Partnerships Victoria

Guidance Material - March 2001

Overview

Victoria
The Place To Be

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Partnerships Victoria Guidance Material set includes:

- Practitioners' Guide
- Risk Allocation and Contractual Issues
- Public Sector Comparator *Technical Note*
- Overview

This document has been prepared by the Victorian Department of Treasury and Finance, with the assistance of Deutsche Bank.

Explanatory Note

This document is an Exposure Draft only and is being provided to interested parties for comment. A final version of this document will be published following the consultation process. The final version will be distributed to recipients of this draft and will also be available at www.vic.gov.au./treasury/treasury.html.

This Exposure Draft is one of an initial set of four documents, which make up the guidance materials for the implementation of the *Partnerships Victoria* policy.

This set includes:

- Public Sector Comparator - Technical note
- Practitioners' Guide
- Risk Allocation and Contractual Issues guide
- Overview

The Government is seeking comment from business and other interested parties on the content of this set of documents. Please forward your comments by Tuesday May 1, 2001 to:

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Treasurer's Foreword

Value for money through *Partnerships Victoria*

The public and private sectors have roles to play in building world-class infrastructure for Victoria.

Partnerships Victoria unites the public and private sectors to deliver improved services to the community. It is a blueprint for working in partnership to deliver innovative solutions, value for money and better services.

The provision of efficient and effective public infrastructure and related ancillary services through *Partnerships Victoria* will deliver benefits to all Victorians.

Its focus on the strategic use of public and private sector resources will create value through innovation and risk management.

The Bracks Government recognises the critical importance of consultation to good governance. Consistent with this approach, we have published these documents — Australia's first detailed guidance material for the identification, establishment and operation of public-private partnerships — for review before their finalisation. The set includes:

- *Overview*
- *Practitioners' Guide*
- *Risk Allocation and Contractual Issues*
- *Public Sector Comparator* – a technical note

I commend the *Partnerships Victoria* guidance material to you and look forward to delivering, through successful partnerships, the world-class public infrastructure and related services that Victoria needs.

John Brumby MP
Treasurer

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1. Introduction

1.1 The policy

Partnerships Victoria is a government policy, launched in June 2000, providing a framework for integrating private sector investment in public infrastructure.

The policy focuses on whole-of-life costing of infrastructure and related ancillary services and a full consideration of the benefits of risk transfer to private parties. When considered from this perspective, it is apparent that the private sector can often deliver public infrastructure services more cost-effectively than government can.

Once government has determined that new public infrastructure and related ancillary services are required, departments and agencies need to consider carefully how they can best be delivered. The method of delivery may be by government alone, by government in combination with the private sector, or by the private sector entirely. There is no presumption that the private sector is invariably more efficient in building and operating public assets. Equally, there may be no obvious benefit in holding or keeping assets in public ownership if the private sector is better placed to build or update them, and services to the community are improved or delivered at lower cost. The key issue is which form of project delivery provides the best value for money in meeting government service objectives.

1.2 The procedures

Making this judgement requires new procedures and tools. While many of the procedures under *Partnerships Victoria* will be familiar from past practice, there are some key innovations and differences.

One of these is the concept that government itself should retain direct control of certain public services for which it has particular responsibilities to service recipients and the community. For example, a policy premise is that public healthcare services are best provided by doctors and nurses in public employ. These core services are identified on a case by case basis as projects arise.

Another innovation is the use of a Public Sector Comparator (PSC) to compare private bids with the costs that would be associated with government procurement of the desired project outputs. The PSC provides a financial benchmark for assessing the value for money of private sector bids and is used to evaluate the risk transfer that occurs under a *Partnerships Victoria* approach.

The policy also requires all potential *Partnerships Victoria* projects to be assessed against a public interest test to ensure that they can meet requirements of probity, transparency and other criteria designed to protect the interests of the community and to ensure that no group is unreasonably disadvantaged by, or denied access to, the proposed infrastructure as a result of the way services are to be delivered.

In this way, *Partnerships Victoria* builds upon and improves the policies of past Victorian governments. It seeks to reap the financial and efficiency benefits of partnerships with private parties, without compromising community values. With improved understanding between government and private parties, there is scope to improve contestability in the provision of infrastructure-related services, improve outcomes for all parties, and maintain Victoria's attractiveness as a place in which to invest.

1.3 The guidance material

When Cabinet approved the *Partnerships Victoria* policy, it recognised that new guidance material would be needed to assist public sector practitioners in developing and implementing *Partnerships Victoria*. The private sector would also need to understand how government intended to implement the policy.

Three pieces of guidance material have been prepared initially. These are:

- *Practitioners' Guide*
- *Risk Allocation and Contractual Issues*
- *Public Sector Comparator.*

The *Practitioners' Guide* is the base document and sets the context for the treatment of more specialised issues in the *Risk Allocation and Contractual Issues* guide and the *Public Sector Comparator*.

Before outlining the purpose and broad content of each of these guides, this *Overview* sets out the fundamentals of the *Partnerships Victoria* policy.

2. Policy evolution

The guidance material reflects a policy evolution from the traditional idea that government's main intention in contracting with the private sector is to procure physical assets such as courts, prisons, hospitals or roadways. In a *Partnerships Victoria* project, government's intention is to procure the *services* which depend on (or are otherwise associated with) that infrastructure.

This distinction is critical to the economies which can be delivered through *Partnerships Victoria.* Purchasing services (not assets) releases government from responsibility for the asset, gives it greater strategic flexibility and focuses attention on the quality of the services being delivered.

The clearest reflection of this policy evolution is in the area of accommodation services. In the case of the Victorian County Court project, for example, instead of commissioning the building of a court facility, government contracted with a private party to receive *court accommodation services.* These services cover the availability of courtrooms and other specified spaces within the privately owned and operated court building, and the operation and management of those areas to specified requirements. Information technology and other ancillary services were also provided. Government's only direct responsibility is to pay for the services received. If something goes wrong and the services are not received, or are not delivered to the specified standard, government pays less or does not pay.

For this reason, the language of *Partnerships Victoria* is service-focused. Ownership and control of the infrastructure is a subordinate issue, although sometimes ultimate ownership of the asset may be strategically important to government.

The Government's focus on service delivery means that contracts are structured with strong incentives for the private party to ensure continuity of service delivery, through the payment mechanism and specific contractual provisions.

3. Determining the best form of service delivery

In choosing the appropriate form of delivery of particular public infrastructure services, government has regard to:

- whether any part of the proposed service should be delivered by government itself;
- whether involvement of the private sector will deliver value for money and, if so, how to optimise that value; and
- whether the project will satisfy the public interest criteria which form a key part of the *Partnerships Victoria* policy.

These three questions are known as the 'core services question', the 'value for money question' and the 'public interest question' and are applied to all *Partnerships Victoria* proposals.

3.1 The core services question

Services that should be delivered wholly by government fall outside the *Partnerships Victoria* framework. However, even where government retains delivery of core services, there may be areas of service, including accommodation services to house the core services delivery, which the private sector may be better positioned to deliver on a value for money basis. The challenge, in each case, is to determine the point at which the core ceases and private sector service provision can start. Ultimately, this is a decision for Cabinet.

3.2 The value for money question

All *Partnerships Victoria* projects are subject to a full benefit-cost analysis and bids are assessed against public sector benchmarks to ensure value for money, as compared with the cost to government to deliver the project itself.

The *Public Sector Comparator* allows government to calculate the full, risk-inclusive cost of providing the service over the life of the project. In the absence of other counter-balancing factors, including non-quantifiable risks and the broader costs and benefits of private delivery, government will opt for private party delivery if it represents value for money in comparison with the Public Sector Comparator.

3.3 The public interest question

Partnerships Victoria projects are assessed against public interest criteria relating to effectiveness, accountability and transparency, equity, public access, consumer rights, security, privacy and rights of representation and appeal at the planning stages by affected individuals and communities.

The public interest question is a threshold question, asked before the project is put to the market. Only if mechanisms can be established (e.g. contractual and/or regulatory means) to satisfactorily meet the public interest, is the project offered to the market as a *Partnerships Victoria* project.

4. Value for money drivers

The major value for money drivers underlying the *Partnerships Victoria* approach are:

- **risk transfer**, relieving government of the substantial, but often undervalued, cost of asset-based risks;
- **whole-of-life costing**, fully integrating — under the responsibility of one party -— up-front design and construction costs, with ongoing service delivery, operational, maintenance and refurbishment costs;
- **innovation**, providing wider opportunity and incentive for innovative solutions as to how service requirements can be delivered; and
- **asset utilisation**, developing opportunities to generate revenue from use of the asset by third parties — which may reduce the cost that government would otherwise have to pay as a sole user.

Together, these can create significant cost savings for government, while giving an opportunity for innovative service delivery.

In assessing the potential for a *Partnerships Victoria* delivery method to provide value for money, projects with the following attributes are likely candidates:

- **scale**, contracts with a value of $10 million or more;
- **duration**, service delivery requirements of up to 30 years or more;
- **service focus**, clearly definable and measurable output specifications, suitable for payment on a 'services delivered' basis;
- **risk transfer**, scope for significant transfer of risk to the private sector;
- **complexity**, sufficient complexity and/or other characteristics which invite innovative solutions; and
- **market appetite**, existence of a genuine business opportunity, and sufficient capable private sector parties, to create an effective and competitive bidding process.

5. Variety of partnership models

There is no preferred model for *Partnerships Victoria* partnerships. For a given project, the model is determined by the answers to the three questions set out above (the questions of core services, value for money and public interest). As a result, there is likely to be a greater variety of models than in the past.

The varying extent of government and private party involvement within different models under *Partnerships Victoria* is expressed in the following table.

Increasing role of the private sector →				
Private party role	Infrastructure services only	Infrastructure and ancillary services	Infrastructure and partial private-to-public service delivery	Infrastructure and service delivery to users
Government role	All public-to-public services	Delivery of core public services	Delivery of core public services	No operational role
Example	Public buildings	Non-core hospital services, non-judicial court services	Community facilities linked to educational facilities (e.g. after-hours usage)	Roads, rail, port facilities, car parks

6. Payment for services

If government is to achieve its objectives for a *Partnerships Victoria* project, the basis on which it pays for services must align with those objectives. For example, if the purpose of a project is to receive water conforming with specific quality standards, the system of payments should be geared to delivery of all treated water according to those standards. If another purpose is to be able to receive certain volumes of treated water, there might also be a payment component related to the plant capacity to meet minimum throughput rates. If the purpose of upgrading an existing road system is to relieve congestion, the system of payments should reward availability more than volume of usage.

It is also important that payments are unitised, so that the overall payment can be reduced if services are not delivered, or fall short of what is required. Apart from exceptional circumstances, 'no service' should mean 'no payment'. This is consistent with a fundamental premise of *Partnerships Victoria* that the private party bears the overheads (and reaps any profits) of asset ownership, while government has the certainty of paying only for what it receives.

Government's capacity to control the quality of service delivery through the payment structure may depend on the control it has over demand for the services and the nature of that demand. If the major demand is from government itself, it should be easy to devise a payment structure which implements government's objectives in detail. Where government has little control over demand and the costs of service delivery are fully or primarily funded by private users, the payment structure will, in the main, reflect usage. Nevertheless, to the extent that there is some level of direct payment by government, there is scope for government to use the payment mechanism to directly achieve service quality outcomes.

7. Optimal risk allocation

By adopting a service focus and paying only for services received, *Partnerships Victoria* presupposes that the private party bears all the risks associated with designing, building and operating the infrastructure, including the risk of obsolescence and/or low residual value.

In practice, the value for money principle dictates that government takes back some risks which it can manage at a cheaper cost than it would have to pay the private party to take the risk. These are generally risks over which government has some control (such as the risk that State law applying to the project will change). Government undertakes this take-back analysis for each project, to optimise the risk allocation, before beginning the *Partnerships Victoria* bidding process.

Where one or the other party is able to control a risk, either by limiting the likelihood that it will occur or limiting the consequences if it does, it costs that party less to assume the risk than another party with no control over it. Thus, for both pricing and management reasons, optimal risk allocation dictates that particular risks are allocated in line with capacity to control and manage. These principles are discussed in detail in *Risk Allocation and Contractual Issues*. The *Public Sector Comparator* technical note also includes information on risk, including how to price risks in order to adjust the public sector benchmark against which private sector bids are compared.

The more difficult issue, discussed at length in *Risk Allocation and Contractual Issues* and more briefly in this *Overview*, is how to achieve the best value for money when allocating risks which are essentially outside the control of either party.

8. Achieving a successful partnership

One risk which cannot be transferred to the private sector is that government may contract with an unsuitable partner. The question is whether a relationship between government and the private party can be sustained over the longer term. This depends not only on the probity and stability of the private party, but also on the willingness of the parties to cooperate to resolve difficulties, and the creation of a genuine business opportunity for the private party. Projects proceeding on the basis of an exceptionally low bid from an inexperienced player are unlikely to deliver true value in the long term.

The ingredients of a successful *Partnerships Victoria* partnership are:

- **planning and specification**, so that government's desired outcomes and output specifications are clear to the market;
- a **genuine and viable business opportunity** for the private party;
- **certainty of process**, so that any conditions to be fulfilled are clearly understood before the project proceeds;
- **balanced bid evaluation**, based on more than simply financial comparison;
- **project resourcing**, to enable government to advance the project and address issues in line with published timeframes;
- **clear contractual requirements**, centred on key performance specifications, to promote performance and minimise disputes;
- **contract management**, to monitor and implement the contract; and
- **recognition of the partnership**, to encourage good faith and goodwill between government and the private party in all project dealings.

In a successful partnership, the private party derives suitable (but not exorbitant) rewards from its investment, and government receives required services without capital outlay and at a fixed price (subject to indexation as appropriate). The future of the asset beyond the contract term is programmed into the service charge paid by government to the private party. Depending on government's view of the strategic importance of the asset or the site, an asset may then be transferred to government when the contract expires.

9. *The Practitioners' Guide*

Objective

The *Practitioners' Guide* addresses the what, why and how questions in relation to *Partnerships Victoria* projects and sets out the approach to key commercial issues (e.g. payment structures and bid evaluation) and public process issues (e.g. public interest test, probity, and reporting and disclosure).

Structure

The guide is structured in three sections:

Part One

This section discusses the key drivers behind *Partnerships Victoria,* with a specific focus on value for money and creating commercial opportunities for the private party. It deals with three key questions:

(i) What are Partnerships? This discussion differentiates *Partnerships Victoria* from outsourcing and also the procurement of goods and services which do not involve investment in significant infrastructure.

(ii) How should a *Partnerships Victoria* structure be contemplated? This discussion outlines the characteristics of *Partnerships Victoria* projects and the key features which need to be present for a *Partnerships Victoria* approach to have a high likelihood of delivering a value for money outcome.

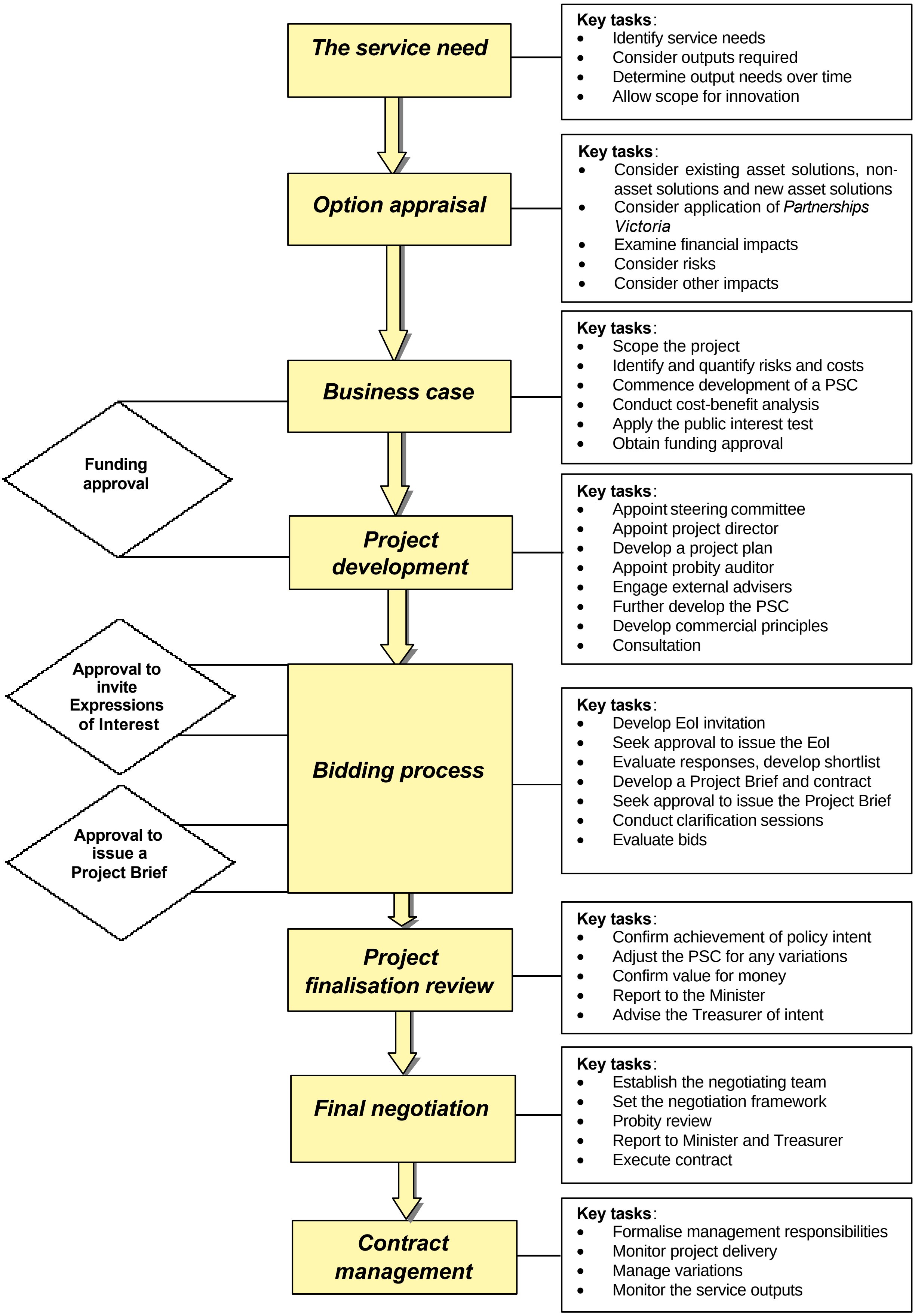
(iii) What makes a successful partnership? This discussion summarises the key factors necessary for a successful *Partnerships Victoria* project.

Part Two

This part focuses on the process through which a *Partnerships Victoria* project is identified and developed. The guide recognises that the starting point needs to be the identification of a service need, alignment with government policy and rigorous options analysis. It then works through each of the key steps in the development and delivery of a project and the points at which approval of Cabinet is required.

Figure 1 sets out each of the major stages of a *Partnerships Victoria* project. The boxes on the left-hand side show the points at which Cabinet approval (or approval by a Cabinet committee) is required to enable the project to proceed.

Figure 1: Major stages in developing a *Partnerships Victoria* project



In addition to emphasising the key questions of core services, value for money and the public interest, Part Two of the *Practitioners' Guide* draws attention to the following:

- the need for specifications in a *Partnerships Victoria* project brief to focus on outputs rather than prescriptive inputs. For example, a project for a water treatment facility might specify the requirement as providing drinking water to World Health Organisation standards, rather than as a need to build a plant with defined engineering characteristics. Attempts to prescribe inputs may discourage innovative solutions and jeopardise the transfer to the private party of the risk of not achieving the desired outputs;
- the importance of investing time and effort in the development phase of a project to ensure that service specifications are clearly specified, risk allocation carefully considered and the whole-of-life impacts of the proposed arrangements assessed in terms of service delivery outcomes;
- the need to have all policy, commercial, risk allocation and procedural issues resolved before the release of the project brief to shortlisted bidders, as release of the project brief signifies that government is prepared to proceed with the project, providing a conforming bid offering value for money in comparison with the Public Sector Comparator is received;
- the need to consider the financing structure in the context of risk transfer rather than as the central element of the project; and
- the critical importance of considering a project from the perspective of bidders, making the process as efficient as possible, creating a genuine business opportunity for bidders and maintaining consistent rules in relation to hurdles to be overcome if the project is to move forward.

Part Three

This section discusses in detail a number of technical and process issues associated with the delivery of a *Partnerships Victoria* project. The areas covered include risk allocation, use of the Public Sector Comparator, commercial issues (including taxation, the structuring of payment mechanisms, financing issues and end of term arrangements), techniques and principles for evaluating bids, the protections available for intellectual property, accounting treatment and disclosure, the content of the public interest test and satisfying probity requirements.

These issues are dealt with in sufficient depth to alert practitioners to the range and complexity of matters that must be managed.

In the case of taxation issues, for example, the guide draws attention to Section 51AD and Division 16D of the Commonwealth *Income Tax Assessment Act 1936* which operate to deny tax deductions to private sector owners where assets are used, or their use is deemed to be controlled, by tax-exempt entities such as government. Awareness of these provisions is clearly very important for all parties when pricing and structuring *Partnerships Victoria* projects.

Similarly, in the case of the payment structure, the guide notes that many *Partnerships Victoria* contracts use a combination of two or more of the following elements in structuring the service charge:

- availability of the service;
- use of the service;
- level of performance of the service; and
- wider defined benefits.

The most appropriate combination of payment elements differs from project to project and is influenced by factors such as whether government is the service recipient, the extent to which demand risk can be transferred to the private party, the nature of the services being provided and government objectives for the project. However, it is important that these elements are not subject to their own independent payment regimes, but are constructed as components of a unitised payment which reflects overall service performance. In this way, payment for usage, for instance, is not paid without regard to whether availability and/or performance standards were met at the relevant time.

In addition to the above, the *Practitioners' Guide* has appendices containing sample templates for:

- Expression of Interest document;
- project brief document;
- indicative project timeline;
- probity documents;
- public interest test; and
- risk allocation matrix.

10. *Risk Allocation and Contractual Issues*

Objective

The *Risk Allocation and Contractual Issues* guide outlines the background methodology for risk transfer, describes major types of project risks and contractual issues and sets out the government-preferred approach for each. Where appropriate, example contractual clauses are provided.

Structure

The guide is structured in three sections:

Part One

Part One outlines the philosophy of risk management and, in particular, risk allocation. It recognises that the transfer of risk away from government, in a way that optimises value for money, is at the heart of the policy.

The guide refers to government being in partnership with ‘the private party’, because in each project the government expects to contract only with one private sector party which will bear full responsibility for all contracted services.

For its starting point, the document takes the position that, by contracting to receive services rather than to procure assets, government rids itself of all project-associated risk except the risk that the private party will prove unsuitable (sponsor risk).

However, the guide also adopts the *Partnerships Victoria* policy principle that ‘risk will be allocated to whoever is best able to manage it at least cost, taking into account public interest considerations’.[1] As discussed earlier, this is the principle of optimal risk allocation.

Reconciling these two positions involves government taking back those risks (or parts of risks) which it is best placed to manage or can manage at a lower price than the private party. In some cases, especially for risks which are outside the control of either party, risks may be shared using special risk-sharing regimes. This take-back exercise takes place before the *Partnerships Victoria* project is put to the market.

Risk allocation is just one part of the risk management cycle, which begins with risk identification and proceeds through risk assessment and risk allocation to risk mitigation and monitoring and review. Each of these phases is discussed. The guide also attempts to set out the private sector's general approach to risk and attitudes to particular risks, along with the special concerns it may have about contracting with government and the means for addressing them.

Part One also includes a section on reflecting risk allocation in the contract, which introduces a number of key contractual issues concerning service specification, the role of payment and pricing structures, and enforcement through breach and termination provisions. These and other contractual issues are elaborated in Part Three.

[1] Department of Treasury and Finance, *Partnerships Victoria*, Melbourne, 2000.

Part Two

Part Two classifies the major project risks into ten categories and recommends a government-preferred position on allocating each of the identified risks. The analysis of each risk is extensive and offers insight into sub-categories of the risk, as well as the possibility of government unintentionally taking back risks which have been allocated to the private party.

The following summary sets out the general position adopted for each risk, but should not be relied on as a substitute for the detailed analysis provided in the guide itself.

1. Site risk

The coverage of this risk extends beyond site suitability to risks associated with land contamination, statutory approvals, land acquisition, and indigenous issues, including native title.

Site risk is allocated to the private party, except that government may take back or share risks associated with:

- defects in existing infrastructure or pre-existing environmental liabilities on a government-owned or designated site (unless the defect is identified contamination which has been priced into the bid);
- planning and environmental approvals where these are complex or have cost outcomes above an agreed level (including risks arising prior to contract execution);
- native title issues arising from a government-preferred site; and
- process costs as agreed on a case-specific basis.

2. Design, construction and commissioning risk

This risk is allocated to the private party, except where government initiates a change in design or construction or otherwise interferes in the design and construction process, in which case it will share the cost of the changes.

The guide notes the importance of government avoiding unintentional take-back of this risk by over-specifying or formally endorsing a design.

3. Sponsor and financial risk

This risk — that the private party will be unable to fulfil its contractual obligations and that government will be unable to look to that party or its sponsor(s) for relief, or that the private party will be otherwise inappropriate or unsuitable for the delivery of a *Partnerships Victoria* project — falls on government as a result of entering into the contract. The guide sets out the means to mitigate this risk.

Financial risk includes:

(i) the risk that private finance will not be available;

(ii) the risk that changes in financial parameters will alter the bid price before financial close; and

(iii) the risk that the project will not prove financially robust.

Government may assume or share the second of these risks, for example by agreeing to accommodate interest rate changes during that period. The first and third will affect government to the extent that it may need to obtain alternative services if the project fails. However, the financial consequences of these risks materialising will be borne by the private party. Ways of mitigating these risks include requiring bids to have firm funding commitments and government undertaking a reality check in respect of each bid so that the lowest bid is not automatically accepted.

There may be benefits to the private party in refinancing the project at some stage. Generally, government does not share in any upside benefits of private party refinancing, on the assumption that the opportunity to refinance following completion (when the risk profile lessens) is factored into the bid price. However, where the private party receives a 'windfall' gain from a refinancing, as a result of lower interest margins (mature markets) or benchmark interest rates, government may seek to share in those benefits.

4. Operating risk

This risk is allocated to the private party, except that government will bear costs arising from government intervention or interference (e.g. changes in output specifications and certain changes in law or policy).

5. Market risk

Market risk comprises demand and price risk. The extent of demand risk borne by the private party depends on value for money questions and whether government is the only service consumer. To the extent possible, however, demand risk is to be assigned to the private party.

In projects where government pays for the service, price risk is implicitly transferred to the private party by fixing the service charge payable by government for the contract term, subject to appropriate indexation adjustments. For some ancillary services, price risk may be shared in the sense that benchmarking and market-testing may be used to periodically readjust the service charge to current market values (which may increase or reduce the cost to government).

6. Network and interface risk

Network risk includes the risk that a complementary network on which the contracted services depend will be removed or altered, and the risk that a competitive network will alter demand for the contracted services. It also extends to the quality of publicly provided inputs used in providing the contracted services (e.g. raw water provided to a water treatment facility).

Even though network risk is often within government control, the guide recognises government's competing obligations to the community and recommends that network risk be assigned to government only where a network change will actively discriminate against the project. Any undertakings by government with respect to management of the public network should be limited to matters which directly affect project viability.

Interface risk is network risk in microcosm. It is the risk that the method or standard of delivery of the contracted services will prevent or in some way frustrate the delivery of core services by government and vice versa.

Allowing for the variety of possible interfaces in *Partnerships Victoria* projects (where, for example, the ancillary services provider may differ from the primary contractor), the allocation of interface risk may be complex. The position adopted in the guide is that, essentially, the private party and the government will each bear the risk of its services interfering with the other's service delivery.

7. Industrial relations risk

Unless the circumstances of a project necessitate otherwise, all industrial relations risk is transferred to the private party. The private party is usually best placed to manage issues with regard to its workforce.

8. Sovereign risk

This includes risks associated with government powers and immunities, and changes in policy and law. Government will accept much of this risk by warranting its ability to contract, agreeing to share risks associated with government 'acts of prevention' (that is, government activities which interfere with the private party's ability to perform its obligations), and agreeing to accept the risk of certain changes in law and policy.

With respect to 'change in law' risk (which is generally defined to include change in policy, government will take back the risk of changes in State law where these are directed specifically or exclusively to the particular project. Other changes in law risk (including the risk of change in Commonwealth law) are generally allocated to the private party. However, government will share (within specified limits) the risk of a general or sector-specific change in law which results in the need for significant capital or operating expenditure.

9. Force majeure risk

Force majeure risks which are able to be insured on commercially reasonable terms are generally allocated to the private party, which is ordinarily obliged to apply any insurance monies payable as a result of a materialised risk to repair or rebuild the infrastructure.

Uninsurable force majeure risks (or those which are insurable, but at an unreasonable cost) will be shared, provided value for money is achieved. Different risk-sharing mechanisms, involving varying levels of risk transfer to government, may be applied and will vary with project type and the nature of the force majeure event.

10. Asset ownership risk

This risk stems from ownership of the infrastructure and covers design, technical, maintenance and obsolescence risks, the risk of losing the infrastructure (through a force majeure event or as a result of early termination) and residual value risk.

With the exception of uninsurable force majeure risk, asset ownership risks applying during the term of the contract are allocated to the private party. However, for technology-dependent infrastructure, government may agree to share some of the capital cost of periodic technical upgrade and will expect to share in any consequent cost savings.

If early termination occurs and results in the early transfer of the asset to government, government will pay fair compensation for the asset under the principles set out in the guide. These principles vary according to whether the infrastructure is still in construction or is operational. Government will not underwrite the private party’s investment on early termination.

Where government will ultimately own the asset, it bears a measure of residual value risk. Government will need to put in place arrangements to ensure that the asset transfers to it with a pre-determined life or asset condition.

Part Three

Part Three of *Risk Allocation and Contractual Issues* discusses some of the key issues when implementing and enforcing the risk allocation through the contract and provides some sample clauses. It includes a discussion of 'difficult to allocate' risks, which may be best dealt with through a material adverse effect or other risk-sharing regime. Here, the fine detail of the risk allocation is postponed until a risk event occurs and its nature and the management of its consequences can be worked out jointly by the parties in the overall interests of the project.

It also includes detailed discussion of topics such as sharing the benefits of risk, providing for changes to service specifications, when and how government may step in, default and termination provisions and other contractual issues where a principled approach is necessary to give confidence to all parties.

A template risk matrix embodying the government's preferred risk allocation as set out in Part Two is provided for summary and sample purposes only. While it may be adapted as a base for use in a particular project, it is essential that risk identification takes place by other parallel means, so that the matrix does not substitute for independent thinking. That said, departures from the risk allocation patterns set out in the matrix should not be undertaken lightly or without consultation with the Department of Treasury and Finance.

11. *Public Sector Comparator*

Objective

The construction of a Public Sector Comparator (PSC) is necessary in almost all *Partnerships Victoria* projects to test whether any private investment proposal offers value for money in comparison with the most efficient form of public procurement. The PSC is the hypothetical risk-adjusted cost of government delivering the project output specifications.

The *Public Sector Comparator* technical note outlines the role of the PSC and provides step by step guidance on how to construct one, including the valuation of project risks. As noted earlier, use of a PSC as a means of testing private party bids for value for money is a central element of the *Partnerships Victoria* policy.

Structure

The guide consists of an introduction, a chapter dealing with the role of the PSC in *Partnerships Victoria* and seven further chapters which deal in technical detail with the components of the PSC, the sequence in which the PSC is constructed and refined, and its application in bid assessment and procurement processes under *Partnerships Victoria*.

The PSC:

- is based on the most efficient public sector method of providing the defined output;
- takes full account of the costs and risks which would be encountered in that style of procurement; and
- is expressed in terms of the net present cost to government of providing the output under a public procurement, using a discounted cash flow analysis which adjusts the future value of expected cash flows to a common reference date. This enables comparison with bids and makes allowances for the imputed cost to government of obtaining capital for a public procurement. The discount rate to be applied will be advised at the time by the Department of Treasury and Finance.

The primary purpose of the PSC in *Partnerships Victoria* is to provide a quantitative benchmark against which to judge value for money of *Partnerships Victoria* bids, not to establish what level of service charges may be affordable to government under a contract for services.

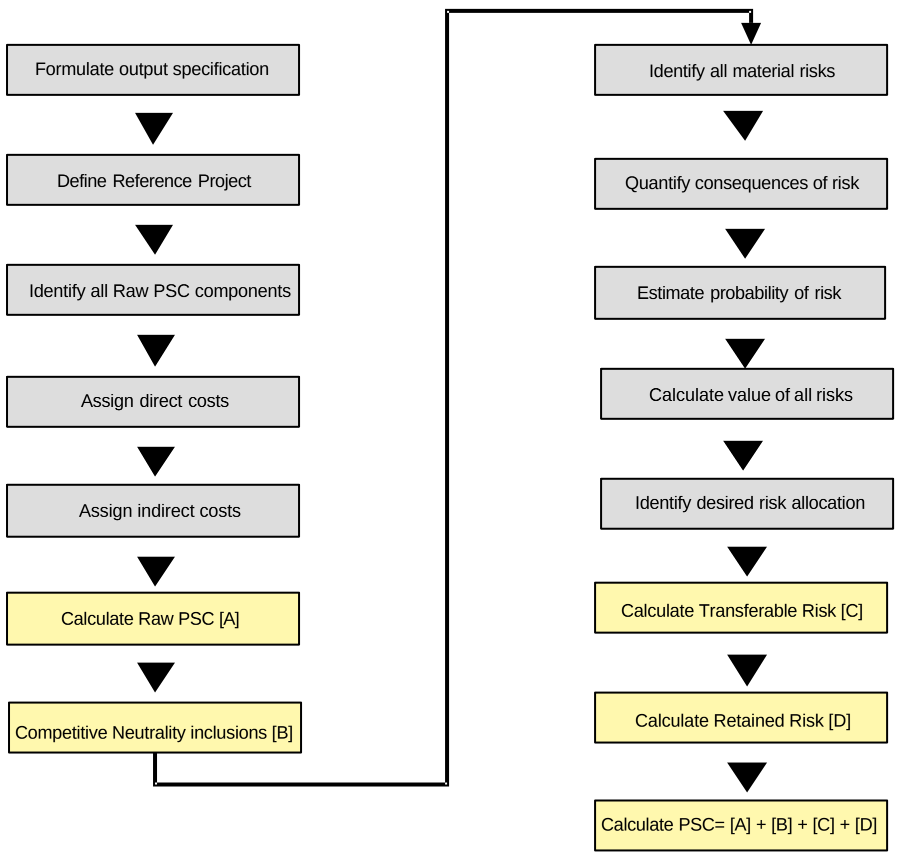
The PSC has four core components.

- **Raw PSC**. This is the base cost of delivering the services specified in the project brief under the public procurement method where the underlying asset or service is owned by the public sector;
- **Competitive Neutrality adjustment**. This removes any net advantages (or disadvantages) that accrue to a government business by virtue of its public ownership;
- **Transferable Risk**. The value of those risks which government would bear under a public procurement but is likely to transfer to the private sector under a *Partnerships Victoria* approach is added to the PSC to reflect the full costs associated with public procurement. This is innovative, because a comprehensive pricing of risk has generally not been included in previous benchmarking exercises.

- **Retained Risk**. The value of those risks that are likely to be retained by government under a *Partnerships Victoria* approach is added to each private sector bid, to provide a true basis for comparison.

The place of these four major components in the detailed construction of the PSC is indicated in the diagram of the PSC process (Figure 2).

Figure 2: The PSC process



The **output specification** sets out the range of services that government is seeking to procure and the performance levels required for each of those services.

The **Reference Project** is the most likely and efficient form of public sector delivery that could be employed to satisfy all elements of the output specification based on current best practice. It should provide the same level and quality of service as expected to be provided by bidders to enable a like with like comparison. For example, in a court accommodation project, the building cost element would be developed on the basis of directly relevant experience of the government agency in building a similar facility, or on the basis of an opinion of development costs obtained from an external consultant with expertise in developing this type of facility. This may involve providing the facility under a turnkey, or design and construct contract.

The **Raw PSC** is the base cost to government of producing and delivering the Reference Project. This is similar to previous financial benchmarks and is based on the principle of output costing, as set out in the *Output Costing Guide, Victoria*. It includes all direct costs and indirect costs, less any identifiable third-party revenue.

The **Competitive Neutrality** adjustment removes the public ownership distortions which would otherwise arise in comparing bids against the PSC. Competitive advantages from public sector ownership typically include State taxes, such as land tax, which are levied only on private enterprises.

The cost of **Transferable Risk** should be calculated as if it would remain with government, as this best represents the value to government of transferring the risk. Care should be taken to exclude risks typically transferred by government under a traditional procurement. For example, in a traditional design and construct delivered under a turnkey contract, where a maximum contract price is specified, transfer of most design and construction risks will have already been taken into account in the Raw PSC.

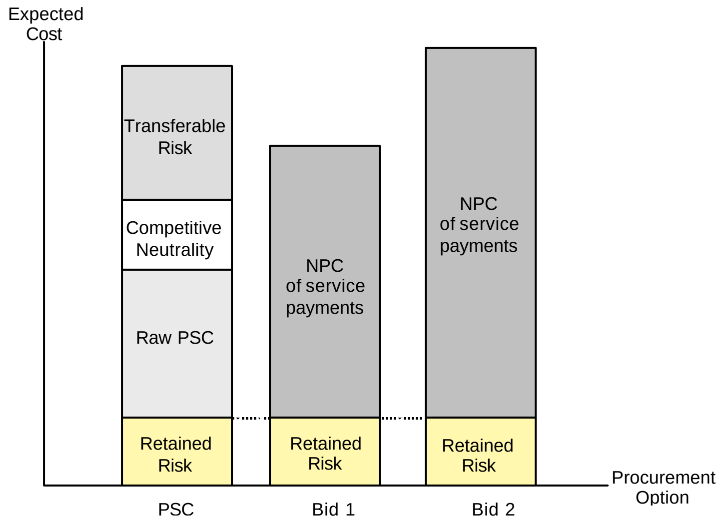
When adding the cost of **Retained Risk** to the private bids, any risks associated with government's provision of core services should not be included, as core services will be outside the scope of the contract. The level of Retained Risk may also need to be adjusted between bids to reflect the same level of risk transfer proposed by government.

There are a number of conceptual and statistical methods for valuing risk. This technical note includes the cost of project risks in the cash flow numerator, by estimating and adding the cost of transferable risks to the cash flows in the relevant year(s). In estimating the value of the risks, a commonsense approach is necessary: 80 per cent of the effort should be spent on valuing the most important 20 per cent of risks and important unquantifiable risks should be noted for consideration among the qualitative factors in the value for money assessment.

Assessing private bids against the PSC

Figure 3 illustrates the value for money comparisons between a PSC and a *Partnerships Victoria* bid. The diagram shows how an adjustment for risk can be critical in determining whether the PSC is more or less than the best *Partnerships Victoria* bid.

Figure 3: Value for money of PSC versus *Partnerships Victoria* bids



In the absence of counter-balancing qualitative and broader considerations, Bid 1 would be selected, as it represents the best value for money to government.

These qualitative and broader considerations may include:

- material costs (including risk) that are not capable of being quantified;
- identity, credit standing and proven reputation of the bidder, creating confidence in its capacity to deliver;
- higher transaction and contract management costs to government in comparison with traditional procurement methods;
- differences in the deliverable service which cannot be quantified or adjusted for; and
- any wider net benefits or costs that a *Partnerships Victoria* approach may entail. (For instance, wider social benefits may include earlier provision of key infrastructure services than could be delivered under a public procurement, or establishment of better benchmarks for publicly delivered services).

Disclosure of the PSC

The general government position on disclosure of the PSC is that disclosure should occur where it is likely to assist the competitive bidding process. It is expected that this will be the case in most projects. The portfolio Minister (and the Treasurer where relevant) retains ultimate responsibility for determining the disclosure policy for a particular project.

Disclosure is restricted to an aggregate figure including the Raw PSC and the Competitive Neutrality adjustments, together with key assumptions used, and should occur with the release of the project brief. Where information is disclosed, care should be taken to ensure that all bidders have equal access to the information disclosed.

Changes to the PSC during the bidding process

In general, the PSC should not be refined after release of the project brief, unless the scope of the project changes or it becomes apparent that a significant component has been mispriced or omitted. The portfolio Minister needs to seek approval from Cabinet or the relevant Cabinet committee for any material departures from the approved PSC after the bidding process begins.

A private bid that proposes a more efficient delivery method than that identified in constructing the PSC should not cause an adjustment to the PSC to reflect that alternative delivery method. Such innovation is one of the benefits of *Partnerships Victoria*. By not adjusting the PSC, the value of the innovation will be explicitly recognised.

12. Conclusion

Partnerships Victoria offers new opportunities for private sector participation in the delivery of public infrastructure and related ancillary services and seeks to establish fair, open and transparent processes for receiving and assessing private bids. A cornerstone is the transfer of risk away from government, in that government purchases services on behalf of the community rather than risk-laden assets.

The guidance materials have been formulated on the basis not only of what is good for government, but also on the principle of fairness to all parties. The positions adopted on risk in *Risk Allocation and Contractual Issues* do not seek to transfer risk to the private sector at any price, but to optimise risk transfer for the benefit of each project as a whole. The *Public Sector Comparator* is designed to provide an objective measure of value for money to safeguard taxpayers' interests and give objectivity and transparency to the evaluation of bids. The *Practitioners' Guide* acknowledges the need to minimise bidders' costs and for government and the private party to behave in the spirit of partnership for the common good, implicit in the *Partnerships Victoria* approach.

It will not serve government's long-term interests to enter a partnership which does not serve the public interest or where the project proves untenable because the business opportunity for the private sector is not genuine. The processes and understandings set out in this guidance material draw on the best local and international experience. This has been done in an attempt to give all parties confidence in *Partnerships Victoria* as a policy with strong theoretical and practical underpinnings, which has the capacity to deliver the best value for money solutions for the public sector, to allow the private sector to contribute its capital, expertise and capacity for innovation, and to retain the confidence of the community.

Projects under *Partnerships Victoria* will be at the forefront of the future economic and social development of Victoria. Any project of a suitable size and complexity, with clearly definable and measurable service requirements and scope for risk transfer, should be strongly considered for delivery under the *Partnerships Victoria* approach.