97 percent of public sector contract managers rated the relationship with their private sector counterpart as satisfactory or better, 72 percent rating it as good or very good.

Meanwhile, a survey by a local government project delivery specialist, 4ps (the PPP program), which questioned a select number of local authorities on sectors ranging from schools, housing to waste and street lighting, also discovered few concerns regarding the operational performance of contracts. Those surveyed reported that end-users' expectations had been largely met or exceeded.

KPMG and the Business Service Association, meanwhile, surveyed 93 private sector contract managers, covering about 800 PFI deals and its feedback was positive in many respects as well. Its report revealed that in more than 90 percent of cases, hard and soft services were being delivered to an acceptable standard, either always, or most of the time. It also found that the percentage of respondents reporting a "very good" performance had risen 59 percent, up 10 percent from the previous year's survey. Satisfaction in day-to-day relationships had also improved since the previous report, 24 percent of respondents considering them good and 56 percent very good.

Andy Carty, chief operating officer of Partnerships UK, was slightly taken aback by the findings. "One of the surprises when we did review the operational projects was how successful they were. That sounds a bit trite perhaps but I guess we, like a lot

of people, get a slightly jaundiced view in that we tend to only see the projects that are having problems."

However, Tim Stone, global head of infrastructure and projects at KPMG, does urge caution: "The data about what happened conventionally is shocking – but there's very little compared to the volume of data about PPP/PFI deals, so there's the danger of it being a sort of 'sound of one hand clapping' argument."

Tim Steadman, a construction partner at Clifford Chance, also provides a caveat: "One of the reasons why PFI can be shown to have delivered an improvement in the UK is that the UK had such a poor record of public procurement before PFI. Other countries that may have been better at it may realise a smaller relative advantage."

Nonetheless, Stone says there is a lot of evidence that suggests PFIs work quite well. "You'll never get perfection but, compared with what used to happen it's materially better."

LESSONS TO LEARN

In fact, the reports haven't been entirely glowing in their findings. And, there is certainly room for improvement. One issue that appears to have become more acute in the operational phase is the flexibility of contracts.

While 83 percent of contracts are described as always or almost always accurately specifying the services required, numerous small changes are required.

"That shouldn't be surprising," says Carty. "They were effectively set up to be long-term, fixed price deals."

According to the HM Treasury report, it is the variation mechanism within some older projects which is considered sub-optimal.

However, Tony Rucker, infrastructure and government partner and head of business services at KPMG, also blames the public sector approach.

"The clear call we had is that government needs to allow the public sector to be more flexible and the contracts themselves should be more flexible in allowing for what are minor, but often very simple and logical, changes to the contract," he says.

KPMG's report showed that 13 percent of respondents had more than 100 variations in their contracts. It's a lot, says Rocker, and some contracts, he points out, had many hundreds of variations.

"The problem is that the contracts are so rigid that if both sides want to change the frequency of when a cleaner cleans something, the only way to really do it legally is in the contract. There has to be a contract variation."

But Steadman denies there is a problem. "The contracts I've done have always contained very flexible provisions that allow the services to be varied."

He believes the issue is one rather of politics. "I think one of the misfortunes of PFI is that it has always coincided with a series of rapid changes in the underlying services which it is addressing."

Health care, for instance, is undergoing a complete revolution in favour of day treatment and away from long-stay hospitals, he notes, while education is in a state of perpetual policy turmoil in the UK.

"And all the spending departments don't have as much money as they would ideally like," he adds.

Nevertheless, a new standard contract was announced in March 2007 which attempts to address the issues of variations. Says Carty: "Version four of our standard contract concentrates much more on how to carry out variations, whereas variations in the early contracts were just a side issue and were dealt with after, quite frankly, in an unhelpful way."

While Carty says that a significant percentage of contracts have probably already been dealt with by way of what he calls "work arounds" – a way, that is, of working around the contract – he believes version four will pre-empt this. "What we're trying to do is make sure that new contracts have those work arounds in them from the start."

DIFFERENT STANDARDS

This raises the issue of whether standardisation is, in itself, problem free. And, not everyone is a big fans of it in the UK.

Barclays' Elliott argues that it prevents innovation. "The drive towards standardisation has taken a lot of the creativity out of the deals. I'm not a great fan of standardisation. I think the fact that we're in an industry that is effectively less than 12 years old and we're on to standardisation document number four seems to me rather contradictory.

"You've got to be a little bit braver and let the market and the public sector decide what they want. I think the whole system would improve if that degree of flexibility could be brought back so people could actually determine what it is they want."

David Webster, investment director at ABN AMRO Global Infrastructure Fund, says that it is a matter of how the standard document is used: "If used correctly, standardised contracts help expedite matters. But by used correctly I mean people understanding why standards have arisen the way they have and actually being able to vary the standards where appropriate.

"I think too many people blindly apply the standards or precedent without understanding whether it's appropriate for that transaction. When the standards first came out they were supposed to be deals not rules, now these are very much rules not deals."

WHEN LONG IS TOO LONG

Another issue that has been raised is the sheer length of contracts. UK Partnership's Carty plays this down: "It doesn't seem to be a big issue. I think people have used different ways of getting around that. Some people started to use technology tools; others tend to produce what we colloquially call an idiot's guide to the contract – a simplified version."

He believes it's more a matter of time.

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TONY ROCKER – KPMG

As the contracts mature, people know what the services are and, according to Carty, reference to the contract is very rare.

But Rocker disagrees. It was an issue in KPMG's 2005 report and he says it hasn't improved: "People are still referring to contracts every week which are thousands and thousands of pages long.

"There is a clear, clear need from both sides for something that is easy to read, that just encapsulates what the contract is meant to deliver."

BENCHMARKING BENCHMARKS

A lot of the UK's PPP contracts include a provision to benchmark or market test services after the first five years to ensure the agreed pricing is still relevant. This has raised considerable concern in both the public and private sector, largely because contracts have given little guidance as to how this should be handled.

The public sector was concerned that prices would be raised to unaffordable levels, putting departments in a position where they could only cut services. The private

sector, meanwhile, was worried they wouldn't be able to demonstrate what the actual cost was – a genuine issue given 24 percent of projects were reported as not being profitable, says KPMG's Rocker.

Both were concerned also about the prospect of a dispute. Says Rocker: "People were worried that benchmarking would pitch you right back into legalistic, opposing sides and would ruin all of that work they've built up over five years."

The worry has not been unfounded. In 2005, the Edinburgh Royal Infirmary PFI was at the centre of a court action when the initial benchmarking resulted in a huge price inflation. The matter was eventually settled.

While there's been fewer than 20 benchmarkings done to date and the jury's still out, Rocker says KPMG's report shows people are less worried. However, HM Treasury's report

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JOHN PILKINGTON – AMEY

details continued concerns. It says there is "a need to clarify the process, identify comparable data, and to ensure a value for money outcome".

It found that public sector managers wanted further support and guidance and had expressed concern at the cost implications for projects. Ultimately, the Government preferred market testing to benchmarking where soft services in contracts were concerned, emphasising the need for a transparent process.

ALL ABOUT SERVICE

Issues surrounding soft services are becoming more salient due to the fact that a substantial portion of the UK's projects coming to the market are now centred on public service delivery in the social infrastructure space, rather than large construction projects. It is in this area that the UK stands as an interesting example as it attempts to innovate and move beyond the traditional idea of a partnership.

John Pilkington, managing director of strategic development at Amey, a support services provider, says PFIs have seen a distinct shift in this regard.

Rather than the public sector providing services, its role,

says Pilkington, is to commission public services.

"The provision of public services will be done by a combination of private sector/public sector and the third sector, which is the voluntary organisations."

As part of this, Pilkington sees a change in focus from outputs to outcomes.

Outputs, he says, may relate to the building of a school, for example. On the other hand, "outcomes would be where the public sector is saying, what we want to do is have more intelligent kids, the outcome being related to the user".

Pilkington believes this shift is inevitable, and already in evidence in a number of deals. "It's unlikely there will be any partner who is not prepared to sign up to outcomes in the next three to five years.

If we're not prepared to sign up to that, then I don't think we'll survive. That's a big shift in thinking."

Two initiatives, the National Health Service's LIFT (Local Improvement Finance Trust) and Building Schools for the Future, exemplify this new approach.

Says Elliott: "Innovation in structures has come from LIFT and BSF, where proper partnerships between public and private sector are created from day one."

LIFT, launched in 2000, aimed to address the NHS's primary health care goal of providing 500 new one-stop centres and substantially improving 3,000 GP surgeries.

A new form of PPP, called a LiftCo, was established for the purpose whereby each LiftCo was a joint venture between a local primary care trust, a new delivery vehicle called Partnerships for Health (a joint venture between the Department of Health and Partnerships UK), and a PPP selected through an open competitive process. By early 2005, the establishment of LiftCos and the procurement for the projects was substantially complete, says Partnerships UK.

BSF, launched in 2003, aims to rebuild, refurbish or relocate every secondary school in the UK. It is also making use of a new delivery vehicle called Partnerships for Schools, the aim being for the private sector to engage with its local authority partner at the strategic level. Only three projects have been closed to date.

Says Pilkington: "If there has been any criticism it is that projects have been slow off the mark initially. But the reality is it was always going to have a measured start up.

"They're still learning what it is about – how they have to respond, build their cases if you like."

One sticking point is evaluation.

Strategic partnerships with an emphasis on outcomes are far more abstract concepts and are difficult to quantify or qualify. Says Elliott: "There is a desire to try to get more of a partnership culture. It always struggles on the evaluation at financial close. How do you evaluate the benefits of partnership 20 years down the road?"

He adds: "I think there's a will to change, but I don't think there's an enormous number of examples outside LIFT and BSF where new ideas are being applied in practice." ←