Public Infrastructure Bulletin

Volume 1 | Issue 9 Article 6

5-29-2014

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Recommended Citation

Jagger, Norman (2014) "Risk a lot or risk averse? Studies from the Southbank PPP," *Public Infrastructure Bulletin*: Vol. 1: Iss. 9, Article 6.
Available at: http://epublications.bond.edu.au/pib/vol1/iss9/6

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RISK A LOT OR RISK AVERSE?

Studies from the Southbank PPP

NORMAN JAGGER

ABSTRACT

In the late 1990s the Queensland Government announced its first Public Private Partnership (PPP) contract. No Queensland public sector agency had PPP experience and the search for a suitable project that would test the new Queensland PPP policy evoked disparate expectations within government and within the private sector. The subsequent debate was long, arduous and highly charged on issues of ideology, government business and risk.

The Government accepted the business case for the redevelopment of the Southbank Education and Training Precinct (SETP) and nominated Southbank Institute of TAFE (SBIT) as the public sector agency to lead the procurement of the Government's first PPP. Supported by a very capable advisory group, the Queensland public sector embarked on a steep learning curve. In April 2005, following a lengthy procurement phase, the winning Axiom Education bid was evaluated as offering greater value for money (VfM) than the Public Sector Comparator (PSC). The Southbank Education and Training Precinct was a social infrastructure project which demanded an extremely complex range of capital and operational outcomes of its PPP solution. The value of transferred risk was a major feature of the evaluation process.

It was evident during the post-procurement stage of the project that the public sector failed to adequately identify and value its own risk, to appreciate and account for the cost of transferred risk over whole of life, and to implement a diligent value management system that ensured the cost of risk would continue to deliver VfM over the life of the project. Many aspects of the Southbank PPP have provided benchmarking lessons on VfM, but the risk allocation and risk transfer process may well be the most important one.

THE RISK ALLOCATION PROCESS

The project brief proposed the demolition of existing facilities on the site and development of a world class educational facility, a synergistic business community with greater public access and community use. With the final PPP policy still under review, and without useful precedent, the agencies and advisors preparing the brief analysed the size and shape of education and training delivery thirty years into the future. This 'crystal ball' process attempted to anticipate future government decisions on the commitment to training, demand for domestic and international training, and long term use of training facilities. The decision to procure thirty years of availability with concomitant risk was inextricably tied to the analysis.

In the absence of a Queensland precedent, and few social infrastructure PPP precedents in Australia, the risk analysis in an environment that was underpinned by tension between political imperatives and Government business. Such tensions surround all risk transfers that primarily seek better economic solutions. PPP relationships typically bring together partners with different and, at times competing priorities, goals and stakeholder concerns. The private sector remains dedicated to the generation of revenue and to meeting market and shareholder expectations. In contrast, the public sector responds to constituent pressure and has a responsibility to act in the interests of the public in an open and transparent manner (Noble, G. 2006).

In the case of the SETP, the argument to retain or transfer risk and the price point for this determination was exhaustive and contentious, contributing to a longer gestation period than was expected. In the end, risk aligned to the delivery of educational core services was retained by the State, while risk aligned to non-core services including finance, construction and operations was transferred to the private party as summarised below.

CORE SERVICES: STATE OWNERSHIP	NON-CORE SERVICES: PRIVATE MANAGEMENT
• Program delivery, content and teaching delivery	• Infrastructure and equipment
• Administration of corporate services	• Buildings
• Commercial learning opportunities	• ICT backbone
• ICT services except the ICT backbone infrastructure	• Energy systems
• Library	• Plant
• Commercial activities	• Facilities management
• Timetabling, examination, administration and tutor support	• Maintenance of the facilities
	• Maintenance of the plant and equipment
	• Operations
	• Cleaning, pest control, grounds maintenance and security
	• Provision and maintenance of building systems
	• Other services e.g. cafeteria and out-of-hours use of facilities

Risk allocated to the private party was perceived to be good value when benchmarked against the low performance and high cost of operations established under State governance. The purpose of the transfer was to ensure cost effective and timely access to facilities and services at a given standard, with significant penalties for failure. A fuller understanding of the business contingencies underpinning the existing risk benchmarks might have enabled agency officers to better appreciate the variable cost of 30 years worth of risk. In a fluid business environment overestimation of risk could result in an excessive risk premium while underestimation could result in a costly variation to the contract.

SCOPE OF RISK

As the State's first PPP, the SETP established a benchmark of sorts for risk transfer. Maximum risk was viewed favourably by government, and seen to be a tangible economic argument for the procurement of a PPP. Any risk with the potential to impact adversely on SBIT's operating budget was considered to be transferable.

The risk analysis also required that SBIT reduce its business risk exposure. In a traditional budgetary process, generous forward estimates ensured a reasonable budget allocation. However, in the context of a PPP, generous business estimates can inflate the risk quantum, and consequently the risk premium. Without the benefit of a post completion review it is difficult to assess the true value of transferred risk in the SETP at this point in time.

Public statements by political leaders during the SETP procurement reflected an attitude that PPPs were mainly beneficial for those investing in them. This public message was an early indication that the price paid by Government for finance and risk transfer was too high and that government could leverage better deals by becoming an investor in their own projects.

KEY RISKS TRANSFERRED TO AXIOM	
• Pricing	• Operator
• KPI deduction	• Operator default and replacement
• Lifecycle	• Refinance insurance – premature and unavailability
• Damage	• Malicious damage
• Change in law	• Termination
• Consequential loss	• Defects

Subsequently, in 2007, the Queensland Government chose to procure a PPP for the Queensland Schools Project (QSP) using an innovative Supported Debt Model (SDM) (McKenzie 2008). The use of the SDM was justified in the 2010 Department of Education and Training PPP Financial Management Guide. The guide outlines the principle that some PPP projects are often refinanced once major project risks have passed, typically following major delivery milestones such as completion of construction, and that project agreements usually include provision for refinancing gains to be shared by the consortium and the State.

The SDM included provision for the Queensland Treasury Corporation (QTC) to refinance the QSP. The justification concluded that although independent review findings found that SDM offered less VfM than a privately financed PPP, internal modelling of the SDM highlighted that 'the SDM attempts to derive savings by better matching the risk profile of the funding with the various stages of the Project (the constructions & operating stages) … which … is likely to enhance the VfM to the State in comparison to a 100% privately financed PPP delivery option.'

The State believed it could extract a better finance deal in the QSP, but with a greatly reduced level of transferred risk. Accordingly, the cost of retained risk is still closeted in the State's coffers and lacks transparency. Whether the risk transfer options of either SETP or QSP deliver VfM is yet to be determined. However, the private sector has found that SDM and the credit guarantee fund used in the UK had the effect of reducing VfM overall because the 70% senior debt cap required higher levels of more expensive mezzanine and equity capital.

FLAWS IN THE PROCESS

There are several obvious outcomes of a successful risk transfer strategy. One is a better managed asset; another is greater business flexibility. In the case of SETP and QSP there should also have been a reduction of operational costs to the State.

SBIT's risk analysis included historical management shortcomings as key risks to its future business that is, it built into assumptions the systemic operational failures of a state management option. By 2005/6 SBIT was earning a substantial portion of revenue from commercial sources. It argued that its potential market share was at risk, and that it could not attract students in the lucrative but competitive international student market with dilapidated facilities and outmoded technologies. At this time the maintenance backlog was many millions of dollars; many buildings were not compliant, failing to provide access for people with a disability or to meet fire regulation requirements; and most buildings lacked IT network connectivity. At the time SBIT was described as a collection of buildings well past their use by date, but which by virtue of circumstance had become very valuable thanks to the booming development of the adjacent South Bank entertainment and cultural precinct (Quiggin, J. 2004). The combination of a valuable land parcel, increased student numbers and a lucrative international revenue stream provided SBIT with a cogent argument for redevelopment under the State's emerging PPP policy.

The prospect of transferring poorly performing assets and non-core business to the private sector added weight to the business case. Little research was undertaken to determine why the assets and the noncore business sector were performing so poorly. Very few questions were raised about optimism bias contained in estimates for managing the maintenance backlog, the OHS non compliance and the failing technology. Many risks which passed to the private sector during this process were tied to human resource, industrial relations and financial management problems buried deep in the CEO's 'hard basket'. Using stochastic analysis, some risk transfer decisions were favourably considered for their capacity to apply innovative solutions to wicked problems. The risk wasn't necessarily allocated to the party best placed to deal with long term risk.

Numerous government jurisdictions have identified bureaucratic inconsistencies with risk processes and lacking familiarity with contractual detail in the post contractual period. Further, the Victorian Government's Review of Private Investment in Infrastructure revealed that early PPP projects focused excessively on deals that transferred maximum risk to the private sector and on undertaking projects at lowest cost. By contrast the focus on delivery of government services was insufficient and demonstrated a shortage of management skills and experience in service delivery functions (McPhee, I. 2011).

In a recent UK experience hospital services were exposed to unsustainable debt through contractual obligations that frequently forced the payment of many hundreds of pounds for items as simple as a padlock or a light fitting; and by ill informed bureaucrats who showed 'cavalier disregard for taxpayers money' (Burns 2012). Such failings are extensively identified across many jurisdictions including Queensland and raise questions regarding the efficacy of risk transfer processes.

Partnerships Victoria has introduced the Investment Logic Mapping (ILM) program which attempts to deal with these issues. Queensland has yet to implement any typical review process, or to adopt a similar program.

UNEXPECTED BENEFITS

There are creditable examples of where well managed retention of unquantifiable risk can provide unexpected returns. Some unexpected benefits in the SETP project accrued as a consequence of Government's delayed PPP policy and the Project's protracted contractual closure. Contractual close came with a master plan and a confirmed final price, but details with respect to floor layout and function were incomplete. SBIT had a unique opportunity to engage with the building designers to shape a final solution, within the contracted footprint and cost framework.

To some, this represented an unacceptable risk given the limited Agency talent pool to deal with the State's largest project undertaking at the time. Some believed this risk was increased by the potential for design development to bog down resulting in costly delays, or conversely that poorly conceived and hastily contrived solutions would result in high cost variations and rectifications. Worse, that buildings in the final iteration would not be deemed fit for purpose. The deliberations surrounding this risk alone consumed several weeks.

But a worst case scenario did not eventuate, and significant benefits accrued to SBIT, government and the community from the PPP. This window of opportunity allowed the Institute a final review of its classroom practices and to strive for improved and innovative delivery solutions. SBIT took the opportunity to map these conceptual developments into a modern training facility, highly functional and technologically attuned to the needs of a new generation of learners, and enhancing its capacity to deliver a modern training agenda.

In 2006, less than twelve months into the construction contract the Qld Government promulgated a new training policy, the *Queensland Skills Plan,* which completely changed the nature of SBIT's business outputs. The policy shifted the responsibility for trade training to a different provider, while SBIT was invested with a new set of responsibilities that changed its outputs to higher level training outcomes. Floor plans designated for trade training at contractual close were now obsolete. Under many contractual arrangements, such a total review of floor space during the construction phase would have incurred a substantial delay notice and a very costly variation to contract. Because of the incomplete status of design development, SBIT was able to renegotiate within its existing contract parameters to avert any costly delays and variations.

Other benefits then followed for the private party. The 'develop as you go' design process allowed the contractor to restructure the accommodation plan. The shift of curriculum activity prompted a revision of the availability schedule which increased the range of buildings suitable for temporary accommodation. With a substantial reduction in the need for purpose built temporary accommodation and fewer business migrations, the contractor was able to complete the construction phase well ahead of time, sharing a sizeable windfall with the Institute by way of rent free early access. The rewards for well managed risk are seldom evaluated or acknowledged to the same extent as the penalties for poorly managed risk. Certainly in the case of the SETP the rewards were worth the risk.

RECLAIMED RISK

Findings from the Report of the Australian National Audit Office revealed that even though the Victorian Government paid a high premium for the transfer of risk to the private sector, large components of this risk often revert to the government (2006). Examples from the SETP also suggest a less than diligent risk management process. The original SBIT risk assessment categorised many operational activities high risk because they regularly exceeded budget and were therefore considered better placed with the private sector. Constant underfunding of budgets for cleaning, grounds and maintenance were claimed to have contributed to the derelict state of SBIT's facilities and operations. History may show that the funding provided to the Institute for these service outputs did not materialise because of internal budget decisions.

At the conclusion of the assessment two key risks may have added unreasonably to the price of risk and cost of the project.

First was the availability requirement for business operations. Availability of facilities and services was a key contractual deliverable for the Operator. From a 2005 revenue base generated by 28,000 students SBIT had predicted a significant uplift in student numbers driven by new facilities and technologies. However, student numbers declined rather than lifted leaving the Institute with contracted facilities and services for up to 50,000 students. The student reality in 2013 is closer to 20,000.

In order to boost the project affordability, SBIT chose to retain its commercial revenue interests and concomitant risk. The decline in student numbers, specifically international students, also brought diminishing commercial returns. Effectively SBIT were paying more and earning less. While not all commercial interests could have been divested, a more diligent approach to risk transfer could have minimised this impact.

In this scenario, the veracity of data used in the SBIT business case is debatable. It is highly likely that an overstated student demand and a poorly assessed scope of service led to the creation of an availability requirement and service provision that was far greater than required.

Second was the standard of service. The project was promoted to the people of Queensland as a 'world class' precinct, an example of landmark architecture designed to attract students from all over the world. Understandably a 'world class standard' was a far higher standard than in the unaffordable past, and would attract a far higher risk premium. Yet SBIT effectively argued that the unaffordable past would become immediately affordable, even at the higher cost, if transferred to the private sector. Whether the risks associated with a world class standard and whether the higher risk premiums of a world class facility were necessary or even affordable remains doubtful. In both cases the evidence overwhelmingly points to underutilised facilities and services that are provided at a significant cost and paid for by the State.

Mechanisms to monitor VfM for the resources dedicated to ongoing maintenance and operations are not apparent. A subtle ongoing degradation of KPI's has been observed. Expensive landscaping is being replaced by durable pedestrian friendly artificial surfaces. Expensive native plant species are not being replaced. High end and hard wearing paint finishes are being replaced by cheaper warehouse quality paints, and durable but costly outdoor furniture is being rearranged and supplemented by cheaper flat pack furniture.

As early as 2005 SBIT compiled a risk management register which highlighted policy change, revenue loss and management failure as high order risks. Failure to restructure its business model to better meet its financial targets questions whether adequate risk mitigation was implemented.

The absence of risk mitigation measures and mechanisms to closely monitor the VfM extracted from the resources devoted to the program (McPhee 2011) is evident as the gap between the revenue stream and the payment stream widens. Without a quality monitoring mechanism, risk and service premiums can turn into a windfall for private partners and reduce by millions the VfM to the State over the life of the project.

WHAT ARE THE LESSONS?

In a traditional sense, lessons from projects like the SETP lead to improved practice in the future. In the case of the SETP, a better understanding of the risk allocation process and the associated costs would have influenced differently the amount and type of risk reallocated to the private sector.

With many more years to run, it is clear at this stage that the premium paid for some transferred risk will not represent good VfM. Risk will always come at a price, and rightly so, but the principle of VfM must still drive the purchase of risk just as it drives the purchase of construction and services.

The fact that risk can't be identified as a single cost component in a project bid, and can change significantly with the complexity of the project, is sufficient argument for bureaucrats to be highly skilled in the development of project briefs. Bureaucrats must show a greater understanding of the scope and nature of risk to be transferred and exercise greater diligence in subsequent analysis and allocation.

Just as the PPP is not the most appropriate vehicle for every project, every PPP project is not necessarily an automatic avenue to transfer maximum risk. From the outset, the type, amount of, and necessity for risk transfer needs to be appropriate to the project and its outcomes.

Strategies to maximise risk transfer need to be tempered against the reality of necessity. Simply transferring risk experimentally because a range of options are available is not sufficient justification to commit valuable resources without a summative understanding of the cost.

Greater clarity with respect to policy development within government is needed. Much risk transferred through the SETP project was beneficial to the State at the time. Examples are transfer of operational arrangements and activities considered a risk to core business, and the retention of commercial risk associated with a revenue stream fundamentally aligned to project affordability.

In recent months the State has announced new policies restructuring TAFE as a Statutory Authority and making all TAFE funding contestable. Hindsight shows

that the contractual mix of retained and transferred risk would better serve this policy either as a holistic risk transfer based on the certainty of a future policy, or holistic risk retention based on lack of certainty around developing policy. Without doubt these policies were on the drawing board at the time of the SETP risk allocation and should have been openly discussed and better understood. Arguably a risk profile better aligned to the future training market would have been produced, creating a different business model for the Institute, making substantial savings for the taxpayer, and engaging the private partner differently and more relevantly into the intended business outcomes of the future.

Recognising that career bureaucrats have a different management paradigm to private sector professionals, it is inconceivable that a State moving towards greater private sector involvement does not provide a formal program of education for its senior bureaucrats (Noble, G. 2006).

When government uses a vehicle such as the PPP to implement significant policy change, it is surely incumbent on that government to ensure that the management structure charged with this responsibility is appropriately educated into the process. Political expedience as a basis for decision making is neither sustainable nor acceptable and it is time that VfM had genuine meaning in this process. The Victorian Government has long recognised this need in its governance process, and acknowledges the lessons from this Queensland project. By comparison, governance in Queensland still has a long way to go.

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ENDNOTES

1. A wicked problem refers to public policy matters that are difficult for government to manage either because the outcomes of decisions disadvantage large sections of the community or costs outweigh the benefits.

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