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Keeping public private partnerships responsive to change

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This paper notes the maturation of the PPP market in Australia, in particular for social infrastructure; with many PPP deals now well into the operating phase. An emerging issue, consistent with the new focus on the operating phase, is the need to make PPP agreements responsive to the inevitable State-initiated changes over the concession period. State-initiated changes are a fact of life in social infrastructure, driven by legislative and social policy imperatives of incumbent Governments. Consequential impacts on facilities are reflected in building capacity increases, upgraded technology systems and modified programmatic spaces. The great partnering challenge in PPP delivery is that the parties respond flexibly and positively to the necessary changes to the operating environments in these facilities. This paper outlines some of the innovative PPP arrangements which have evolved to provide the means to achieve this.

INTRODUCTION

In Australia, over 20 social infrastructure public private partnership (PPP) arrangements have been contracted since PPP’s were first adopted for such infrastructure in the early 1990’s. The PPP market in Australia, then, is entering a new developmental phase in its development, where track records for PPP project delivery and ensuing operational performance are becoming apparent. For example, in Victoria, the Fulham Prison has been operational for almost 10 years and the Victorian County Court for almost five years.

PPP’s will become progressively more accepted, and less controversial, as end users see the positive benefits arising from their whole-of-life facility servicing. This acceptance will be enhanced as PPP outcomes are compared with facilities delivered under traditional procurement, as these latter buildings start their inevitable deterioration, due to Government tendencies to under-resource maintenance regimes and sweat their assets.

Consistent with the increased focus on the operating performance of PPP’s, is the need for effective response to State-initiated changes to the operating environment in these facilities, over the contracted period. PPP’s are characterised by long-term concession periods – at least 20 years – and flexibility in the PPP arrangements is critical if the facilities are to remain relevant and useful for the full term.

STATE-INITIATED CHANGE IN SOCIAL INFRASTRUCTURE

Consequential impacts, arising from Government legislative or policy changes, on social infrastructure are a fact of life. Most social infrastructure in Victoria, irrespective of how it is procured, has been or will be subjected to alterations to their building fabric - by way of capacity increases or service upgrades – or service mix – through program re-orientation or security rating, over their useful life. In the Victorian Justice sector, nearly all of the State’s prisons have had substantial modifications to their structure within the past five years – by way of additional capacity, building modifications to better implement social policy objectives, security upgrades and consequential architectural and services infrastructure works.
an implementation and payment process for a defined set of State initiated changes which impact on the contractor's obligations under the PPP agreement. This provides a contractual platform for State modifications, with commensurate financial compensation to the Contractor, dealing with both the development and operational parts of the PPP agreement.

These provisions have been more or less standardised and have been published in PPP guideline materials on most Australian jurisdictions. There is little that can be added with respect to these contractual provisions here.

**Refurbishment/Refresh Provisions**

Clear refurbishment specifications across the whole contract operational term are a critical part of the Contractor’s facility management obligations. The Contractor can benefit from the delivery of a high-quality facility that best manages the Contractors facility management obligations under the refurbishment regime. From the State's perspective, refurbishment regimes are a negotiable bid item, and should be closely scrutinised during the PPP procurement process.

Once contracted, the refurbishment regime can be best managed through a good contract administration relationship between the State and the Contractor, and where a flexible approach to the refurbishment regime has been fostered. Under this scenario, State-driven refinements to the operating environment can be managed through careful manipulation of the refurbishment regime. Some useful refurbishments principles which can facilitate the approach are:

• Clear specifications for each year of the concession period, aligned under performance standards of the contract – so that the refurbishment regime does not take on the Contractor's performance obligations;
• Fixture, fit-out and equipment replacements are aligned with respective warranties;
• Fixture repairs and replacements reflect a realistic upkeep, recognising the Contractor’s maintenance obligations;
• A float provision, where refurbishment to agreed areas in a particular year can be rolled over to future years; and
• Flexibility in the regime so that it can be altered by agreement, once the facility commences operations and with the benefit of operational experience.

Technology services, where part of the Contractor’s ancillary services to a PPP agreement, can also be assigned a ‘refresh’ regime. This technology refresh is usually confined to generic desktop IT, as specialised equipment (eg. high-tech security systems) is subject to a much higher redundancy risk and price variability over time for which refresh provision may not be applicable. High tech systems are best market-tested on a periodic basis (see Service Contracts below).

Under the refresh agreement, the PPP lease payment to the Contractor has a separable payment stream redirected to a special-purpose, interest bearing fund, which covers an agreed amount of replacement cost of desktop IT to a comparable scope and quality on say, a three year cycle. This IT refresh fund, while a

For example, Fulham and Port Phillip Prisons, both delivered as BOO projects in the 1990’s, have had significant additional capacity increases and internal modifications to meet State policy and standard changes. The Victorian County Court commenced operations in 2002 and is currently having two ‘shell’ floors fitted out to meet an increased demand for major crime trial courtrooms.

Changes to the operating environment can have marked contractual repercussions unless there is flexibility for such change in the PPP arrangements.

Further, generally speaking around Australia, PPP policy dictates that core services in social infrastructure must be delivered by the public sector. This adds complexity when instigating changes to a PPP facility’s operating environment, because the environment is provided and maintained by one party (Contractor) to the other (State operator), in a bespoke facility and often to stringent State operational requirements (for example in a prison).

The challenge is to develop an effective operating environment, suitable for core service delivery over a long concession period, in a constantly changing policy environment. The remainder of this paper is devoted to describing ways in which PPP arrangements can be crafted to be more flexible and responsive to these inevitable changes. This responsiveness is likely to be a critical success factor and to come under increasing scrutiny as more PPP’s are delivered and establish operating performance histories.

**FLEXIBILITY MECHANISMS FOR PPP ARRANGEMENTS**

**Change in Policy Provisions**

State policy-driven changes to PPP operating environments have traditionally been dealt with through change in policy provisions in PPP contracts. Changes in policy provisions in PPP contracts provide
set capped amount, must be manipulable to meet, as far as possible, changes in the State’s IT standards, available products and users' expectations over the contracted term. Such technology is also heavily exposed to foreign exchange and taxation risks, which would be borne by the States under the available funds. To some extent, these IT delivery risks can be offset by the generally reducing costs of the generic IT products and the interest accrued in the fund.

Service Contracts Re-Tender Option
The State/Contractor relationship can be encouraged and/or enforced by the State’s options to re-tender the ancillary services sub-contracts on a regular basis through the contract term. This has become accepted PPP procurement practice. Most PPP’s now to offer these non-cores services - such as technology services, building security, maintenance/landscaping services, on a five year initial grant from the main PPP agreement, with the option to continue or re-tender the services at three-to-five year periods thereafter for the concession period. This gives the State options to test the market at regular intervals in these service sectors and also to re-visit the service specifications to keep them relevant to the State’s operating environments.

Augmentations
State variations to scope which result in modifications to the operating environment can occur over the contract term in response to successive Governments’ policy changes.

There is, however, peak variation activity in the first years of the operating contract as project-specific issues are identified by the State operator, once they commence operations. In the Victorian experience in the first year of prison facility operations, the State operators invariably seek a myriad of scope variations to refine the facility’s operating environment. This can be anything from additional internal fences to extra wall hooks; which as individual items are inexpensive, but as an accumulated expense can grow to a substantial amount.

The State project team will normally have contract administration processes in place to manage these variations, which differ from the defect liability obligations of the Contractor. Consequential costs, including the Contractor’s margin, must be borne by the State, where these variations cannot be made to fit the project scope or fit for purpose provisions. This creates a problem, because in a standard PPP there is no construction contingency for the State operator to pay for these facility refinements.

The recent Victorian PPP prison projects, anticipating these post-delivery risks, sought that the concession payments incorporate an “augmentation” capacity to $1,000,000 capital to pay for State operator requests in the first twelve months of the operating period. This has provided a general fund to enable refinements to the operating environments of the two prisons, based on the State’s operators experience in running them.

Additional Spaces
Typically new PPP social infrastructure is provided to meet community demand for accommodation to house social programs. In the case of the prisons, this means additional prisoner beds for specific prisoner types, supporting infrastructure for social programs and staff and visitor amenities. Demand for Justice facilities follows a principle of social economics, that demand will always exceed supply and, where supply is provided to a part of the Justice system, demand will inevitably re-focus to meet the supply. Given that delivery of PPP Justice facilities takes around three to four years from funding approval to operational commencement, they are often full to capacity in ensuing years and will require additional accommodation units to meet the demand growth.

All Victorian PPP Justice facilities are now developed with provision for additional capacity – as vacant space within the facility perimeter or as ‘shell floors’ in multi-storey buildings. Facility engineering services
infrastructure is also required to be able to meet the additional demands from the increased accommodation once it is implemented.

**End of Term Arrangements**

State specified end of term arrangements direct the financing model adopted by Contractors in their bid submissions.

The State may also direct that the facilities revert to the State at the end of the concession period, with the following impacts:

- The life of asset may be extended beyond the term - under this scenario, the State must ensure the facility is designed and constructed for the longer term use. The State may also seek the option to extend the service contract with the Contractor;
- End of Term audit - if the State assumes control of the facility at the end of the concession period, an agreed process is necessary to ensure the facility has been maintained to an agreed performance level;
- Financial modelling - the Contractor will respond with a financial model reflecting the full cost of the facility meeting financial costs and return on investment over the term;
- Flexibility lost - the State will be expected to continue to operate the facilities, having paid for them and thereafter bear the redundancy risk; and
- Taxation implications - the financial model requires adjustment for taxation implications, based on commercial advice.

The State may direct that the facilities be redundant at the end of the concession period - that is with no terminal value. The risk under this scenario is that the Contractor will allow the facility to run down over the last years of the concession period. Careful monitoring by the State is required to mitigate this risk.

**Contractor Responses to Flexibility**

In this discussion of the capacity of PPPs in an operating environment to accommodate changes in scope as Government policy evolves, it is crucial for stakeholders to appreciate the implications for project finance structures of “embedding” these flexibility mechanisms in the up-front contract.

Historically, the lowest cost financing model for PPPs has been highly geared, non-recourse debt finance of a special purpose vehicle (SPV), that has effectively and permanently outsourced its construction and operating obligations, for example by entering fully “back to back” contracts with builders and facilities managers. Having passed through these risks, debt and equity investors can then aggressively price the underlying State payment streams for the length of the concession term.

Invariably where the State sought to preserve some flexibility, its cost and risk to the private sector was factored into the financial model e.g. through reserves/contingencies held by the SPV, or by additional risk margins paid to third party service providers.

However, as the industry matures and more PPPs move into an operating phase, it is anticipated that the financing markets will more readily accommodate flexibility that is transparently “value for money” for the State, that is, the State can readily see the trade-off between up-front cost and the ability to manage true “whole of life” cost. The Contractor may invest in additional upfront build quality to offset downstream facility management risk.

This emerging track record of PPPs in operation, and the increasing capacity of more active equity owners and sponsors to demonstrate they understand whole
of life risk and can actively manage the contract relationships with the State, will increasingly be seen by project lenders as a more effective method of managing financial risk than the “locked box” of 20-25 year outsourcing arrangements.

In projects like the County Court, one can look beyond rigid contractual provisions and see the genuine commercial incentives upon both the State and the private sector equity owners to sensibly negotiate changes that could not have been contemplated at the original contract signing. In this project, it is in both parties interest to ensure the court facility stays a relevant and effective court operating environment for well beyond the concession period.

The financial market has also responded to the need for longer-term funding flexibility over the life of the PPP agreement. Some PPP bidders are offering “standby fund facilities” (SFF) as part of their financial bid to capital fund State-initiated changes over the term. Such SFF are arranged as part of the larger bank or bond financing structure, at pre-arranged rates, at the development stage. Where subsequent State-initiated changes are sufficiently substantial to warrant accessing the SFF, they provide an ever-ready effective means to access capital funds, at the State’s discretion, and which can be repaid through an alteration to the PPP concession payment stream.

CONCLUSION

This paper noted the maturation of the PPP market in Australia, in particular for social infrastructure; with many PPP deals now well into the operating phase. An emerging issue, consistent with the new focus on the operating phase, is the need to make PPP agreements, responsive to the inevitable State-initiated changes over the concession period.

State-initiated changes are a fact of life in social infrastructure, driven by legislative and social policy imperatives of incumbent Governments. Consequential impacts on facilities are reflected in building capacity increases, upgraded technology systems and modified programmatic spaces.

The great partnering challenge in PPP delivery is that the parties respond flexibly and positively to the necessary changes to the operating environments in these facilities. Innovative PPP arrangements have evolved to provide the means to achieve this.

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