Public Private Partnerships –
The dawn of a new era for project financing?

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CONTENTS

1. Introduction and Background to Public Private Partnerships 314

1.1 Background to UK PFI Model 315
1.2 PFI Transaction Structures 315
1.3 Other Policies Supplementing PFI 316

2. The Australian Experience 316

2.1 Victoria – Partnerships Victoria Policy 316
2.2 New South Wales: Working with Government – Guidelines for Privately Financed Projects (November 2001) (*NSW Guidelines*) 323
2.3 Queensland: Public Private Partnership Guidelines 324
2.4 Western Australia 325
2.5 South Australia 325
2.6 Northern Territory, Tasmania and the Australian Capital Territory 326
2.7 The Commonwealth 326

3. Perceived Advantages of the PPP Model 326

4. Types of Projects which might Qualify for Public Private Partnerships 327

5. Some Issues of Concern for Financiers – An Australian Context 328

5.1 Power of the government parties to contract 328
5.2 Government guarantees or other support 332
5.3 Government security – ranking and priority 332
5.4 Step In and Cure Rights 333
5.5 Force majeure, damage and reinstatement 336
5.6 Insurance 338
5.7 Termination 344
5.8 The Need for Direct/Tripartite Agreements with Key Parties 350
5.9 Refinancing of PPP projects 350
5.10 Dispute resolution 353
5.11 The Need for Competitive Funding 354
5.12 Procurement of Services – the critical concepts of Availability and Performance 355
5.13 Scope of the Government's Right of Set-Off 357
5.14 Change in Services 357
5.15 Service Charge Variations 358
5.16 Restrictions on Assignment by Financiers 359
5.17 Scrutiny of Financing Documentation 359
5.18 Tender Process Risks 360
5.19 Land Acquisition and Tenure Issues 360
5.20 Taxation Issues 361

6. Problems Encountered – Lessons to be Learned from the UK Experience 361

6.1 Problems encountered 361

7. The Dawn of a New Era for Project Financing? 363

Public Private Partnerships – The Dawn of a New Era for Project Financing?

1. Introduction and Background to Public Private Partnerships

An issue of continuing importance to Australia is the role that the private sector can play in the delivery of public infrastructure. Traditionally, federal, state and local governments in Australia have dominated the provision of public infrastructure. However, in various States the private sector is becoming increasingly involved in the financing, design, construction, operation and ownership of infrastructure facilities and the provision of public services.

State governments have for several years publicised that they welcome private sector involvement in the delivery of public infrastructure. This rhetoric of enthusiasm towards private sector involvement was reflected to some degree by the publication by successive governments of policy guidelines in the 1990s that invited, and purported to regulate, such private sector involvement.

Inspired by the apparent success of the then called Private Finance Initiative (***PFI***) concept in the United Kingdom, Australian State and Territory governments are reviewing or have recently reviewed their policies with a view to encouraging a new wave of "public/private partnerships" in the infrastructure sector. However, the concept of the public and private sectors collaborating to deliver public infrastructure or services is not novel in Australia. DCM, DCMO, DBFO, BOO, BOOT, BOT and LBO methods are just some examples of the ways in which approximately 170 infrastructure projects, spanning a range of industry sectors and valued in excess of $60 billion, have been delivered during the past few decades in Australia.[1]

The device by which the Public Private Partnership (***PPP***) or PFI seeks to achieve its objectives is most commonly the humble concession, although it is often titillated by acronymic finery, some examples of which are referred to above, which the public/private participation in infrastructure delivery has spawned. However, in essence, PPP projects are frequently simply another version or versions of the BOOT scheme.

The new Australian State policies which have emerged to date have been adapted largely from the UK PFI model (more recently known as Partnerships UK). Therefore, it will be of use to consider briefly the background to the UK PFI model before considering the characteristics of the various Australian State equivalents.

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[1] As gleaned from historical research undertaken by the Australian Council for Infrastructure Development (AusCID).

1.1 Background to UK PFI Model

The traditional means by which Australian governments have purchased assets to meet current needs have not always been designed for future flexibility nor provided for cost effective management of those assets throughout their useful lives. As a consequence, operating costs have often been higher than they need to be and assets have not been developed to meet changing requirements.

As a consequence of similar problems, PFI, which was introduced by the UK government in late 1992, was devised to become one of the UK government's main instruments for delivering higher quality and more cost effective public services.[2] Its aim was to involve the private sector more directly in the provision of public services, with the public sector as facilitator and, where desirable, guardian of interests of the users and customers of public services.

PFI focused on the purchase of services, not assets. It recognised that taxpayers are more interested in what they get out of public facilities than in who owns the assets. The political imperative is the quality of public services. The public sector does not need to own many of the assets it uses to deliver public services; indeed, the public sector often carries out the responsibilities of owner rather badly.

Under the PFI, the UK government procures a service from the private sector rather than acquiring the underlying asset itself. The PFI therefore transforms government departments and agencies from being owners and operators of assets into purchasers of services from the private sector.

Private firms become long term providers of services, rather than simply up-front asset builders, combining the responsibilities of designing, building, financing and operating the assets in order to deliver the services demanded by the public sector.

1.2 PFI Transaction Structures

Broadly speaking, PFI transactions in the UK have been structured in one of three ways:-

1.2.1.1 The first type involves services being sold directly to the public sector.[3] The public sector purchases services from the private sector which is then responsible for the upfront investment in capital assets. The public sector client makes payment only on delivery of the services to specified quality standards.

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2 PFI was launched by Norman Lamont when he was Chancellor of the Exchequer.

3 Many UK bridge projects proceeded on this basis.

Typically, the private sector, often acting in consortia, aims to obtain benefits from synergies arising from the designing, building, financing and operating of the capital asset that would otherwise be unavailable to the public sector acting alone.

1.2.1.2 Financially free standing projects, whereby the private sector supplier designs, builds, finances and then operates an asset, recovering costs entirely through direct charges to the private users of the asset rather than from payments by the public sector.[4]

The role of the public sector is restricted to enabling the project to proceed through assistance with planning, licensing and other regulatory approvals and procedures. There is no government contribution or acceptance of risk beyond this point and any government customer for the service is charged at the full commercial rate.

1.2.1.3 A hybrid of the first two whereby the private and public sector enter into a joint venture arrangement. In this scenario, the costs of the project are met partly from charges to the end user and partly from public subsidies. The subsidy can take a number of forms, but the government's role is limited to a contribution towards asset development. Operational control remains with the private sector.

There is of course scope for a number of other models to emerge, depending on the specific requirements of each particular infrastructure project. The choice as to which revenue system is preferable for any given project is often politically driven.[5]

1.3 Other Policies Supplementing PFI

The PFI was one of a range of policies designed by the UK government to increase the involvement of the private sector in the provision of public services, or of services that were once publicly provided. Other government policies with a similar aim included privatisation and contracting out.

All three policies represented a fundamental change in the focus of the public sector in the UK away from being a direct provider of services to the public and towards becoming a procurer of services and a regulator. The logic of this transformation is to allow both private and public sectors to concentrate on doing what they are likely to do best. Better management results in better value for money. The provision of goods and services is the core business of the private sector. The private sector's usual incentives, where coupled with competitive pressures, should ensure the most cost effective outcome.

2. The Australian Experience

2.1 Victoria – Partnerships Victoria Policy

2.1.1 Change in policy focus

Partnerships Victoria is a Victorian government policy, launched in June 2000, providing a framework for integrating private sector investment in public infrastructure. It reflects a policy departure from the traditional idea that government's main intention in contracting with the

[4] Various DBFO road projects assumed this structure.

[5] For example, there are many UK examples of motorway projects where it was considered to be politically unacceptable for tax payer motorists to pay cash tolls, and the government elected instead to pay shadow tolls.

private sector is to procure physical assets. In a Partnerships Victoria project, the government's intention is stated to be to procure the services which depend on (or are otherwise associated with) that infrastructure. The similarity with the UK PFI model is immediately obvious.

The Victorian government considers this distinction is critical to the economies which can be delivered through the new Partnerships Victoria model. Consistent with the philosophy underpinning the UK PFI model, 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. In this way, the Victorian Government's only direct responsibility is to pay for services received. If the promised services are not delivered, or are not delivered to the specified standard, the Victorian Government will pay less, or will not pay at all.

The language of the Partnerships Victoria policy is therefore service-focused. Ownership and control of the infrastructure is a subordinate issue, although the new policy recognises that sometimes ultimate ownership of the asset may be strategically important to government.

The Victorian government's focus on service delivery means that contracts will in future be structured with strong incentives for the private party to ensure continuity of service delivery, through the payment mechanism and other specific contractual provisions.

2.1.2 Determining the best form of service delivery

When determining the most appropriate form of delivery of particular public infrastructure services, the Victorian government proposes to have regard to:

2.1.2.1 Whether any part of the proposed service should be delivered by government itself (essentially a Victorian Cabinet decision) (***the core services question***).

2.1.2.2 Whether involvement of the private sector will deliver value for money and, if so, how to optimise that value (***the value for money question***).

Partnerships Victoria projects are to be subject to a full cost-benefit analysis and bids are to be assessed against public sector benchmarks to ensure value for money, as compared with the costs to government to deliver the project itself. The development of a Public Sector Comparator (***PSC***) will allow the Victorian government to calculate the full, risk inclusive costs of providing a service over the life of the project. The PSC is an estimate of what the project would cost the government were it to be dealt with on a different basis (usually a direct government let) using only public finance The Victorian government has confirmed that it will generally opt for private sector delivery if it represents value for money in comparison with the PSC. The major value for money drivers underlying the Partnerships Victoria approach are stated to be:

(i) risk transfer, relieving government of the substantial, but often undervalued, cost of asset-based risks;[6]

(ii) whole of life costing, fully integrating upfront design and construction costs, with ongoing service delivery, operational, maintenance and refurbishment costs;

(iii) innovation, providing wider opportunity and incentive for innovative solutions as to how service requirements can be delivered; and

(iv) asset utilisation, developing opportunities to generate revenue from use of the asset by third parties – which may reduce the cost the government would otherwise have to pay as a sole user.

2.1.2.3 Whether the project will satisfy the public interest criteria which form a key part of the Partnership Victoria policy (***the public interest question***). Partnerships Victoria projects are to be 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. Public interest is considered to be a threshold question which is to be asked before the project is put to the market. Such projects will only proceed if appropriate contractual and regulatory mechanisms can be put in place, where necessary, to safeguard these public interest concerns.

2.1.3 Partnerships Victoria Guidance material

When the Victorian government approved the Partnerships Victoria policy, it recognised that new guidance material would be needed to assist the public and private sectors in developing and implementing the new policy.

The Victorian Government has issued three principal publications, which are:

2.1.3.1 The Practitioners' Guide;

2.1.3.2 The Risk Allocation and Contractual Issues Guide; and

2.1.3.3 The Public Sector Comparator Guide.[7]

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[6] Since most governments borrow at cheaper rates than the private sector, it seems curious, initially at least, that any project involving the sale of services to the public sector is ever embraced as a PPP project. Apart from the obvious lack of government resources to carry out all projects as direct lets, the other principal reasons relate to risk transfer. It is a myth that governments have access to "cheaper" finance to undertake infrastructure projects: a government's ability to borrow more cheaply is purely a function of its capacity to levy taxes to repay borrowings. However, when it comes to raising finance for a project, it is the risks of the individual project that determines the real cost of finance. The difference between the private and public sectors is that private sector capital markets explicitly price in the risk of a project into the sources of finances. In the public sector, on the other hand, taxpayers implicitly subsidise the cost of a project by bearing the risk of cost overruns, time delays or performance failures, which are not prices into the government borrowing rate. It is now becoming commonly accepted that governments must put a price on the transfer of risk to the private sector.

[7] The Victorian Government has also issued a publication entitled "Non-Metropolitan Urban Water Authority Approval Process" which sets out a streamlined process for a Non-Metropolitan Water Authority when pursuing water and waste water projects under the Partnerships Victoria Policy. Further publications are proposed.

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 Guide.

2.1.4 The Practitioners' Guide

This guide provides detailed guidance to those considering how Partnerships Victoria can be used to meet infrastructure and related service requirements. It provides step by step guidance on all elements of a Partnerships Victoria project, from identification of a potential project, through to contract management. The guide is divided into three parts:

2.1.4.1 Part One

Part One provides an overview of the nature of the projects contemplated by Partnerships Victoria, the key drivers for developing projects and the critical elements for achieving a successful result. It deals with critical questions, such as:

(i) what are partnerships and the possible range of partnership models;

(ii) the benefits of such partnerships and the key features which need to be present for a Partnerships Victoria approach to have a high likelihood of successfully delivering a value for money outcome.

2.1.4.2 Part Two

This part focuses on the key steps in the development and delivery of a Partnership Victoria project and the points at which the approval of the Victorian Cabinet is required. Major stages in developing a Partnerships Victoria project, which are taken from the UK PFI model, are stated to include:

(i) **The service need** – This stage involves identification by the department or agency of service needs; outputs should be identified which will be necessary to achieve particular outcomes. The focus is on outputs only and not a prescriptive solution or on defined inputs and so allows a bidder to devise innovative solutions.

(ii) **Option appraisal** – Available options for meeting service needs are identified. Partnerships Victoria as a delivery option is likely if it satisfies the following criteria:

* the scale of the project exceeds a $10 million threshold;
* outputs are capable of clear specification;
* opportunities for risk transfer exist;
* there is a potentially viable commercial project and a level of market interest in it.

A detailed options report covering the most viable delivery options must be prepared. The key issues to be covered include a project overview, an analysis of the financial impacts, risk analysis, public interest, affordability and service delivery impacts.

(iii) **Business case** - This will set out an overview of the rationale supporting a Partnerships Victoria approach and a preliminary view as to how the project will be delivered. It is prepared by the department/agency and is

submitted to obtain government endorsement of the project and approval of funding. It should contain:

* project objectives;
* a description of the outputs to be delivered;
* an outline of all material risks associated with the project and allocation between government and the private party;
* project structures being considered;
* indicative costs and a preliminary PSC;
* the extent of government support required;
* a cost benefit analysis;
* the likely level of market interest in the project;
* proposed performance measurement and payment mechanisms;
* key stakeholders;
* employment issues and local content policy;
* public interest issues;
* site issues;
* environmental impacts;
* a project timetable and estimated time for service delivery to commence.

(iv) **Project development** - Following endorsement by government and any necessary approval of funding, the project is further refined in readiness for the seeking of formal market interest. A procurement team is assembled to develop and deliver the project, and a detailed project plan and timetable is prepared. A preliminary PSC is developed (the quantitative benchmark against which the value for money delivered by private bids is compared).

(v) **Bidding process** – This stage involves developing the bid documents, formally engaging the market and identifying preferred bidders. Cabinet approvals are required before issuing an invitation to register Expressions of Interest and prior to issuing a Project Brief. EOIs submitted must be assessed in accordance with criteria set out in the Partnerships Victoria guidelines. The procurement team then arrives at a shortlist of bidders to receive the project brief. A project brief and draft contract is then developed. Bids are then evaluated in line with the evaluation criteria. An evaluation report must be prepared and a preferred bidder nominated.

(vi) **Project finalisation review** – This involves a check that the bid meets all identified outputs and offers value for money in comparison with the PSC. A report must be given to the Minister and should include a timetable for negotiations, contractual close and commencement of service delivery. After considering the project director's report, the Minister formally advises the Treasurer of the conforming bid and his intent to enter into the contract.

Once the Minister and Treasurer have approved the project, all bidders are notified.

(vii) **Final negotiation** – A negotiation team is formed to negotiate contractual terms with the preferred bidder. At the end of negotiations the contract is awarded to the successful bidder and all parties execute the contract before a public announcement is made.

(viii) **Contract management** – A management team is formed which is responsible for monitoring project delivery through the construction and commissioning phases.

2.1.4.3 Part Three

This section deals with a number of technical and process issues associated with the delivery of a Partnerships Victoria project. They are dealt with in detail to highlight the range and complexity of matters to be managed. The Guide recognises that expert advisers will need to be retained in a number of areas. The issues dealt with include:

(i) risk allocation;

(ii) use of the PSC;

(iii) commercial issues (including taxation, the structuring of payment mechanisms, financing issues and the end of term arrangements);

(iv) techniques and principles for evaluating bids;

(v) the protections available for intellectual property;

(vi) accounting treatment and disclosure;

(vii) the content of the public interest test; and

(viii) satisfying probity requirements.

The Practitioners' Guide also contains sample templates for:

(A) Expression of Interest document;

(ix) project brief document;

(x) indicative project timeline;

(xi) probity documents;

(xii) public interest test; and

(xiii) risk allocation matrix.

2.1.5 The Risk Allocation and Contractual Issues Guide

This Guide is designed to:

2.1.5.1 increase understanding of risk allocation and the objectives of public and private parties when negotiating risk allocation;

2.1.5.2 identify all major risks relevant to Partnerships Victoria projects, outline the legal and commercial issues associated with them, and indicate the preferred government position on allocating the risks;

2.1.5.3 indicate the Victorian Government's preferred position on major risks, and offer guidance on how each of these risks may be best addressed in their particular project, recognising that each project has unique features; and

2.1.5.4 lower transaction costs by providing, where appropriate, examples of suitable clauses to give effect to the government's preferred position on some of the more standard risks, again acknowledging the need to assess their application in any given project.

This guide is divided into three sections. Part One outlines the philosophy of risk management and, in particular, risk allocation. It stresses that transfer of risk away from government, in a way that confirms value for money, underpins the Partnerships Victoria policy.

Part Two categorises the major project risks and outlines the government's preferred position on allocating each of the identified risks.

Part Three then covers the key contractual issues in effecting risk allocation and provides examples of suitable clauses where appropriate.

2.1.6 The Public Sector Comparator Guide

The construction of a PSC is necessary in almost all Partnerships Victoria projects to test whether any private investment proposals offer 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. This guide outlines the roles of the PSC and provides guidance on how to construct one, including the valuation of project risks. The PSC 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 the 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.

Use of a PSC as a means of testing private party bids for value for money is an essential element of the Partnerships Victoria policy. It has four core components:

* raw PSC (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);

* 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).

2.2 New South Wales: Working with Government – Guidelines for Privately Financed Projects (November 2001) (*NSW Guidelines*)

The New South Wales government has taken a slightly different, though nevertheless similar, approach to that of Victoria.

The NSW Guidelines acknowledge that the New South Wales government has engaged the private sector in the delivery of services and associated infrastructure to the public for many decades and that full public provision of infrastructure is rare.[8] Given its decision to expand private sector involvement in economic infrastructure into areas of social infrastructure, such as health and education, the New South Wales government undertook an extensive review of its current procedures. During the consultation process associated with the Working with Government Green Paper,[9] it was strongly advocated that a consistent approach to PPPs in Australia would enhance the development and evaluation of infrastructure proposals, increase confidence in the processes and reduce transaction costs.

The NSW Guidelines acknowledge the common sense in an Australia wide symmetrical approach by providing procedural consistency with the Partnerships Victoria model. The NSW Guidelines therefore draw heavily on the Partnerships Victoria guidance material, particularly Section 5: Risk Management, Section 6: Contractual Issues, and Section 7: Public Sector Comparator. Appendix 3: Risk Table, of the NSW Guidelines, is also substantially reproduced from the Partnerships Victoria guidance material.

The NSW Guidelines define PPPs as "covering any contracted relationship between the public and private sectors to produce an asset or deliver a service". However, the NSW Guidelines only specifically address privately financed projects (***PFPs***).

The rationale for having a distinct set of guidelines for PFPs is explained on the basis that PFPs raise unique issues and risks for government stemming from private financing and private sector ownership and the typically long term nature of the commitments involved.

The development and approval of outsourcing and conventional procurement are to remain subject to normal contracting arrangements.[10]

The NSW Guidelines address:

2.2.1.1 those types of projects which are suitable for PFP;[11]

2.2.1.2 the various phases of PFP development including:

(i) project definition;

(ii) expressions of interest and shortlisting;

(iii) detailed proposals and assessment;

(iv) negotiations and contracts;

(v) disclosure and implementation;[12]

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8 Working with Government: Guidelines for Privately Financed Projects, November 2001, page 1.

9 Working with Government – Private Financing of Infrastructure and Certain Government Services in NSW; NSW Government, November 2000.

10 Refer to NSW Government Procurement Guidelines at: http://www.dpws.nsw.gov.au/DPWS/Policy/Publications.

11 Ibid, footnote 8, Chapter 2.

12 Ibid, footnote 8, Chapter 3.

2.2.1.3 project management structures (including the establishment of a steering committee by the delivery agency; the appointment of a project manager, probity auditor and project team comprising specialist legal, financial, technical and other advisers);[13]

2.2.1.4 risk identification and management;[14]

2.2.1.5 contractual issues;[15]

2.2.1.6 public sector comparator;[16] and

2.2.1.7 probity and accountability issues.[17]

2.3 Queensland: Public Private Partnership Guidelines

Queensland released its PPP policy entitled "Public Private Partnership Policy – achieving value for money in public infrastructure and service delivery", in September 2001.[18] The draft guidance material underpinning the PPP policy was released for public consultation on 2 May, 2002. Comments on the guidelines have been invited to be submitted to the Queensland Department of State Development by 7 June, 2002. The Queensland government hopes to have the guidelines adopted by Cabinet and implemented by August, 2002.

The draft guidance material has been developed following consultation with government agencies and representatives of the infrastructure sector and is generally consistent with the PPP regimes being implemented in Victoria and New South Wales. The aim of the guidelines is to provide a clear framework which reflects the objectives of Queensland's PPP policy, namely:

- to deliver improved services and better value for money through appropriate risk sharing between public and private sector parties;
- encouraging private sector innovation;
- optimising asset utilisation; and
- integrated whole of life management of public infrastructure.

The Queensland government has released (or proposes to release) the following draft guidance material:

(i) **Overview Document** - this aims to guide government and the private sector on the process and issues likely to arise in analysing and developing major infrastructure proposals, and where appropriate, delivering PPP's. It acknowledges that the guidance material draws on the Partnerships Victoria material, in terms of the general structure of the process, and in particular, the detailed analysis and allocation of risk.

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[13] Ibid, footnote 8, Chapter 4.

[14] Ibid, footnote 8, Chapter 5 and Appendix 3.

[15] Ibid, footnote 8, Chapter 6.

[16] Ibid, footnote 8, Chapter 7.

[17] Ibid, footnote 8, Chapter 8.

[18] The policy replaces the Queensland government's 1997 policy document, "Private Sector Involvement in Public Sector Infrastructure and Service Delivery".

(ii) **Guideline Framework** – this provides a comprehensive description of the major stages in the procurement process, how appropriate delivery options for a project will be evaluated and how the most appropriate option will be selected.

The framework is broadly consistent with the approaches taken in the other abovementioned jurisdictions, particularly in relation to risk allocation, contractual issues and the construction of the public sector comparator.

The emphasis is on the consistent application of whole of life, risk adjusted costing and comparison of delivery alternatives against a benchmark reflecting traditional procurement practices. The objective is to select from the full range of delivery options (including traditional procurement), the option which provides the best value for money outcome.

(iii) **Risk Management** – this document focuses on risk and its management in PPP projects.

Part One outlines the background methodology for risk allocation and Part Two identifies the major risks in PPP projects and outlines the Government's preferred position on each identified risk.

(iv) **Probity and Process Governance** – the PPP process is to be underpinned by probity practices that ensure that the procedural integrity of the process is maintained. The probity principles of accountability, transparency, confidentiality and management of conflicts of interest are discussed in detail. According to the guidelines, a probity plan that sets out the probity guidelines and procedures to be followed should be prepared prior to the commencement of the competitive bid process. At the completion of the transaction, a probity audit should be undertaken to check for compliance with the guidelines and conditions established for the competitive bid process.

(v) **Project Resourcing** – the purpose of this document is to assist government agencies in assembling resources, including the procurement of specialist advisers, and developing a project structure for a PPP project. It is advisory rather than mandatory, providing guidance on good practice.

(vi) **PPP Business Case Development** –this document, although referred to in the draft material, is still to be finalised and released.

2.4 Western Australia

Western Australia is apparently planning to release guidelines later this year although it has been foreshadowed that this may be delayed. Western Australia has indicated that it will be following the Partnerships Victoria model.

2.5 South Australia

PPPs were on the agenda of the previous South Australian government which had developed internal guidelines known as "Partnerships Australia". However, these guidelines have not

been made publicly available. The recently elected South Australian government has announced its intention to conduct an internal review and reassessment of the guidelines.

2.6 Northern Territory, Tasmania and the Australian Capital Territory

No guidelines have yet been developed in Tasmania or the Territories but it is assumed that they too will follow the lead of Victoria.

2.7 The Commonwealth

At the federal level, the Department of Finance and Administration has established a private financing unit to advise and assist Commonwealth agencies, with defence and transport noted as being likely areas for future projects. The Commonwealth government released its policy principles for the Use of Private Financing in October 2001. The purpose of these policy principles is to establish a policy framework for the Commonwealth government to use private financing in future procurement of major assets and infrastructure.

3. Perceived Advantages of the PPP Model

As the Australian PPP models have been based essentially on the Partnerships UK/PFI model which has been operational for almost a decade, it is worthwhile considering the perceived benefits attaching to the UK PFI model.

The UK Government believes the PFI model can offer the following advantages over conventional procurement methods:

3.1.1.1 For the public sector, and the public in general, PFI's primary benefit has been more and better projects and better services. Generally speaking, these services should also cost less than if provided by traditional public sector means, because the private sector achieves efficiencies in delivery by better design and management.

3.1.1.2 Since the private sector assumes responsibility not only for the construction but also for the operation of a project, private sector bidders are forced to take a whole of life approach to costing. Integrating the different functions of design, construction and operation releases the synergies between them and discourages low capex, high opex solutions.

3.1.1.3 PFI contracts concentrate on the what, not the how. The UK experience has been that too often in the past, the public sector specified what it required to the last detail, leaving bidders with little scope to compete other than on the basis of the lowest cost in the short term. A switch to output specifications allows innovation in design, avoids gold-plating and delivers service benefits over the life of the contract.

3.1.1.4 The public sector receives guaranteed services of a specified quality because it is usually on that basis that the private sector gets remunerated. The private sector is motivated to perform year after year, failing which its income would be jeopardised. A slap-dash approach to construction simply causes increased maintenance costs and jeopardises the payment stream if unreliability results.

3.1.1.5 Risks can be allocated more efficiently by allocating the private sector responsibility for managing and delivering services and the public sector the responsibility for policy and legislative frameworks.

3.1.1.6 The bottom line incentives that motivate private sector developers are a more powerful management tool than mere public sector controls, irrespective of how hard the public sector tries to replicate those same incentives in its own approach.

3.1.1.7 The PFI model forces public servants to take a strategic approach to procurement. PFI contracts are long term and procurers have to think carefully about the future plans of their departments before committing to long term payments under a PFI contract. This helps counteract a tendency to "short-termism" by focussing on the expenditure implications of an asset and not just the cost of building it.

3.1.1.8 The PFI model leads to new investment opportunities. This is demonstrably the case with financially freestanding projects or with joint ventures in which the private sector is only looking for a limited input of public funds. In those cases, projects may proceed which would not have occurred had they been mainly dependent on public funds.

4. Types of Projects which might Qualify for Public Private Partnerships

It is imperative to consider the UK experience in this context.

The sheer volume of PFI transactions, since PFI commenced in the UK in late 1992, is compelling. More than 400 transactions have been completed with an aggregate value of approximately £20 billion. New PFI transactions are closing at the rate of 30-40 per year.[19]

The following examples illustrate the diversity:-

* transport;
* health;
* defence;
* accommodation;
* urban regeneration;
* information systems;
* prisons;
* higher and further education;
* water and sewerage.

There is little doubt that the PFI model has successfully boosted public sector investment levels in the UK.

Since PFI's introduction, the range of projects embracing the PFI model has blossomed. Initially, the PFI model was directed to the more obvious sectors for private participation such as roads and bridges; railways, rolling stock and train systems; airport terminals; and privately managed prisons. Subsequently, however, the UK government expanded PFI into the

[19] *Project Finance International*, May 16, 2001, pp 68-70.

provision of social infrastructure such as hospitals and medical equipment, schools, universities and social housing. The PFI model has also been implemented in the context of government accommodation, waste-to-energy plants, and water treatment projects. The UK government is also finessing PFI techniques to apply not just to capital investment in a new asset, but as a vehicle to bring private skills into the management of the flow of capital expenditure over time; for example, in the refurbishment of the London Underground.

However, not all infrastructure projects will be suited to PFI procurement. For example, very small projects may result in PFI procurement costs which are disproportionate to the size of the project or the benefits that might be achieved. However, even in these situations, small projects may be packaged together with other similar projects to overcome this disadvantage. This has been the case in the UK where the PFI has been applied to bundled school projects which individually were too small to generate market interest or to achieve the desired cost savings.[20]

5. Some Issues of Concern for Financiers – An Australian Context

5.1 Power of the government parties to contract

As the number of PPP projects blossom, financiers will continually need to investigate and be satisfied that the relevant government party has the power to contract in the manner contemplated by the project in question.

Governments operate through a variety of forms. The "Crown" as it is called in Australia, describes each of the bodies politic comprising the Commonwealth of Australia, each of the States and each of the Territories. It has long been established that each of these bodies represents a separate and distinct entity for the purposes of the law.[21] The Crown includes the various ministers, departments, divisions and other bodies which make up the government unless those bodies have been granted independent legal status by legislation (eg statutory corporations and local authorities).

The Commonwealth's power to make contracts is constrained by the constitution which contains specific enumerated powers. The States and Territories, however, have no enumerated legislative powers[22] and, apart from their place in the federation,[23] are not limited in their power to enter into contracts.[24]

This latter point is made legislatively apparent in Queensland by the Acts Interpretation Act 1954 (Qld). Section 47C provides that the State may carry out commercial activities. "State"

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20 For example, the much lauded Glasgow Schools PPP Project, where the Glasgow City Council has contracted with a private sector consortium to modernise and refurbish 29 secondary schools and provide a range of services over a 30 year concession period.

21 *Minister for Works for Western Australia v Gulson* (1944) 69 CLR 338.

22 *New South Wales v Bardolph* (1934) 52 CLR 455 (per Evatt J at 474).

23 It would be legally ineffective for a State to legislate so as to infringe s92 of the Constitution or to engage in an activity which was within the Commonwealth's exclusive power.

24 *Building Construction Employees and Builders Labourers Federation of NSW v Minister for Industrial Relations* (1986) 7 NSWLR 372

is defined to mean the Executive Government of the State of Queensland,[25] which is attributed all of the powers, and the legal capacity, of an individual.[26] "Commercial activity" is defined to include commercial activities that are not within the ordinary functions of the State[27] and it is made clear that commercial activities may be carried out without any further statutory authority and without any appropriation by parliament.[28]

By contrast, a statutory corporation's capacity to contract is usually governed by its enabling legislation, although its power may be affected or qualified by other legislation.[29]

That same proposition applies to local governments, which are invariably constituted as a corporation with specific powers under their relevant local government legislation.

It is therefore possible for a statutory corporation to make a contract which is beyond power. Although there is no general equivalent in the public sector to the Corporations Act 2001, ss124-125 (which abolished the ultra vires doctrine for private sector corporations), some government owned corporations legislation has either modified or abolished the doctrine with respect to those corporations not bound by the Corporations Act.[30]

Similarly, it is possible for local governments to encroach beyond the bounds of their enabling legislation and also engage in ultra vires activities.[31] It is relevant to note that, as more and more local governments embark upon infrastructure projects in conjunction with the private sector, the various State and Territory local government legislation varies widely in dealing with the extent to which local government may engage in entrepreneurial activities. Furthermore, there exists a raft of different procedural requirements under the various legislation, the failure to comply with which may also render the proposed project and associated contracts ultra vires.[32]

Another obvious preliminary issue involves the identification of the government legal entity which is to be the contracting party. This issue is made sometimes more challenging by the occasional practice of governments to refer in negotiations or correspondence to a description of the contracting party which is technically incorrect. For example, the named party may be the representative of the government who has the authority to enter the contract[33] or the part

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25 Acts Interpretation Act 1954 (Qld), s47A

26 Ibid, s47B

27 Ibid, s47C

28 Ibid, s47C(3)

29 For example, generic government owned corporations legislation of the relevant jurisdiction may affect a statutory corporation's power to contract.

30 See the Commonwealth Authorities and Companies Act 1997 (Cth); Territory Owned Corporations Act 1990 (ACT); Government Business Enterprises Act 1995 (Tas); State Owned Corporations Act 1989 (NSW); Government Owned Corporations Act 1993 (Qld); Public Corporations Act 1993 (SA) and the State Owned Enterprises Act 1992 (Vic). However, as pointed out by Seddon N, Government Contracts (2nd Ed) at pages 61-63, the position is patchy and by no means uniform.

31 There are numerous recent examples of English local councils entering into financial transactions (mainly speculative interest rate swaps transactions) which were held to be ultra vires. See, for example, *Hazell v Hammersmith and Fulham London Borough Council* [1992] 2 AC 1; *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669; *Kleinwort Benson Ltd v Birmingham City Council* [1997] QB 380.

32 Seddon, N. above at 63-65.

33 For example, the "Minister for Education", rather than the relevant State or Territory government the Minister represents. See *Town Investments Ltd v Department of the Environment* [1978] AC 359.

of the government entity to whose business the contract relates,[34] rather than the legal entity which for the purposes of the law is the relevant contracting party.

Another reason why the correct description and nature of the government contracting party is important is because of the common law rule that it is not possible for a legal person to contract with himself or herself[35]. If, in respect of a key contract relating to an infrastructure project, one government contracting party is the same legal entity as the other party with which it is purporting to contract, there may be no effective contract.

Therefore, the following key governmental power issues will need to be assessed by project sponsors and their financiers:

5.1.1.1 what is the legal status of the government bodies which are proposing to enter into the project contracts?

5.1.1.2 do those bodies enjoy the requisite power to enter into and perform the contracts in question, and if necessary, delegate its powers or functions in favour of a private sector party?

5.1.1.3 has the relevant government party complied with any procedural requirements imposed on it in connection with the formation of the contract?

5.1.1.4 does the officer of the government party who purports to sign the contract enjoy the requisite authority to do so?

5.1.1.5 are the obligations of the government party in fact obligations of the Crown or of a separate statutory body (whose lesser financial worth may demand a guarantee by the Crown of its contractual performance)?

Finally, the ability to enforce the contract against the relevant government party needs to be visited by the financiers. Where the government party represents the Crown, the position in Australia is dictated by the various Crown proceedings statutes, which are not uniform. As Seddon observes,[36] the general pattern is to maintain Crown immunity but, at the same time, to provide for the responsible person (being the Treasurer, Governor, or other specified person, depending upon the jurisdiction in question) to satisfy a judgment against the Crown out of consolidated revenue.[37]

Of relevance in assessing the strength of a government covenant, guarantee or indemnity, it is worth noting that the responsible person is under a mandatory duty to pay out of consolidated revenue in five jurisdictions only.[38]

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34 For example, "Department of Transport" being only a part of the relevant legal entity which is the relevant State or Territory government.

35 However, the law now recognises that a person may enter a contract with itself in a different (eg. as trustee) capacity; see *Gulland v Federal Commissioner of Taxation* (1983) 72 FLR 362, 377ff. (at first instance). There are also some limited statutory exceptions to this common law rule. See, for example, ss.14 and 50 of the Property Law Act 1974 (Qld).

36 Seddon, N above at 163-165.

37 Judiciary Act 1903 (Cth), s66; Crown Proceedings Act 1992 (ACT), s13(2)-(6); Crown Proceedings Act 1988 (NSW), s7(1); Crown Proceedings Act 1993 (NT), s11(2)-(5); Crown Proceedings Act 1980 (Qld), s11(1); Crown Proceedings Act 1992 (SA), s10(2)-(6); Crown Proceedings Act 1993 (Tas), s11(2)-(5); Crown Proceedings Act 1958 (Vic), s26(1)-(2); Crown Suits Act 1947 (WA), s10(1)-(2).

38 The Commonwealth (Judiciary Act 1903 (Cth), s66; New South Wales; Queensland; Tasmania and Western Australia. In Victoria, the provision merely states that it shall be lawful for the Governor to pay.

In the remaining jurisdictions, the relevant legislation is phrased more permissively.[39]

Perhaps of greater significance is not all of the Crown proceedings legislation themselves overcome any possible problem about a lack of appropriation to satisfy a judgment. In some jurisdictions, the legislation itself provides merely for satisfaction of a judgment out of legally available funds (or similar wording).[40] Thus, it is theoretically possible that the government in those jurisdictions could resist the payment of a debt or damages ordered by a court on the basis that there was no appropriation to cover the amount in question. It would, of course, be extraordinary (and debilitating for its credit rating) for a government to defy a court order on this basis.

Some of the abovementioned difficulties are overcome in New South Wales by the operation of the *Public Authorities (Financial Arrangements) Act 1987* (the ***PAFA Act***), which provides statutory comfort for private sector parties participating with government in the delivery of public infrastructure. For example:-

(ii) section 20 of the PAFA Act empowers authorities[41] to enter into joint financing arrangements[42] with other persons in relation to infrastructure and other capital assets;

(iii) section 22A of the PAFA Act provides a statutory guarantee of financial accommodation raised by an authority, which guarantee is stated to continue despite the fact that the authority may later cease to exist or cease to be responsible for the exercise of the functions relevant to the performance of the obligations the subject of the guarantee,[43]

(iv) the New South Wales Government may in its discretion guarantee an authority's performance of any obligations incurred by it in connection with any arrangement authorised by the PAFA Act;[44]

(v) the Treasurer is authorised to act on behalf of the government in respect of such guarantees,[45] and

(vi) there is a statutory appropriation of money to meet any liability under any joint financing arrangements or guarantees given in respect of them.[46]

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39 However, Seddon argues that it would be inconceivable in practice that any of the remaining four governments (ACT, NT, SA and Tas) would fail to satisfy a judgment on the ground that the statutory language was merely permissive. Perhaps some financiers may not be sufficiently confident in all cases to adopt that view.

40 See, for example, Judiciary Act 1903 (Cth), s66; Crown Proceedings Act 1988 (NSW), s7(1). In Queensland, by contrast, the Acts Interpretation Act 1954 (Qld), s47C(3) makes it clear that an appropriation is not necessary.

41 "Authority" is defined in s3 of the PAFA Act to include a State owned corporation or its subsidiary.

42 The term "joint financing arrangement" is defined widely in s5A of the PAFA Act to embrace BOOT type projects and the like.

43 Section 22AA of the PAFA Act.

44 Section 22B of the PAFA Act.

45 Section 22F of the PAFA Act.

46 Section 22I of the PAFA Act.

The *Statutory Bodies Financial Arrangements Act 1982* (Qld) is also relevant in this context.[47]

5.2 Government guarantees or other support

With most PPP projects, a lengthy concession term or service contract period will be the norm to underpin financially the level of private sector investment that is likely to be necessary. Whilst a prolonged concession or service provision period will be of no concern where the public sector counterparty is either the government or another entity representing the Crown (so that, in effect, the obligations are Crown obligations), if the public sector entity does not represent the Crown, financiers may consider that a government guarantee must be obtained.

Project sponsors and their financiers will often be unwilling to assume the credit risk of a public sector authority in such circumstances, especially if there is any realistic likelihood that:

(a) the public sector entity might be privatised during the life of the project; or

(b) the industry in which the project company operates is likely to be restructured in a way which may impact adversely on the project company's projected revenue streams.[48]

Although the power of the relevant Federal, State or Territory government to grant such a guarantee will not normally be a contested issue, the possible need for a specific appropriation to satisfy any amount payable under the guarantee should not be overlooked.[49]

For some PPP projects, the project company or its financiers may wish to negotiate for some additional form of government support; for example:

5.2.1.1 an off take agreement with the government or a creditworthy public sector party (whose obligations may be guaranteed by the government), under which the project company's revenue streams are largely underpinned by the use of a take-or-pay sales agreement,[50]

5.2.1.2 a government undertaking to maintain the credit rating of the government owned entity which has contracted to purchase the project product;

5.2.1.3 a government undertaking to procure the substitution of another creditworthy public sector counterparty to purchase the project product, if the original public sector party defaults or its credit rating deteriorates;

5.2.1.4 a government undertaking not to exercise its influence or control over the government owned counterparty in such a way that might adversely affect its financial position.

5.3 Government security – ranking and priority

In the case of many PPP projects, the government will often be contracting with a party which is a lowly capitalised special purpose vehicle with no track record of service delivery and

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47 See, in particular, ss15-17 of this Act, which collectively provide that a guarantee by the State of the performance of a statutory body's obligations under a financial arrangement entered into by the body under the Act may be given only by the Treasurer, in respect of which there is a statutory appropriation of money to meet any liability under the guarantee.

48 This might be a relevant issue, for example, in the electricity industries of Queensland and New South Wales, which are yet to be finally restructured.

49 See above discussion in paragraph 5.1.

50 For example, to purchase a prescribed quantity of power and gas haulage capacity, as has been offered by the Queensland Government in respect of the Townsville Gas Pipeline and Power Station Project.

whose main asset will be its interest under the project documents. The government will therefore require comfort that the project company and its sub-contractors will be able to meet their contractual obligations to provide the services and any corresponding financial liabilities.

The government will often wish to ensure that continuity of service supply is maintained even if the project company is insolvent.

In a traditional procurement, such comfort would usually take the form of guarantees, indemnities and collateral warranties to the government by the project company its parent company, or principal creditworthy shareholders and sub-contractors. However, for undertakings of a duration typical of most PPP contracts, such unsecured guarantees, indemnities and warranties assume a much riskier profile.

Governments may therefore require that the project company provide additional security, such as a fixed and floating charge over its assets, to secure its various obligations to the government. This will typically occur where, for example, the PPP project is structured on a BOOT basis, to ensure that the project company's obligation to transfer unencumbered title to the project assets to the government at the expiration or earlier termination of the concession term is appropriately secured.

The project company's financiers will wish to ensure that any government security will rank behind their first ranking security. However, the government may insist that it enjoy first ranking priority for particular amounts; for example, costs incurred by the government in the exercise of its step in rights.

5.4 Step In and Cure Rights

In a PPP context, the manner in which step in rights, being rights given to the government and the financiers to take over some or all of the project company's obligations for a certain period and in certain circumstances, are addressed in the project documentation will be of critical interest to the financiers.

5.4.1 Government Step In

In some circumstances, the government may wish to step in itself in relation to the project if, for example:

5.4.1.1 there is a need to prevent or mitigate a serious risk to public health, safety or the environment or to discharge a statutory duty;

5.4.1.2 there exists a period of tension, transition to war, or hostilities or where it needs to respond to any national or international emergency, disaster or other unforseen risk.

Such a right may arise due to matters beyond the scope of responsibilities or control of the project company or may arise due to the project company's default. From the financiers' perspective, it is important to distinguish between these two possible scenarios.

5.4.2 Government Step In without Project Company Breach

If there has been no breach, the financiers will be concerned to ensure that:

5.4.2.1 the government notifies both the project company and themselves that it plans to step in and the extent of such step in;

5.4.2.2 essentially the project documentation reflects that the focus of the step in right is for a short term problem that can or must be solved quickly, where the government is in a better position to do so than the project company;

5.4.2.3 it is acknowledged that step in rights for the public sector are not always necessary but that, where they are deemed to be, they should be temporary and relate only to cases of severe failures of services output;

5.4.2.4 although step in rights for the public sector are likely to be necessary for high profile public services for which the government may have a statutory duty to ensure delivery (and can therefore be triggered on short notice), the project company should, where possible, be permitted to delay the step in if it can be reasonably expected to be able to solve the problem itself;

5.4.2.5 as the government needs to act for reasons external to the contract with the project company, the government should pay for the contractual service as if the service had been fully performed,[51]

5.4.2.6 if aspects of the contractual service are affected by the government step in, the government should nevertheless make full payment and its right to terminate for non-performance should be suspended;

5.4.2.7 the government should bear all of its own costs incurred by stepping in;

5.4.2.8 having stepped in, the government must act in accordance with good industry practice and, if it fails to do so, it should indemnify[52] the project company for any loss suffered as a consequence (including any detrimental effect on any termination payments); and

5.4.2.9 the government steps out promptly after the problem has been rectified or is otherwise resolved.

5.4.3 Government Step In on Contractor Breach

Even where the project company is in breach of its contractual obligations, the financiers would wish to negotiate that any right of government step in is subject to:

5.4.3.1 the government firstly notifying the project company of the alleged breach and allowing the project company to remedy the breach within the agreed timetable;

5.4.3.2 any right of step in the financiers may have negotiated directly with the government;

5.4.3.3 if the government steps in, it should continue to pay the project company as if there were no breach, subject to the government being entitled to set off any reasonable costs it incurs in stepping in;

5.4.3.4 the project company is relieved of its obligations to provide the contracted service whilst the government has stepped in;

5.4.3.5 the government behaving in a reasonable manner, acting in accordance with good industry practice (and again indemnifying the project company for failing to do so) and

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51 Appropriate alternative arrangements would need to be considered for projects involving usage-based payment schemes based on third party revenue streams. Appropriate forecasts of any third party income may need to be made.

52 Financiers would prefer liability under such an indemnity to be outside any indemnity caps otherwise applying under the project documentation.

not using its step in rights to undermine any carefully negotiated termination arrangements; and

5.4.3.6 the government stepping out promptly after the problem is rectified or is otherwise resolved.

If the breach subsists following the government step in, the government would normally want the rights to terminate due to the project company's default, but this would need to be subject to any rights the financiers may have under direct agreements with the government.

One point that financiers often fail to appreciate when considering the possible impact of government step in is that it potentially deprives their carefully (and often arduously) negotiated controls on the project of any practical effect. The financiers' reserved discretions may be devoid of any teeth in a step in scenario as the government might, whilst it is stepping in, exercise its contractual rights in a manner which is prejudicial to the financiers' interests.

5.4.4 Financiers' Step In Rights

Financiers will invariably wish to negotiate an acceptable direct agreement with the government (often called a tripartite or consent deed) to regulate, among other things, the financiers' step in rights.

Quite properly, such agreements are increasingly being seen as advantageous to the public sector, as they provide financiers an opportunity to revive the project and, consequently, to avoid the disruption that inevitably follows termination. If the project can be restored with minimal disruption to the contracted services and there is no need for the government to become involved to procure that outcome, both the government and the financiers benefit.

As far as financiers' step in rights are concerned, the important issues are:

5.4.4.1 when the financiers should be permitted to step in;

5.4.4.2 the extent to which the financiers should be obliged to assume liabilities that have been or are being incurred by the project company;

5.4.4.3 the extent to which the financiers should be given the opportunity to rectify the project company's breach;

5.4.4.4 for how long any liability of the financiers should continue;

5.4.4.5 what rights of termination exist on a step in; and

5.4.4.6 what rights of "sale" should the financiers enjoy (either themselves or via their appointed receiver) to replace the project company and substitute a new contracting party, if necessary.

Some governments argue that to the extent the financiers step in, they should be liable for obligations to the same extent as the project company. The financiers' right to step in will therefore only be triggered upon payment of any outstanding amounts owed to the government by the project company and rectification of any other project breaches and if any new breach occurs during the period of step in, then termination can still occur. This has led to the development in some instances of "step in undertakings" under which financiers might agree to accept a degree of liability as the price for their attempt to save the project, although this would normally be hotly resisted by most financiers. Financiers, of course, would normally wish to limit their liability on a step in.

A possible compromise is for the financiers' step in and extended cure period rights to be conditional upon the financiers continuing to use reasonable efforts to rectify the problem pursuant to an agreed program of work and timetable. Ultimately, however, it is critical for the financiers to have the discretion as to whether to rectify or cut their losses and abandon the project in favour of the government.

Governments will also often wish to retain the right to recover from the financiers any damage the financiers caused when they stepped in.

5.5 Force majeure, damage and reinstatement

5.5.1 Force Majeure

Force majeure is a legal concept which exonerates a party to a contract from the consequences of a failure to perform its obligations caused by certain specified supervening events.

The concept of force majeure does not of course apply to loan agreements or other contracts relating to the provision of financial accommodation.

A typical force majeure clause would provide that, if a party was prevented or hindered from performing its obligations under the contract by force majeure, it would be obliged to notify the other parties to the contract and use all reasonable endeavours to find a way of recommencing performance. However, in the interim, the affected party would not be held to be in breach to the extent it was unable to perform its obligations due to force majeure.

"Force majeure" is then usually defined in a general way as some matter or thing outside a party's control, followed by a list of specific events, either exclusively by way of illustration or as an exhaustive list. Drafting such events inclusively by way of illustration, or exhaustively, is one of the methods by which various risk can be apportioned between the parties.

Financiers will need to analyse, in relation to the underlying project documentation, the likely impact and effect of force majeure events. Financiers will have to be satisfied that:

(c) the definition of force majeure is not too narrow;

(d) the definition and treatment of force majeure is consistent and comparable in each of the project contracts. It should be remembered that force majeure will only excuse a party form performing under a particular contract to the extent that performance under <u>that contract</u> is hindered or prevented. This represents a significant drafting trap for the unwary. In the case of related but separate project contracts (eg coal supply contracts and power purchase agreements), if the project company wished to be relieved of its obligations to accept coal under the coal supply contract because, for example, its power plant was unable to generate and sell power because the government's national grid was inoperative for any reason, this would need to be specifically addressed in the force majeure provisions in the coal supply contract;

(e) the termination provisions in the project documents also appropriately deal with the effect of force majeure. It is important for the project company and its financiers that the force majeure provisions have the effect of making a party who might otherwise be in breach of contract not to be in breach if the

reason for its non-performance is force majeure. There are drafting subtleties which must be considered in this context. Any termination event in a project document which is drafted on the basis of the project company being "in breach of its obligations" will therefore not apply to the project company if it is unable to perform due to force majeure. However, a termination clause which is drafted upon the basis of a "failure to perform" might well apply, which would obviously be an unsatisfactory result. If the parties (or the financiers) are concerned about performance of the particular contract being possibly suspended for too long a period due to force majeure, a specific termination provision relating to sustained force majeure would need to be included;

(f) the consequences of a force majeure event are satisfactorily addressed; eg an obligation on the parties to consult to attempt to find a way to continue the project such as altering the service requirement, amending payment mechanisms or even extending the term of the contract, failing which an entitlement to terminate the contract (with or without the payment of compensation) might arise.

5.5.2 Damage and Reinstatement

In traditional projects, if a project is damaged the project owner or its financiers will determine the commercial viability of reinstating the project. There is usually no compulsion on them to reinstate if they elect not to do so.

However, in the case of PPP projects, the position will generally be different and, if an insured event occurs and certain project assets require replacement or reinstatement, the potentially competing interests of the government, the project company and its financiers need to be considered.

The government will normally insist that insurance cover be taken out to permit full reinstatement in the event of damage. Furthermore, the government may wish to oblige the project company to negotiate insurance to reflect the fact that the government's requirements may change after an insurance event occurs and it is possible that there will be a requirement for something other than full or exact reinstatement.

In most PPP projects, the government will have a genuine interest to ensure that any insurance proceeds received by the project company under the physical damage policies are applied in reinstatement of the project. The government will also want to ensure that, upon termination of the project contracts (either by effluxion of time or early termination), it receives the benefit of any insurance proceeds so that it can continue with the reinstatement of the project.

The government will therefore typically insist that the project company will always be obliged to reinstate the project assets and the contracted service if an insurance event occurs.

In some PPP projects, financiers may want to impose an economic viability test to determine whether reinstatement will enable them to recover their outstanding debt in full. If this economic viability test demonstrates that this is not possible, the financiers may prefer to appropriate the insurance proceeds as secured creditor under its first ranking securities, instead of allowing reinstatement.

However, governments are only likely to accept this in limited circumstances. Governments are likely to argue that financiers should focus instead on ensuring that the amount insured under the advance loss of profits and business interruption insurances is sufficiently high or there is a sufficient equity buffer or other provision for contingencies in the project company to address the financiers' concerns.

Governments are also likely to argue that an economic viability test should not be necessary where there is a low risk of total destruction of the project assets (such as a large linear road or rail projects, or a project comprising large number of geographically diverse sites).

Where the risk exists (for example, in the case of a single site project), the government may be prepared to accept an economic viability test, but only on the basis that the financiers cannot abscond with the insurance proceeds and abandon the project if the economic viability test demonstrates that debt service is still achievable. Even then, the government will often still insist that the project company remain under an obligation to reinstate. If, as is likely, it is not financially able to do so, the project company would be in breach of contract and the government could terminate for default in the usual way. The government could then procure the rebuilding of the project assets through a new competitive tender with other interested private sector parties.

5.6 Insurance

5.6.1 Overview

Insurance coverage for both the works comprising the infrastructure project and, post completion, for the operational stage are a critical requirement from the financiers' perspective. In the event of a major or total loss, the project insurances will often be the only viable means of repaying the financiers. Curiously though, in the author's experience, until recently insurance rarely receives the attention it deserves in an infrastructure project context.

The financiers' concerns in the insurance context are to ensure that:

(i) the proposed insurance cover is satisfactory (and this entails an assessment of the risks covered, the exclusions, the amount of cover and the amount of deductibles or excess);

(ii) its interest in the insurance is adequately protected; and

(iii) the project company borrower does not inadvertently commit a default under the project documentation.

As many necessary insurances can only be written on an annual basis, financiers will therefore wish to be satisfied that adequate cover will be maintained for the period that their financial accommodation is unpaid. Finalising the financiers' security interests in insurances is often both complex and time consuming, especially if the project company is a member or representative of a project consortium, which will often be the case.

There is obviously a performance risk in relation to the project company continuing to renew its insurances. However, recent events have elevated both the importance and complexity of insurance in a PPP context and exacerbated this performance risk.

Over the past few years the insurance market both in Australia and overseas has been hardening. Project sponsors and their financiers currently face an extremely volatile insurance market. Commercial premiums have risen dramatically in the past year and there

is a shortage of cover in some crucial insurance classes.[53] Consequently, obtaining satisfactory insurance for infrastructure projects in today's market represents a significant challenge.

The juxtaposition of the collapse of FAI and HIH with the events of September 11, 2001 has been the principal catalyst for the insurance industry's sudden imposition of massive rate rises and the decrease in availability of cover.[54]

5.6.2 Scope of Cover

The following might be considered a standard suite of insurance coverage that a project financier would require a borrower to obtain for most infrastructure projects.

Specifically, the insurances obtained for the construction phase would normally be as follows:

* Contractors special risks;
* Public/product liability insurance;
* Professional indemnity insurance;
* Employers' liability and workers' compensation insurance;
* Motor vehicle bodily injury insurance;
* Combined advance and operational consequential loss (business interruption) insurance; and
* Directors' and officers' liability insurance.

For the better part of the 1990s, a borrower would have had little difficulty in obtaining the above insurance coverage at a reasonable cost. Today, however, a borrower, in addition to the prospect of spiralling insurance premiums, would confront the following difficulties in obtaining the above cover:

(i) Public/Product Liability Crisis

In the past year, Australian businesses have been notified of huge increases in public/product liability insurance premiums as well as a lack of availability in cover. Even in the most risk free projects, public/product liability premiums have risen more steeply than any other class of general insurance, increasing at least 28% in the period from 30 June to 31 December 2001.[55]

The major factors behind the current crisis have been identified as greater incidence of litigation, increased compensation payments for bodily injury claims, past under-pricing and poor profitability in this class of insurance and the collapse of HIH (a major player in the public liability market).[56]

(ii) Terrorism Cover

In response to the events of September 11, 2001, global reinsurers have withdrawn terrorism cover from most of their policies from 1 January 2002. Following this

53 Media release 21/12/01, National Insurance Brokers Association.
54 Insurance and Risk Professional, December – January 2001/2002 at page 10.
55 2001 Interim Insurance Results, Deloitte Touche Tohmatsu / JP Morgan 2002 Insurance Survey.
56 These were the findings of the report prepared by Trowbridge Consulting (which was commissioned by the Commonwealth Treasury).

withdrawal of re-insurance support, insurers are almost universally inserting a terrorism exclusion clause in their covers.

It is estimated that 60% of Australia's commercial property, energy and transport infrastructure will have inadequate terrorism insurance by 30 June 2002.[57] According to Alan Mason, the Executive Director of the Insurance Council of Australia, "this withdrawal is consistent with the industry's longstanding position of not providing insurance coverage for wars because to provide coverage during these events would be to expose the industry to unacceptable financial risks"[58] (cover for war has always been excluded but terrorism has not until now). Importantly, Mr Mason comments that "the withdrawal of terrorism insurance also has the capacity to derail private investment in new infrastructure projects due to the inability to obtain appropriate insurance cover".[59]

(iii) Non-imputation clause

Financiers will usually insist on being co-insureds as this will provide them with a direct contractual claim against the insurers. If the financier's interest was merely noted on the relevant policy, this would generally merely mean that the insurers could not obtain an effective discharge by paying the project company as the named insured.

In the context of insurance coverage for infrastructure projects, it is usually the case that multiple insureds will be covered under one policy obtained by the borrower. Other insured parties will include any security trustee, all participating lenders, the relevant State or other public sector entity and, in some instances, sub-contractors and consultants. It is critical that any insurance policy covering the interests of more than one insured party include a non-imputation or non-vitiation clause in which the insurer agrees to protect the interests of all innocent co-insureds in the event that an individual insured commits a breach such as non-disclosure, misrepresentation, fraud or breach of a policy condition which would ordinarily entitle the insurer to avoid the policy and refuse to pay a claim.

There is now substantial resistance within the insurance market to providing such protection to innocent co-insureds.

It is not due to altruism that contracts of insurance are contracts of utmost good faith. The insurers assess the relevant project risks and calculate and charge a premium based on the facts as disclosed to them. If a co-insured fails to disclose a material fact, the insurers, had they known it, may have refused to underwrite the risk in question or charged a substantially higher premium for assuming that risk.

Some insurers are arguing that this whole notion of full disclosure is undermined if they have to indemnify under a policy despite a material non-disclosure or breach by a co-insured. Ultimately the issue will often become simply one of premium. Heftier

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57 Media release issued by the Property Council of Australia, 19 April 2002.

58 Extracted from speech given at the Insurance Council of Australia's New South Wales Conference, 8 March 2002.

59 Extracted from speech given at the Insurance Council of Australia's New South Wales Conference, 8 March 2002.

premiums will no doubt in many cases persuade insurers to assume what they regard as additional risk.

If financiers are unable to negotiate the inclusion of a non-imputation provision in the relevant policy, it has been suggested[60] that possible ways of addressing the financiers' concerns include:

(1) insist as a condition precedent to draw down, that the project company's insurers confirm in writing, before issuing the policy in question, that they are satisfied that full disclosure of all material facts has been made to them. However, this solution is by no means a panacea, especially as most cover needs to be renewed annually during the life of the financiers' loans. Query also whether the insured's duty of utmost good faith imposes a continuing duty to disclose during the life of the insurance cover and whether, therefore, many insurers would readily provide such a confirmation;

(2) the financiers could take out separate, but parallel, cover to the main policy arranged by the borrower, noting the financiers as the only insured. However, an obvious disadvantage of this option is that the duty of disclosure would then rest with the financiers who would in most cases be relying on information provided by the borrower, which may be insufficient;

(3) obtain separate indemnities from each of the other co-insureds providing that if they should cause the policy to be avoided, they will indemnify the financiers against any loss they suffer as a consequence. Whether the indemnifying parties are creditworthy will obviously be a critical issue in this context;

(4) seek an indemnity from the project company's shareholders against any loss the financiers might suffer, if the insurance policy is avoided. However, this alternative solution is the antithesis of limited recourse financing and is likely to be hotly resisted.

(iv) Notices required to be served under the Policy

It is also usual for a financier to require that any infrastructure insurances include a provision which requires the insurer serving a notice upon the borrower under a policy to also provide a copy of that notice to the financier. This is for the very obvious reason that a notice of default or a notice of cancellation not be served upon the borrower unbeknown to the financier (or any other insured under the policy). The market is now reluctant to provide such coverage.

(v) Rate Increases

General rate increases are now placing insurance out of reach for many Australian businesses. The Deloitte Touche Tohmatsu / JP Morgan 2002 Interim Insurance Survey has projected the following rate rises as the June 2002 renewals fall due:

commercial property – 25%

liability - 32%;

professional indemnity – 25%

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60 Graham D. Vinter, *Project Finance*, (2nd ed.), Sweet & Maxwell, page 179.

directors' and officers' liability – 21%

reinsurance: catastrophe – 30%

reinsurance: fire & industrial special risks – 33%

It is salutary to note these represent average increases for routine insurances. In the context of major infrastructure projects, there have been recent examples where premium increases in excess of 1000% have been applied with a corresponding diminution in the extent of coverage provided.

(vi) Renewal Process

It should also be borne in mind that the above issues do not relate purely to start-ups. Facilities previously obtained which require borrowers to maintain insurances at specified minimum levels over the life of the project may be breached when at each renewal, cover is either refused or diminished.

5.6.3 Potential solutions / ways to manage the crisis

With regard to the issue of terrorism cover and the public liability crisis, key players have sought government assistance.

(i) Terrorism Cover

The Property Council of Australia (together with the Australian Bankers Association and the Insurance Council of Australia) has called upon the federal government to establish a "terrorism insurance pool" modelled on UK's Pool Re (which has successfully operated in the UK since 1993). Under the proposed scheme, insurers would contribute a percentage of each premium to the pool, with the Government acting as guarantor/reinsurer once claims reached a certain limit, which is expected to be $500 million.[61]

On 19 April 2002, the Prime Minister agreed to the Property Council's call for an urgent meeting on the issue of terrorism insurance.[62] The Federal government's formal response to the terrorism insurance crisis is not yet known. However, the Federal Treasurer has recently indicated that the Commonwealth government is formulating a proposal under which the government would offer indemnity, in catastrophic cases, above certain limits. The Federal Treasurer has announced the Government would provide "remainder" insurance for losses above the level of cover available in the market. This will effectively make the Government an insurer of last resort once a business's own cover has been exhausted. The Commonwealth government is apparently keen to limit its liability by capping its ultimate exposure and does not intend to be involved in the terrorism insurance market for the long term. To this end, the Treasurer has stated that any intervention by the Commonwealth will be consistent with the following principles:

(a) the need to maintain, to the greatest extent possible, private sector provision of insurance;

(b) the need to ensure that risk transferred to the Commonwealth is appropriately priced to minimise the impact on the Commonwealth's financial position, and to ensure that the Commonwealth is being compensated by those benefiting from the assistance;

(c) the need to allow the commercial insurance and re-insurance markets to step back in when they are able (that is, ensuring an appropriate exit strategy for Government); and

(c) the need to be compatible with global solutions.

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61 Sid Marris, "Governments forced to indemnify insurers", The Australian, 26/12/01 page 4.

62 Media Release issued by the Property Council of Australia, 19 April 2002.

The Treasurer has also confirmed that the Government will also seek to facilitate a common definition of a "terrorist act" for insurance purposes and will support commercial insurers to implement such a common definition.

The timing is uncertain, although 30 June 2002 is being sought as from that date a significant number of property and infrastructure owners will be without terrorism cover.

In relation to the statutory compulsory classes of insurance (workers' compensation and compulsory third party motor vehicle insurance), State and Territory governments have either amended their legislation to exclude terrorism cover or have agreed to indemnify insurers in relation to terrorism-related losses.

Apart from government assistance, it should be noted that emerging national insurer, Rural & General Insurance Ltd, in partnership with UK-based Asset Underwriting Ltd, has commenced offering Australia's first "Terrorist and War" insurance as a stand alone insurance product.

(ii) Public/product liability insurance crisis

Federal and State ministers have met in search of a solution to this crisis and have agreed to implement a series of reforms aimed at cutting spiralling public/product liability premiums. Key reforms which have been indicated include changing tax laws to encourage the use of staggered settlement payments over time instead of lump sum pay outs, capping legal fees and abolishing aggressive "no win, no fee" advertising by lawyers.[63] It was also agreed that the States and Territories would examine the possibility of broadly based tort reform and protecting volunteers and community groups from the spectre of such claims.

(iii) Risk Management including Due Diligence

An important way in which financiers can tackle the current insurance crisis is to require borrowers to adopt more rigorous risk management practices. The practice of risk management involves systematically analysing the risks confronted by a project, minimising them, insuring against them or reducing any damage that may occur as a result of a mishap, and documenting these procedures.[64] As insurance has now become such a problematic issue, the strategy of simply insuring risks that have been identified in a risk management process are no longer viable.

Bruce Ferguson, President of the Association of Risk and Insurance Managers Australia has commented that "companies are opting to further increase residuals (policy excess) as one way to reduce premiums. But a larger excess means accepting more risk and that means both putting aside more money in reserves, with all the resulting tax and accounting issues that entails, as well as greater emphasis on managing risk".

In the context of discussing the current insurance crisis, Noel Petterson, the Chief Executive of the National Insurance Brokers Association stressed that, "adequate risk management is now a vital facet of any business planning.[65]

Proper legal analysis of risks through a thorough due diligence process and development and implementation of risk management practices is now vital. Facility documentation should now require borrowers to demonstrate to financiers their commitment to this process.

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63 Joint Communique, Ministerial Meeting on Public Liability, 27 March 2002, Canberra.
64 "September 11 Spurs a New Era for Insurance", Mark Lawson, The Australian Financial Review 10/4/02 at page 2.
65 Media Release issued by the National Insurance Brokers Association, 21/12/01.

For financiers, the recent HIH demise also confirms that the due diligence process should include an assessment of the financial robustness of the insurers themselves.

5.6.4 Uninsurability

Financiers will now be concerned to ensure that the project documentation satisfactorily addresses the situation where a risk required to be insured against, and which was previously insurable, becomes uninsurable. Terrorism cover is a current classical example.

The consequences of uninsurability can range from project company default to the government accepting liability for occurrence of the event. Much will depend on the type of risk involved and whether either party was responsible for the uninsurability.

"Uninsurability" in this context means, in relation to a risk, either that:

* insurance is not available in the worldwide insurance market with reputable insurers of good standing in respect of that risk; or
* the insurance premium payable for insuring that risk is at such a level that the risk is not generally being insured against in the worldwide insurance market with reputable insurers of good standing.

Financiers will need to be satisfied that the project company is not required to insure against risks which become uninsurable. If, however, a key insurance risk becomes uninsurable, financiers should expect that a well advised government party would counter with the requirement that the project documentation reflect that the project company will be in breach if it has caused the relevant insurance to be unavailable.

It must be noted that in most PPPs, the project company cannot absorb large increases in insurance premiums, given its fixed limited revenue stream. Financiers regard "insurability" as being limited to events which are insurable on reasonable commercial terms. Hence, when a risk ceases to be insurable, the project company will often have no alternative but to request that the government assume, or at least share, the risk.

5.7 Termination

Termination of government concessions has been an area of critical, and often controversial, interest for project financiers. As interest in PPPs gathers momentum throughout Australia, financiers will need to maintain their focus on the general question of termination. What has fuelled this level of interest and controversy? A brief consideration of the general issue of termination will assist in answering this question.

A project contract will terminate:-

5.7.1.1 on the expiry of the service period; or

5.7.1.2 as a result of early termination.

Early termination can be caused by a number of reasons, the principal ones being:-

(i) government default;

(ii) project company default; and

(iii) force majeure.[66]

Project sponsors and their financiers will be anxious to ensure that the project contact deals comprehensively with the consequences of all types of termination and, in particular, the important issues of what happens to the project assets and what quantum of compensation (if any) is payable by the government in the event of termination. The amount of compensation payable by the government will be influenced by:-

(A) the reason for the termination;

(B) which party retains the project assets after termination; and

(C) whether the project assets are likely to have any alternative use.

With regard to (ii), in most PPP projects the government's long term objectives will be best served by requiring a transfer of the project assets in its favour on expiry or earlier termination because:-

(vii) legal restrictions will sometimes preclude any practical alternative options,[67]

5.7.1.3 contracts involving special purpose assets, such as prisons, hospitals and schools, which cater for a particular service will continue to have a useful economic life if retained by the government,[68]

5.7.1.4 the government requires long term use of the assets for the continued provision of its services; or

5.7.1.5 despite the expiry of the economic life of the assets, the assets may be constructed on lands the title to which the government wishes to revert to it. [69]

(a) Compensation on Termination for Government Default

Most governments would readily accept that in this scenario the project documentation should reflect that the project company and its financiers should be fully compensated so that they are no worse off because of government default than if the project contract had proceeded as expected. However, a well advised government would contend that, as the compensation payable should reflect a realistic calculation of an anticipated claim for damages, the

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66 Termination can also arise by the government counterparty exercising a right to terminate the project contract voluntarily, although such contractual rights of unilateral termination are not common.

67 For example, in the case of road and rail projects, without the benefit of the expired concession, the project company would not be lawfully entitled to operate the assets and hence the road or rail assets would normally have to revert to the relevant public sector authority which had jurisdiction to operate such assets.

68 There may only be limited scope for alternative use on expiry of the project contract as conversion is likely to be costly.

69 It should be noted that the grant of freehold title to the project company would generally be rare. A leasehold interest would usually be given to avoid the possible competing interests of the project company's secured creditors or unsecured creditors in the event of its liquidation.

compensation payment should therefore be an exclusive remedy of the project company leaving no residual claim for damages.

In most PPP projects, equity is invested as a blend of share capital and junior debt, with the project financiers providing the required levels of senior debt. For determining the amounts of equity/junior debt compensation under a government default scenario, the following alternatives have been employed:-

(i) compensation is calculated to reflect the projected base case internal rate of return for equity and junior debt for the entire duration of the contract. The purpose of this method of calculation is to provide equity investors with the returns they expected from the project at the outset, regardless of actual project performance (whether better or worse than expected);

(ii) compensation is calculated to reflect the market value of both equity and junior debt for the entire duration of the project contract. The purpose of this alternative method is to allow the equity investors to take the full benefit of good project company performance but bear the risks associated with poor performance.[70]

Under this method, the government would pay as compensation an amount for both equity and junior debt based on their market value on a going concern basis immediately prior to termination.[71]

The market valuation will reflect:-

(i) the value of anticipated future cashflows (both revenues and costs);

5.7.1.6 risks allocation under the project contract;

5.7.1.7 market appetite for contracts of a similar nature; and

5.7.1.8 the value of any project assets to be retained by the project company after the termination date (which value would be deducted from any termination compensation payment).

(C) Compensation is calculated to reflect the base case return for equity and junior debt for the remainder of the term of the project contract (being the amount of future return that the equity and debt providers originally provided for in the base case bid). This represents a hybrid of the first two alternatives.

Another alternative method sometimes employed for calculating compensation on termination for government default is to determine the actual outstanding debt and then add some agreed return for equity.

After the agreed termination compensation had been paid by the government to the project company, the government would normally expect that all project assets would transfer automatically to it.

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[70] The government party would most likely prefer this alterative if it considers the project's economic validity is questionable or the project company's base case to be unjustifiably aggressive.

[71] That is, the amount for which the equity and junior debt would have been sold to a willing buyer at the relevant date (the calculation being based on the assumption that there had been no government default and that both equity and junior debt were freely transferable).

5.7.2 Compensation on Termination for Project Company Default

The project contract must also deal with the possibility of early termination due to the project company's default. It is in respect of this scenario where most controversy has occurred.

This issue presents a significant negotiating challenge as the project contract must achieve a fair and bankable balance between:-

5.7.2.1 the government's desire to be able to terminate for inadequate service provision, even if caused by relative minor, but persistent, defaults (a right which government parties are used to having in conventional service contracts); and

5.7.2.2 the project company's and its financiers' interest in restricting termination to the severest of defaults, when all other reasonable options have been exhausted (including reasonable rectification or cure periods in favour of the project company under the project contract and in favour of the financiers under a direct/tripartite agreement between the financiers and the government).

The inclusion of an obligation to pay the defaulting project company compensation has been traditionally unpopular with governments for the following reasons:-

(i) governments are generally querulous about paying compensation to the project company when it is the innocent party and it is the project company which is in default. Under a conventional service contract, not only would no compensation be paid but the defaulting project company would expect the government to institute a claim for damages;

(ii) if the government is to be liable to pay compensation when the project company is in default, it would be all too easy for the project company to improperly engineer a default when the project encountered financial difficulties, thereby forcing a termination of the project contract with a fortuitous payment of compensation;

(iii) payment of compensation out of the public revenues in such circumstances would be the antithesis of involving the private sector to provide the service in the first place, especially if a BOOT project is involved;

(iv) any attempt in the project contract to quantify the amount of any payment of compensation in such circumstances may prejudice any claim the government may have against the project company for damages for breach.

The absence of any payment of compensation in these circumstances will certainly be unpopular with financiers as they will be taking a considerable risk on the project company's ability to comply with the terms of the project contract. However, it does not necessarily follow that absence of compensation will always be lethal to a project's bankability.

Many concession agreements (especially in the road and rail sectors where the prospect of default following construction is more remote) have stipulated that no compensation is payable in the event of termination due to default of the concession holder.

Financiers' acceptance of such an arrangement will usually require a strongly protective direct/tripartite agreement between the financiers and the government (incorporating a

generous cure regime) and a high degree of confidence on their part as to the ability of the project company to complete the project and perform its service obligations.

However, various governments have been sympathetic in some cases to the application of a range of termination compensation models for contractor default, where the project assets are to be transferred to government on a termination without compensating the contractor for their value. The principal reason for this softened approach appears to be that governments consider in some cases that a failure to compensate would unfairly benefit them and a court would strive to so hold on the basis of unjust enrichment or possibly other equitable grounds such as unconscionability or forfeiture.[72]

If termination compensation is to be payable for contractor default, a difficult commercial issue is how best to asses what an appropriate level of compensation should be. The range of compensation models which have been adopted for various projects in the United Kingdom and Australia, of which the author is aware, is as follows:-

(D) for various road and rail projects, no compensation for contractor default;

(E) for some prison projects, no termination compensation during the construction period;

(F) for various schools and hospital projects, a wide variety of compensation models, ranging from (at one end of the spectrum) no compensation to a more generous regime usually linked during the construction period to capital costs less rectification costs and during the service period to the net present value of future cash flows;

(G) for some projects, a compensation model which virtually guaranteed a full payout of external debt; and

(H) for some projects, a market value approach, which contemplates (where the project company's financiers (or their appointed receivers) do not exercise their power of sale for any reason), a retendering of the provision of the service (pursuant to a monitored and detailed tender process) and payment of any net proceeds (after deducting the government's tendering costs and other set off entitlements or deductions) to the project company.

The "no compensation" model has been partly driven by a concern that, on the project company's default, the financiers should be encouraged to step in and rescue/work out the project. However, possible disadvantages of this model are:-

(ii) the government is exposed to the criticism that it is seeking to manipulate a windfall gain in the event of a termination (assuming the project assets are valuable); and

(iii) it will result in an increase in the cost of PPP projects to the public sector by compelling bidders to adopt a conservative stance regarding risk pricing, liquidated damages and the limits on liability they require from their subcontractors.

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72 However, it should be noted that at last year's conference the author's colleague, Phillip Cornwell, forcefully contended that financiers cannot be assured that a court will ultimately take that view. See *Project Finance*, Phillip Cornwell, 2001, Banking Law and Practice conference papers.

In the author's experience, various governments have found that compensation models based on the net present value of future cash flows are extremely complex and difficult to negotiate. Invariably, the parties have to resort to external expert financial advice which often also fails to engineer the consensus the parties are seeking. There is frequently the apprehension that these models are unlikely to take proper account of:-

(v) the performance history of the defaulting project or of the project's likely future performance;

(vi) additional costs accruing to the government over the life of the contract; or

(vii) the value/cost of risk transfer to the project company.

In the minds of government, a further perceived disadvantage of these NPV models is that if payments based on NPV calculations were sufficient to fully repay the financiers' debt, the financiers would be less likely to rescue the distressed project.

For the abovementioned reasons, the market value approach appears to be emerging as the preferred compensation model for most PFI projects (other than road and prison projects) in the United Kingdom. The market value approach is increasingly being perceived as possessing the following beneficial attributes:-

(A) it strikes an equitable balance between protecting the government's interests and not subjecting the project company to unreasonable deductions for its default;

(B) it encourages the financiers to step in and rescue the project instead of resorting to any termination compensation to discharge their outstanding indebtedness, because of the spectre of the significant costs/set-off deductions likely to be involved in a government re-tendering.

It is worth noting that the Partnership's Victoria policy foreshadows that any entitlement of the private sector party to compensation for termination arising from that party's default should be considered on a case by case basis but it may be appropriate in some instances for compensation to be paid. Where that project assets are to be transferred to the government and it is considered appropriate to pay compensation, the Victorian government's preferred formula for compensation is stated to be:-

(iv) where termination occurs during the construction phase, an amount sufficient to repay the private sector party the amounts it has invested on completed works, adjusted for any increase in the costs to government to complete the facility, government's break costs and any liquidated damages payable to the government;

(v) where termination occurs during the operations phase, the fair market value of the asset less the government's break costs and any compensation or other amounts payable to the government (which may include additional service costs, rectification and re-tendering costs, and any balance in a maintenance sinking fund)[73].

For the abovementioned reasons, the author expects that a similar position will be adopted generally in Australia.

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[73] Partnerships Victoria Guidance Material, June 2001 – Risk Allocation and Contractual Issues, page 173.

5.8 The Need for Direct/Tripartite Agreements with Key Parties

Direct or tripartite agreements are agreements entered into between the project company, its financiers and the other parties to the projects' key underlying commercial contracts.

In a PPP context, those key contracts would typically include:-

5.8.1.1 the main project deed;

5.8.1.2 the main construction contract;

5.8.1.3 any operation and maintenance agreement;

5.8.1.4 any long term supply and sales contracts;

5.8.1.5 any significant site lease.

Such tripartite agreements, which are invariably sought in traditional project financings, will assume the same critical security relevance for most PPP projects, especially if no compensation is payable on a termination due to the project company's default. Their principal objective is essentially to enable the financiers to step into the shoes of the project company, if it defaults in its financing obligations, to facilitate enforcement. Financiers would normally expect a tripartite agreement relating to a commercial agreement to contain, among other things, the following:-

(i) consent from the third party to the project company charging or assigning by way of security the project company's rights under the relevant contract;

(ii) an undertaking from the third party that it would not exercise any right to terminate the contract without firstly giving the financiers (or a receiver or agent appointed by them) prior written notice and additional (often quite lengthy) cure periods to remedy the project company's default;

(iii) an appropriate regime which allows the financiers to assign the benefit of the contract to a purchaser of the project upon enforcement of the financiers' security.

The tripartite agreement between the financiers and the government would need to incorporate additional (often hotly contested) provisions dealing with further issues such as:-

(a) any conditions attaching to the security enforcement process and the agreed priority between each party's respective securities;
(b) the government's step in rights (in an emergency or upon default);
(c) any conditions attaching to the financiers' cure entitlements and step in rights; and
(d) the extent of application of insurance proceeds for repair or reinstatement purposes.

5.9 Refinancing of PPP projects

Given the prolonged duration of most PPP projects, financiers, project sponsors and governments will need to anticipate the likely requirements for any refinancing that may occur. During the life of the project, the project company may wish to replace or change the structure, nature or terms of the financing package that it put in place at financial close.

Governments should normally be receptive to proposals from the project company to refinance, provided that the proposals will not destabilise the project[74] or will not heighten the risk borne by the government without conferring on it some commensurate reward.

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[74] For example, by increasing debt or reducing equity beyond prudent levels.

Any refinancing proposal will frequently have the effect of increasing or accelerating distributions or returns to investors or of reducing their commitments to the project ("refinancing gains"). Transactions which could be undertaken by the project company after financial close and which might generate a refinancing gain include:

5.9.1.1 extension in the maturity of the debt;

5.9.1.2 increase in the amount of debt;

5.9.1.3 reduction of interest expenses, typically by:

(i) fixing interest rates for part or all of the contract period at a lower rate than assumed in the project's base case financial model/financing plan;

(ii) reduction in interest margins;

5.9.1.4 early repayment of subordinated debt;

5.9.1.5 reduction or release of debt service, maintenance or other reserve accounts, or their substitution by alternative forms of collateral or commitment;

5.9.1.6 release of capital or other contingent forms of equity buffer, or their substitution by other forms of collateral commitment; and

5.9.1.7 relaxation of financial ratios to permit the earlier payment of dividends to equity investors.

The nature of many PPP contracts, notably those which involve substantial investment in infrastructure in the early years of the contract period, means that financing terms available at financial close can often be improved over the life of the contract, especially after the risky construction period has passed.

As the PPP market matures and its stability becomes more assured, more competitive financing terms should become available as financiers compete for PPP project lending. Through refinancings, project sponsors will be able to gain access to these more competitive finance terms as they become available.

In the author's view, it should be expected that governments will increasingly argue that:

(i) a long term contractual commitment by the government to purchase a service, at a pre-determined price, with substantial risk protection for financiers,[75] is pivotal to the original financing of the project and to any refinancing gain that will arise;

(ii) the project sponsors could not themselves negotiate such competitive terms of finance without the government's contractual commitments; and

(iii) the government should therefore share in any refinancing gains that eventuate.

Project sponsors might regard this line of argument a little indigestible, especially as they assumed the financing risks in the first place and any "windfall" refinancing gain is often the

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[75] Usually evidenced by a deed entered into by the financier directly with the government under which, among other things, the operation of any project contract termination provisions are curtailed to protect the financier.

result of a fortuitous drop in underlying interest rates (where interest rates have not been hedged) or because the financial markets have simply re-rated the project as one of a class of projects less risky than first perceived. If the public sector pushes refinancing gain-sharing too vigorously, an obvious private sector riposte is, what happens when interest rates begin to rise? However, the publicly ventilated row that has erupted in the United Kingdom over recent PFI refinancings will most likely entrench the issue as too politically sensitive in Australia to avoid the government argument referred to above.

Construction of the first wave of UK PFI projects has now been completed and private sector contractors are now able to demonstrate an operational track record to leverage for more competitive financing terms. The crux of the dispute in the UK has been the manner of division of refinancing gains between the public and private sectors. The fact that the majority, it not all, of the refinancing gains have been captured by the private sector has generated severe criticism from not only the press but also public sector unions, government departments and politicians. Opponents of PPP in the UK have seized upon this issue to contend that PPP is unfairly taking advantage of the taxpayer and private sector sponsors of the projects in question have been caricatured as unconscionable bandits fleeing with all of the loot.

The row in the UK was initially instigated by the refinancing of Fazakerley Prison in Liverpool in March 2000. The project's original debt finance, a £92.5 million loan, was refinanced after construction had been completed. The refinancing apparently resulted in the margin and interest rates on the loan being significantly reduced and the tenor of the loan was also increased. These more favourable refinancing terms meant that the expected rate of return for the project sponsors increased by a rumoured 75% (approximately £14 million). A report by the UK National Audit Office in June 2001 revealed that, of these refinancing gains, only £1 million was paid to the government authority, Fazakerly Prison Services Limited, with the remainder going to the project sponsors. This is hardly surprising as the project documentation did not provide for any refinancing gains to be shared.

However, when this windfall profit became public knowledge, other examples of even larger refinancing gains were also brought to light.[76] It has not been the size of the refinancing gains that has prompted the outrage,[77] but rather that no gain sharing provisions were incorporated in the original project documents.

The temperature of the row in the UK over gain sharing would have been raised by the recent decision of the Office of Government Commerce to recommend that all future PPP contracts

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[76] One of the more notable was the Norfolk and Norwich Hospital project, where it has been estimated that refinancing gains will approximate to £70 million.

[77] The size of the refinancing gains is simply a factor of market conditions and a softening in risk perception for PPP projects

must incorporate a clause which stipulates that any refinancing gains are to be shared equally between the public and private sectors. That decision is likely to lead to the push for an adoption of refinancing gain clauses in many PPP contracts in Australia, with the government's share likely to be taken as:

(g) a cash lump sum at the time of the refinancing; and/or

- reduced service charges.

For the moment, the Partnerships Victoria guidelines suggest that provided there has been a competitive bidding process, the Victorian government will not seek to share in refinancing gains unless:-

(h) the project contract provides for sharing once the project company's rate of return reaches an agreed level;

(i) lower margins are available because finance markets have re-rated the risk of a particular type of project asset because a number of similar projects have been undertaken by government in the intervening period; or

(j) a benchmark rate has been fixed so that, even after paying break costs there is a cost saving to the project company in refinancing.

5.10 Dispute resolution

This is hardly a novel issue but is nevertheless worth mentioning briefly in a PPP context as it can inadvertently cause financiers and project sponsors some grief.

The project contract will usually specify a procedure for handling disputes, simply because litigating through the courts may not be appropriate for the majority of disputes likely to arise under a PPP contract.

A common form of dispute resolution in PPP contracts involves a three stage process as follows:

5.10.1.1 the government and the project contractor consult with each other for a fixed time period (possibly involving different levels of internal consultation) in an attempt to arrive at a mutually satisfactory resolution of the dispute;

5.10.1.2 if consultation fails, the parties may then submit the dispute to an independent expert to decide. The expert's appointment is regulated by the contract. The identity of the expert will vary depending upon the nature of the dispute requiring resolution; and

5.10.1.3 if either party is dissatisfied with the expert's decision, it may refer the dispute either to arbitration or to the courts for a final and binding decision.

The trap for the unwary stems from the fact that the subcontracts between the project company and the construction contractor/operation and maintenance contractor will also usually specify a dispute resolution procedure. It is important from the financiers' perspective to ensure that the dispute resolution procedures at these two different levels are symmetrical so that a decision made at one level will be binding at the other. Otherwise, the project company may find itself caught in the mire of inconsistent decisions.

Another method of resolving this potential problem is to seek to have the hearing of disputes consolidated, although a common response from government is that any additional costs it incurs as a consequence must be met by the project company.

5.11 The Need for Competitive Funding

As Australian governments evolve more into purchasers of services from the private sector (rather than being owners and operators of assets), they will focus on the availability and cost of finance to the private sector party, especially when capital costs are a significant underlying component of the service fees that they pay.

Although there should always be a natural incentive for private sector bidders to reduce their costs of capital (which will often be captured by the calling of competitive tenders from financiers for any necessary debt funding), it should be expected that governments will subject financiers and the cost of funding to even greater scrutiny and rigour in many PPP projects in the future.

If the UK experience is to be followed, Australian governments may require preferred bidders to conduct a funding competition for some projects in the expectation that greater value for money might be achieved, because:

5.11.1.1 financiers are likely to offer more competitive terms to a preferred bidder; and

5.11.1.2 prospective financiers may be less likely to seek significant changes to the project documents if confronted with the prospect of competition from other financial institutions willing to offer finance to the project company for the project.

In the United Kingdom, the following types of projects have been perceived to be potentially suitable for funding competitions:

(i) larger projects that require a significant level of capital investment by the preferred bidder;

(ii) more novel projects, including those based on market risk where financiers may each adopt a markedly different approach and so offer greater choice to borrowers;

(iii) projects where there are very few bidders and the government decides that re-tendering the project is not feasible;

(iv) where the preferred bidder's financiers are seeking significant changes to the project documentation despite the fact that the project assumes a high degree of standardisation; and

(v) a significant delay is likely to arise between appointment of the preferred bidder and financial close because, for example, of the time needed to obtain necessary approvals.

However, a funding competition will not be appropriate for every PPP project, as they will usually exhibit the following risks and costs:

(vi) a possible lack of market interest in the funding competition, particularly if it is delayed until after the preferred bidder is selected;

5.11.1.3 the government will incur higher financial advisory fees because of the additional work and responsibility which will be required of its financial advisers.

As the PPP market in Australia matures, the author suspects that, for the majority of projects, the actual benefits achieved from funding competitions would be relatively insignificant. One might therefore expect that funding competitions will only be conducted infrequently. However, it should also be anticipated that Australian governments may adopt the practice of reserving the right in invitations to tender to conduct a funding competition for many PPP projects, to ensure that any financing package which underpins a preferred bidder's tender is highly competitive.

If the practice of funding competition does develop momentum in Australia, it may not fit easily with the exclusive alliances which some of Australia's major contractors have negotiated with particular financiers.

Financiers generally will not welcome funding competitions with open arms. Financiers spend countless hours in collaboration with bidders to devise effective financing structures. The prospect of having well advanced, complex project financing deals being made even more mercurial will not be cherished by them. Sponsors, too, are likely to have mixed feelings. For sponsors, it is critical to team with a financier with significant PPP experience. Sponsors will not delight in dealing with, for example, an inexperienced building society simply because it is "cheaper". The commercial reality is that the government does not generally have to deal with the financier when amendments or waiver of technical defaults have to be requested. An experienced PPP financier will adopt a commercial approach to these issues; an inexperienced one may not.

5.12 Procurement of Services – the critical concepts of Availability and Performance

The essential ingredient of PPP transactions is the procurement of a service. It follows, therefore, that unavailability of the service should result in a reduced payment by the public sector counterparty or, in certain circumstances, no payment at all.

In order to raise project finance, the amounts payable under the PPP project documentation must be predictable. A key issue in most PPP projects will therefore be what constitutes availability.

Projects which are predicated upon availability based payments must therefore incorporate in the project documentation what is meant by "available". The definition will typically need to specify the various conditions which must be met if the service is to be treated as available.

The definition of availability will be more straightforward in some sectors than in others. For example, for projects involving merely the provision of major equipment, a significant aspect of availability will depend on whether the equipment operates functionally. For other projects, however, the drafting task will be more challenging and considerable thought and investigation may be required to identify the appropriate availability criteria.

From a project financier's perspective, the likely issues of concern in this context will include:

5.12.1.1 as payment will depend on the availability criteria being met, the definition of "availability" must be objective, clearly measurable, reasonable and not contain criteria which are practically unachievable or immaterial in the context of the services as a whole;

5.12.1.2 the availability definition should therefore focus on the core functions of the service and comprise clearly measurable criteria so that it will be apparent to the parties whether the criteria have been satisfied;

5.12.1.3 unavailability should be measured as simply as possible. Complex definitions that require excessive monitoring costs should be avoided;

5.12.1.4 payment for availability of the service will vary according to each project. However, where the service is divided into areas, the financial consequences of unavailability of an area should depend on its criticality level, as some areas will be more crucial to the provision of the service than others. The project documents must therefore properly specify which areas are most important and allocate them a higher weighting for default purposes. For example, in hospital projects, accommodation is often graded in terms of criticality in the following areas:

(i) the most important area, comprising accident and emergency facilities and patient spaces including bathrooms, operating theatres and intensive care;

(ii) the next area of medium importance, including general waiting areas and clinical support areas such as pharmacy and physiotherapy; and

(iii) the least important areas in this context, comprising office areas and educational facilities;

5.12.1.5 the project documents must specify precisely when unavailability starts so that any permitted rectification period can be measured by the parties. The project company must be notified as soon as practicable when unavailability is discovered;

5.12.1.6 the contract documents should provide for a rectification period within which the project company has the opportunity to rectify the problem without triggering the commencement of an unavailability period. If the project company rectifies the failure within the relevant rectification period, no availability deductions should be made;

5.12.1.7 where a service disruption occurs, if the project company is able to supply the service by alternative means and the project documents permit this option, availability payments should continue to be made;

5.12.1.8 the government counterparty should pay for services on time and payment should not be unreasonably withheld. Any payment deductions should reflect only the actual degradation in service;

5.12.1.9 unavailability should be excused if it is caused by government step-in;

5.12.1.10 the project documents should incorporate a mechanism for determining when availability has been restored and for all parties to be so notified;

5.12.1.11 there should be no deduction for unavailability or performance deductions during the periods when agreed maintenance is taking place;

5.12.1.12 the contract must provide whether the stated performance regime applies in full from the service commencement date (eg. for road projects) or if there is a settling in period where some flexibility is permitted (eg. for prisons);

5.12.1.13 there are performance monitoring arrangements in place, which are appropriately proportional to the consequences of service failure; and

5.12.1.14 the financiers must have confidence (taking into account, where relevant, the advice from their technical advisers) in the project company's ability to perform and/or rectify defective performance.

It is worth emphasising this context that financiers are very concerned to ensure that there is a robust cashflow because if the deduction regime is too onerous, not only might it lead to default, but it would also depress the market value compensation on a re-tendering. For most financiers, that would be an unacceptable double whammy.

5.13 Scope of the Government's Right of Set-Off

Standard practice in most fields of civil procurement has been for the government to enjoy the right to set-off amounts owed to it by the contractor against amounts due to the contractor under any contract between the contractor and the Crown.

In a PPP project context, this can be an issue of concern for the project financiers. If the project company has entered into or is likely to enter into other contracts with the Crown, its financiers would normally want to ensure it did not agree to an expansive set-off clause which permitted amounts relating to other contracts[78] to be set off against amounts due under the contract in question.

A well advised government should not usually seek to expand its set-off rights beyond the right to deduct liquidated damages, overpayments, amounts claimed under indemnities and other liquidated amounts owed to it by the project company under the contract in question from any payments it is obliged to make to the project company. However, the government would normally be unwilling to insulate the financiers' entitlement to debt service from this right of set-off or deductions.

If set-off becomes too contentious an issue, it should be able to be resolved by the use of a specially incorporated project company whose only business is limited to the contract in question.

5.14 Change in Services

Given the duration of most PPP projects, it can be anticipated that the nature of the contracted services will need to be varied during the life of the contract.

Any proposed change in services may involve construction and/or operational changes. Depending upon its nature, costs may be incurred in implementing the changes which were not originally anticipated. Accordingly, in most PPP contracts there will be an inevitable tension between cost and flexibility. Put simply, the cheapest charge may provide the

government with the least flexibility in managing the contract, as the ability to absorb unforeseen changes and risks inevitably comes at a price.

From the financiers' perspective, the critical issues regarding changes in services proposed by either the government or the project company are:

5.14.1.1 whether the changes are mandatory; and

5.14.1.2 how the cost of implementing such changes is to be allocated.

The financiers will need to consider the following factors:

(i) whether the proposed service changes will have an adverse impact on the project's economics. In order to submit a competitive bid, it is likely that the project company will only have budgeted a small contingency to cover service variations;

(ii) unless offered additional security, whether they should prevent the project company from agreeing to any change in services which would increase project risk, financing risk or reduce the rate of return. The banks would want any additional finance required for the change to be subject to their approval;

(iii) whether any increase in costs resulting from a government requested change is appropriately accommodated by an increase in the service charge.

5.15 Service Charge Variations

The project contract will usually set out the service charge for the entire contract term. However, due to the uncertainties of inflation rates and the quantum of operating costs over a long term contract, the financiers will be concerned to ensure that the contract provides for varying the service charges in certain specified circumstances.

The project company will also be concerned to insulate itself against inflation rates increasing over the course of the contract and rendering the initial prices insufficient to meet its operating costs and financing obligations. It would be highly unusual for prices to be fixed for periods for which PPP projects are typically let. Governments should therefore accept that appropriate indexation mechanisms may be incorporated.

Care should be taken by financiers when reviewing such price indexation provisions. Choosing an index that may be short-lived, or is not independently produced, is not a sensible approach, nor is it prudent to have too narrow a focus on a particular industry or sector.[79] There will of course be many other issues to consider in this context.[80]

The quid pro quo which may be sought by the government is to incorporate in the contract some means of ensuring the price it has agreed to pay in future years will not be in excess of future market prices for such services. Some form of benchmarking[81] or market testing[82] may be required for this purpose.

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78 Or, of even potentially greater concern, amounts owing to the Crown on any account.

79 he project contract will also need to include provisions dealing with circumstances where the particular index (or indices) specified in the contract is no longer published or the basis upon which it is calculated is changed.

80 For example, how to deal with changes in law, changes in insurance costs and changes in other major inputs (eg utilities), all of which are likely to be beyond the reasonable control of the project company.

81 Benchmarking would typically involve the project company comparing either its own costs or the costs of its sub-contractors against the market cost of such services.

82 Market testing might require the project company to re-tender on the market any relevant sub-contractors' services to test the value for money of those services.

5.16 Restrictions on Assignment by Financiers

Some governments may seek to limit the ability of financiers to assign their rights. The justification sometimes advanced for this is a perceived need to retain the original financiers' involvement, as they understand the complexities and subtleties of the deal which has been negotiated, and confidentiality.

Unless exceptional circumstances apply, financiers should resist any restrictions on assignment. Confidentiality is hardly a legitimate justification. Financiers would generally be under a duty of confidentiality and, in any event, any residual confidentiality concerns can be addressed in an appropriate agreement between the financiers and the government.

Furthermore, restrictions are often also more cosmetic than real as they can often be circumvented by, for example, sub-participations.

If transfer restrictions can be justified, they should focus on objective categories[83] or should prescribe a list of acceptable transferees, rather than adopting the all encompassing approach of a general right of veto.

5.17 Scrutiny of Financing Documentation

Financiers should be aware that governments are likely to want to undertake a detailed due diligence of the project company's finance documents that it is seeking to put in place at financial close. There are several reasons for this, including:

5.17.1.1 the government will want to understand how the project company proposes to finance the delivery of the service and to be comfortable that those arrangements will be sufficient to allow the project company to deliver the service during the life of the contract;

5.17.1.2 except in the case of the project company's default, the amount of any compensation payable to the project company on early termination will often be linked to the amounts owed by it to its financiers under the financing documents. The government will therefore want to understand what those amounts will be and how any break costs will be calculated;

5.17.1.3 the financing documents should reflect the terms of the financial model agreed at financial close.

During due diligence, the government is likely to focus on, among other things:

- interest rate ratchets;
- the financiers' requirements in respect of the funding of maintenance and any other reserve account requirements;
- inter-creditor arrangements, to ensure that they do not undermine any essential principles agreed in the project documents;
- letters of credit, if they are to be used as a replacement for reserve accounts;
- breakage costs; and
- variable interest rate obligations.

83 For example, credit ratings.

5.18 Tender Process Risks

The project company and its financiers will also need to be concerned with tender process risks. These risks include transparency and probity issues, satisfactory compliance by all parties with government tendering procedures,[84] certainty of the government following through with the project and delays that may increase bid costs.

The recent willingness of Kirby J. to grant interlocutory relief to restrain the New South Wales government from entering into a contract with the government's preferred tenderer in respect of its proposed new integrated ticketing system, upon the application of a disgruntled losing tenderer which alleged non-compliance with tendering procedures, is a salutary reminder of the significance of such risks.[85]

5.19 Land Acquisition and Tenure Issues

Most PPP projects will require the acquisition of lands necessary for the project. Such acquisitions will be effected either voluntarily by agreement, or compulsorily by the government exercising its compulsory acquisition powers. Any land acquired by the government compulsorily will usually be intended for the benefit of a third party; namely, the successful private sector bidder which would normally be granted a leasehold interest only for the reasons mentioned previously.[86]

However, it is important in this context to note that the High Court has held that a compulsory acquisition by a public authority for an ulterior, unauthorised purpose would be ultra vires, the fundamental rule being that a statute authorising the compulsory acquisition of land for certain purposes can only be acquired for those purposes and not others.[87] It will be critical, therefore, for project sponsors and their financiers to review carefully the legitimacy of any proposed compulsory acquisitions.

The Queensland government was able to be persuaded to enlarge its compulsory acquisition powers to obviate this potential problem.[88]

Any long term site lease will also be critical from the financiers' security perspective. The financiers will need to confirm that the terms of the lease are appropriate to permit the project company to provide the contracted services for the duration of the project. In this context, the financiers will need to focus on the provisions of the lease which deal with, among other things:-

(i) the description of the land to be leased and the permitted uses;

(ii) the ability of the project company to surrender back to the government any unnecessary parcels of land;

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84 See the judgment of Finn J in *Hughes Aircraft Systems International v. Air Services Australia* (1997) 76 FCR 151 which is critical in this context.

85 See *Cubic Transportation Systems Inc. v State of NSW & Ors* (2001) NSW SC 1195, in which the allegation was made that the government improperly influenced the recommendation made by the tender evaluation committee, in breach of the tender process. Final judgement had not been delivered in this matter at the time of preparation of this paper.

86 See footnote 69 above.

87 *Samrein Pty Ltd v Metropolitan Water Sewerage & Drainage Board* (1982) 56 ALJR 678 at 679; see also *Prentice v Brisbane City Council* [1966] QdR 394 and *R v Toohey; Ex parte Northern Land Council* (1981) 151 CLR 170.

88 See the enlarged compulsory acquisition powers now contained in ss. 125-129 of the *State Development and Public Works Organisation Act* 1971 (Qld).

(iii) the ability of the government to pass on to the project company additional liabilities in the future (such as payment obligations, compensation for subsequent native title claims and other obligations in respect of the land that might be assumed voluntarily by the government).

(iv) default and termination provisions;

(v) any right or obligation to remove infrastructure at any time, including upon the expiry or earlier termination of the lease, and any other make good covenants;

(vi) the rental, rent review and outgoings provisions; and

(vii) indemnity provisions.

5.20 Taxation Issues

Australian taxation laws are currently undergoing a detailed review as a result of the reforms proposed in the 1999 Ralph Review of Business Taxation.[89]

Project sponsors and their financiers will of course need to seek specialist tax advice for all PPP projects, particularly in light of this legislative state of flux. Principal issues in relation to income tax in a PPP context will include:-

5.20.1.1 the existing anti-avoidance provisions contained in Section 51AD and Division 16D of the Income Tax Assessment Act 1936. The Ralph Review recommended that section 51AD be abolished and Division 16AD be modified,[90]

5.20.1.2 the new depreciation and capital allowance provisions,[91]

5.20.1.3 the new thin capitalisation rules,[92] and

5.20.1.4 the proposed new tax consolidation regime.[93]

6. Problems Encountered – Lessons to be Learned from the UK Experience

6.1 Problems encountered

As Australian States and Territories proceed down a path similar to the UK, it is important to bear in mind the following problems that have been identified in the implementation of the PFI model in the UK:-

6.1.1.1 Prioritisation

Initially, the UK government was not sufficiently diligent in controlling the flow of projects to the market. In each new sector, the UK government has since learned to hasten slowly, by identifying a few robust pilot projects and completing them successfully, in order to build both confidence and experience before increasing the flow of projects to the market.

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89 *Review of Business Taxation: A Tax System Redesigned*, Report by a committee of review, (John Ralph AO, Chairman), Canberra, 1999.

90 Latest consultative feedback suggests section 51AD will be repealed allegedly by 1 July 2003.

91 Divisions 40 and 243 of the Income Tax Assessment Act 1997 (Cth).

92 Division 820 of the Income Tax Assessment Act 1997 (Cth).

93 Refer to the New Business Tax System (Consolidation) Bill (No. 1) 2002, to take effect from 1 July 2002 (although a transitional 12 month phase in period is proposed).

6.1.1.2 Bankability

Initially, many projects were introduced to the private sector market prematurely. Many had not been thoroughly considered and were poorly packaged without well developed conditions of contract or appropriately defined payment mechanisms. The UK government now recognises that the public sector must determine precisely what it requires before it can expect to receive a sensible bid from the private sector.

6.1.1.3 Reinventing the wheel

In the early stages, the UK government wasted a lot of time and money "reinventing the wheel" in formulating new solutions to problems which had already been resolved in earlier transactions. This contributed to project delays, bidder uncertainty and, significantly, escalating tendering costs. To circumvent this, in July 1999 the UK government published standard form PFI agreements and accompanying guidance notes for use by all government departments and local authorities. These have been designed to encourage PFI deals to evolve into a commodity product, just as other capital market products have done, to make PFI transactions inexpensive to tender for and more expeditious to negotiate. Victoria has elected to partly follow that example.

6.1.1.4 Optimisation of risk transfer

Unlike the UK government's initial approach, the standard PFI agreements prepared in July 1999 do not seek to impose excessive risk transfer to the private sector. Experience has taught the UK government that excessive risk transfer inevitably results in bidders charging an excessively high risk premium, or they may simply refuse to accept the risk altogether. The UK government now seeks optimal, not maximum, risk transfer.

6.1.1.5 Completing the policy framework

It proved necessary to devise a new policy framework for the PFI. The PFI model was an entirely new procurement regime which meant that rules existing at the date of its introduction either created unintended obstacles or exposed existing policy gaps. It was therefore necessary to reform and complete the policy framework in parallel with the negotiation of some of the initial PFI transactions. It also proved necessary to enlist support at a senior political level to achieve the necessary reforms.

It is worth noting that the policies of several Australian States and Territories still await completion.

6.1.1.6 Improving public sector project management

The UK experience has been that it is not enough simply to invest better; it is also critical to improve the management of individual procurements. Governments generally do not enjoy a good reputation for project management. Many UK PFI procurements were plagued by:-

(i) a lack of clear authority in government departments to make even small decisions;

(ii) an emphasis on process rather than the quality of the outcome;

(iii) unexplained delays in evaluation;

(iv) late changes in policy resulting in new bid requirements;

(v) in some circumstances, even cancellation of the project.

The PFI model has demanded new skills in public sector authorities. PFI projects, like most infrastructure projects, are often extremely complex. PFI projects require skills that are not in abundant supply in the public sector; for example, writing output specifications; negotiating complex infrastructure contracts that underpin PFI transactions; and understanding the financing products that investment bankers promote to underwrite such transactions.

The UK experience has been that appointing the right consultants (the best, not just the cheapest) and making sensible use of them will largely address this skills deficit, but not in all respects. Private sector involvement in public infrastructure projects requires private sector skills. The challenge for UK public sector authorities has been to equip themselves with the private sector skills to ensure that the PFI transactions were satisfactorily concluded.

The UK Treasury Task Force was established to address this problem and to provide some continuity in PFI procurement by being the focal point across government for all PFI transactions. Its mandate was to get the PFI deals done and make the process work. It was comprised of private sector individuals who possessed a track record of concluding PFI transactions in the private sector. They reported directly to the Treasury Minister responsible for the PFI, which enabled them to deploy the political authority necessary to overcome problems.

The UK Treasury Task Force was replaced by a new public private partnership, Partnerships UK, which carried on its work.

More recently, the newly formed Office of Government Commerce has assumed the responsibility of developing the UK PFI guidelines and keeping them up to date.

A similar challenge obviously confronts the various Australian governments.

7. The Dawn of a New Era for Project Financing?

The UK PFI model has evolved significantly since its introduction 10 years ago. Although originally intended as a method of sourcing additional resources to boost investment in public infrastructure, it has transformed into a valuable procurement tool in its own right that it is now being embraced internationally.

The justification for PFI has been that it has demonstrably made better use of taxpayers' funds than conventionally funded alternative procurement methods in the majority of cases where it has been applied.

The UK National Audit Office has confirmed, in its audited reviews of completed PFI projects, that PFI is achieving life time savings of costs of 20% or more in most projects. Its economic justification is therefore simple – it makes taxpayers' funds go further and stimulates additional economic investment. This has been recognised by the Victorian and New South Wales Governments in the formulation of their comparable policies, and the published intentions of the various other Australian states to do likewise.

However, if PPPs are to become a significant feature of the Australian public service landscape, then much still has to change.

A political determination to make a reality of the rhetoric of PPP policy and an acknowledgement by opponents that PPPs do not necessarily constitute privatisation by stealth will be required.

High quality public services need to be a defining feature of Australia. Many would contend that the sooner we get PPPs right, the more likely this will be achieved. Successfully doing so will surely herald the dawn of a new era for project financing.

Alan Millhouse
27 May 2002