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Infrastructure - Changing procurement models

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Introduction

- Infrastructure markets are dynamic, constantly changing and developing.
- Demand for social and economic infrastructure is growing rapidly and governments are seeking new ways to meet that demand.
- Australian Governments have recently seen urban infrastructure as a key driver of job creation in an economy seeking to supplement the resources sector.
- Governments and the private sector are focussing on innovation in the constant drive for greater efficiency in infrastructure delivery.
- Procurement models have evolved to meet new challenges. In Australia, the "normal" Public Private Partnership (PPP) of the late 1990's / early 2000's has given way to a diverse range of PPP procurement models.
- This paper outlines how procurement models differ and what it means for those financing (and advising the financiers of) major infrastructure projects.

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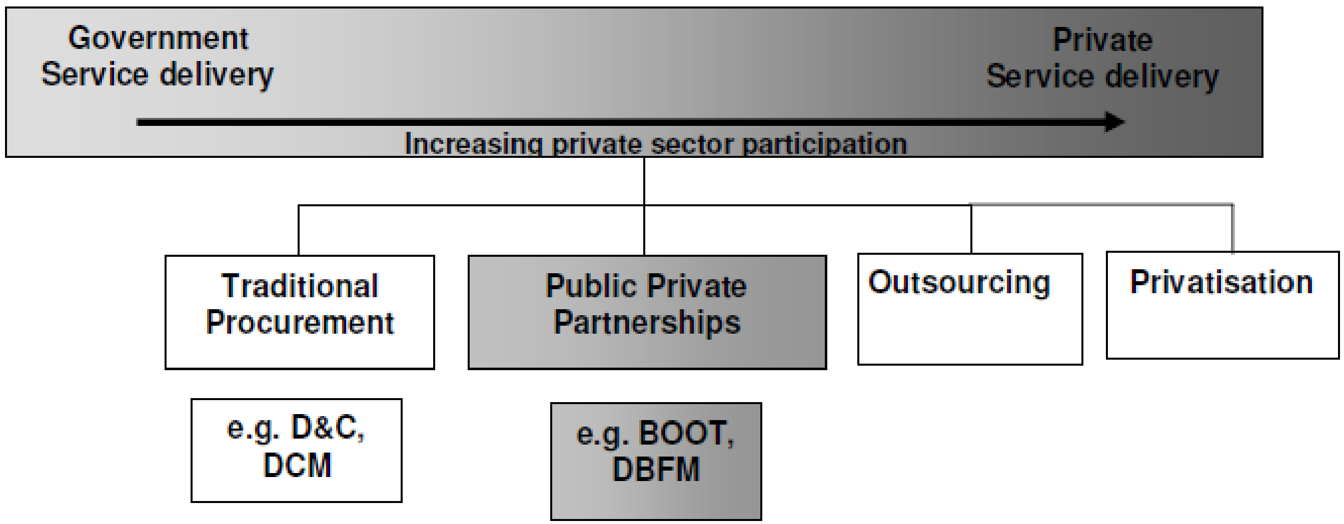
Infrastructure delivery and PPP's

- In Australia, infrastructure has long been procured by Governments in conjunction with the private sector.
- The spectrum of private sector participation has developed over time, with PPPs becoming a well understood model in the 1990s.

Figure 1. Public and private sector delivery spectrum

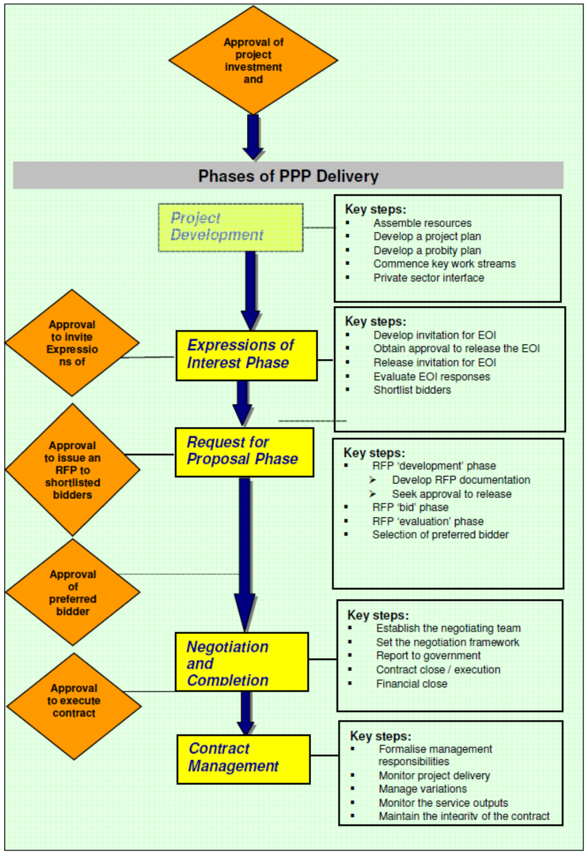


"Traditional" PPP procurement

- In Australia, traditional approach to PPP procurement is summarise in the National PPP Guidelines released by Infrastructure Australia in 2013.
- Each State then has its own policy which supplements this framework.

- Key points to note are:
  1. Most PPPs' have followed this approach – it is well understood and well supported by the market.
  2. A good deal for the State (ie Value for Money) is delivered by a competition between bidding consortia.
  3. Bidding consortia have included equity, D&C, O&M and debt.

Figure 3 Phases of PPP delivery



Why change the approach?

The key drivers which led to changes in the procurement approach were:

- **Market failures** – debt market failures following the GFC, patronage market issues following unsuccessful projects.
- **Value for Money** – driven by risk allocation and features such as the relative importance of some of the operational aspects and misbalance in the risk / return equation.
- **Project Complexity** – large, multi-stage, inter-connected projects have struggled to be efficiently delivered through the traditional PPP model.
- **Differing government priorities** – need to incorporate IR reforms, structural change to industries.

NSW – Unsolicited Proposals

From the NSW Unsolicited Proposals Guidelines 2014 –

*"**Premier's Statement***

The NSW Government is determined to deliver the change the people of NSW have called for to rebuild our State and make NSW number one.

Work is well underway to rebuild the economy, return quality services, renovate infrastructure, strengthen our local environment and communities, and restore accountability to government.

Responsible economic management requires sound strategic planning coupled with rigorous fiscal discipline.

To this end, the NSW Government launched its Guide for Submission and Assessment of Unsolicited Proposals in January 2012 (Guide), in order to further engage with the private sector in the development and delivery of new infrastructure and services.

The NSW Government is encouraging the best ideas and solutions from the private sector and a greater level of private sector investment and participation in projects, with rigorous planning and costing to deliver the highest standards of public value – and confidence to investors and the community."

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NSW – Unsolicited Proposal Process

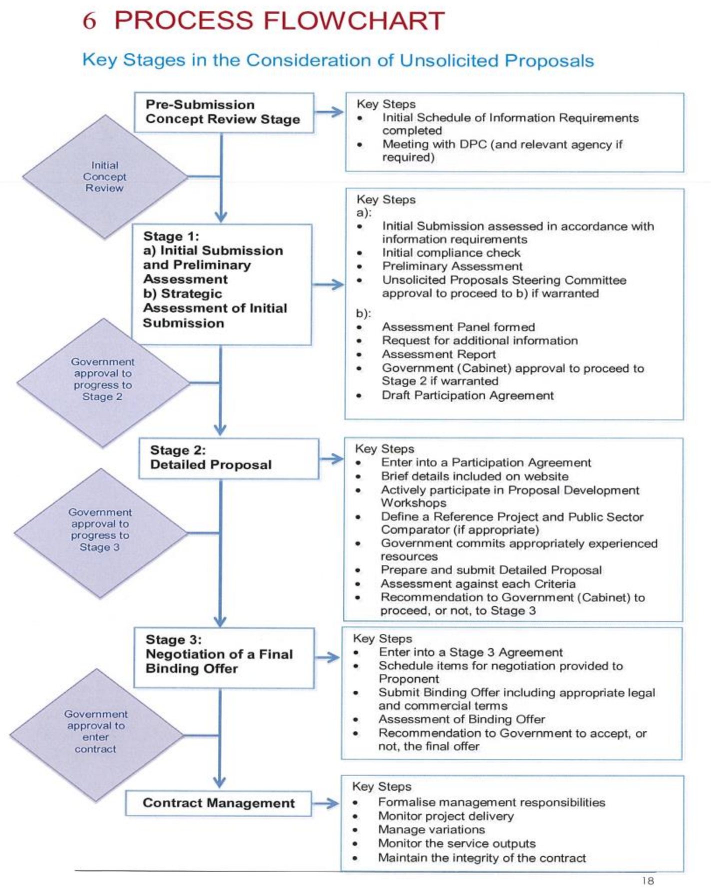
- NSW Unsolicited Proposal guidelines provide a much broader approach to procurement.

- Key features

1. Very difficult to demonstrate uniqueness – few proposals make it through.

2. Different competitive bidding dynamic and challenge to demonstrate value for money.

3. Proponents hold the risk that Government will decide not to proceed.



UK – PF2

- **In March 2012, the UK Government concluded a general review of PFI and released PF2.**

- **As introduction to the reforms, the report states:**

"We have sought to provide access to wider sources of equity and debt finance to improve the value for money of financing projects; to increase the transparency of the liabilities created by long term projects and the equity returns achieved by investors; to speed up and reduce the cost of the procurement process; and to provide greater flexibility in the provision of services. The taxpayer will become a shareholder in projects and share in the ongoing investor returns.

PF2 addresses the fundamental concerns that have been expressed by Parliament, the public sector and taxpayers. By commanding greater confidence among both taxpayers and providers we hope that PF2 will become an enduring part of public sector service and infrastructure provision for many years to come."

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UK – PF2 - Key Reforms

- **Equity**: To strengthen significantly the partnership between the public and private sector the Government will look to act as a minority public equity co-investor in PF2 projects and introduce funding competitions for a proportion of equity to attract long-term investors into projects prior to financial close.
- **Accelerating delivery**: To ensure that procurement is much faster and cheaper than in the past the Government is improve public sector procurement capability by strengthening the mandate of Infrastructure UK and supporting departmental centralised procurement units.
- **Flexible service provision**: To improve the flexibility, transparency and efficiency of services soft services such as cleaning and catering will be removed from projects; • procuring authorities will have discretion on the inclusion of certain minor maintenance activities at the project outset. There will be additional flexibility to add or remove certain elective services once a contract is in operation; • an open book approach and a gain share mechanism for the lifecycle fund will be introduced to facilitate the sharing of any surplus lifecycle funding; and • periodic reviews of service provision will be introduced.
- **Greater transparency**: To transform the approach taken to transparency the Government will: • introduce a control total for all commitments arising from off-balance sheet PF2 contracts signed; • require the private sector to provide equity return information for publication; • publish an annual report detailing project and financial information on all projects where Government holds a public sector equity stake; • introduce a business case approval tracker on the Treasury website; and • improve the information provisions within the standard contractual guidance.
- **Appropriate risk allocation**: To improve value for money there will be greater management of risks by the public sector, including the risk of additional capital expenditure arising from an unforeseeable general change in law, utilities costs, site contamination and insurance.
- **Future debt finance**: The financing structure for PF2 will be designed to enable access to long-term debt finance, and in particular, the capital markets.
- **Delivering value for money**: Government will develop and consult on guidance which will replace the existing Value for Money Assessment Guidance.

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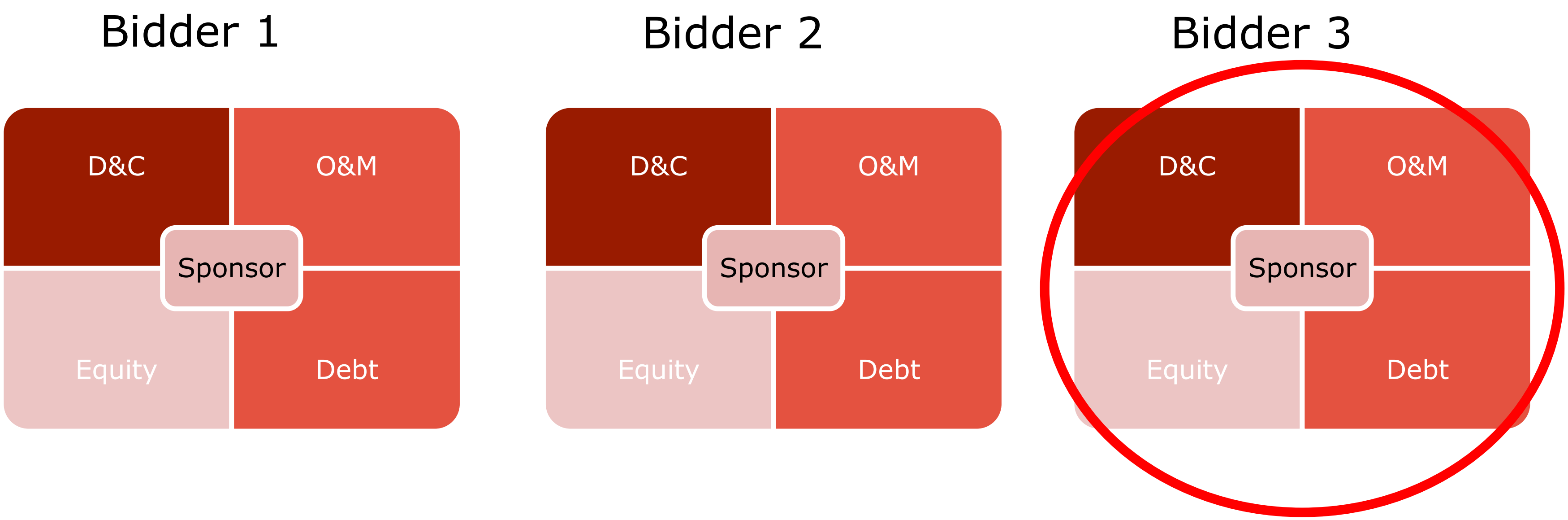
Traditional PPP – bidding dynamic

- Traditional PPP procurement involved the State selecting the best package deal.
- Eg – Toowoomba Second Range Crossing PPP.

- Benefits include competition across all elements of the project.
- Detriments include the fact the State is not able to select the best of each element.



Selected bidder by the State.

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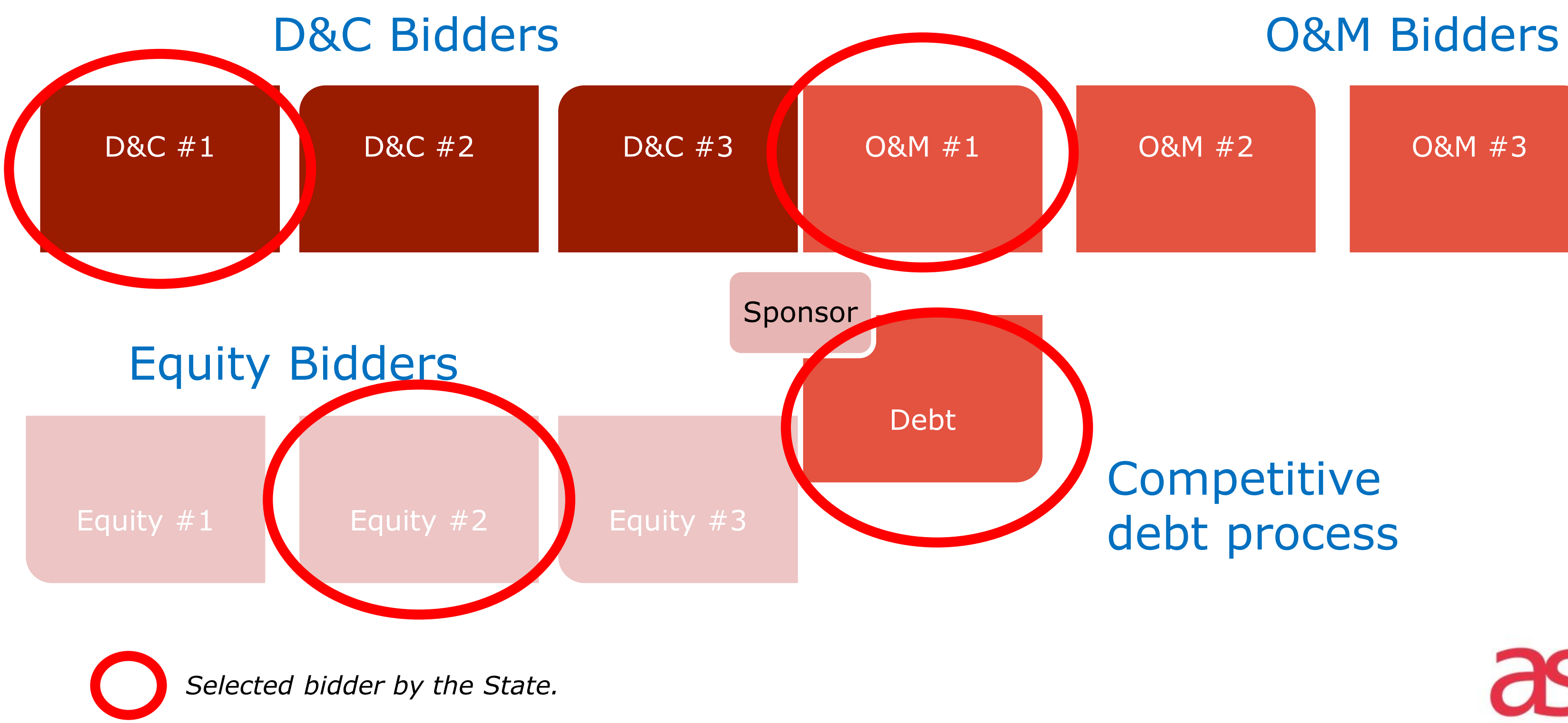
Disaggregated PPP – Bidding dynamic

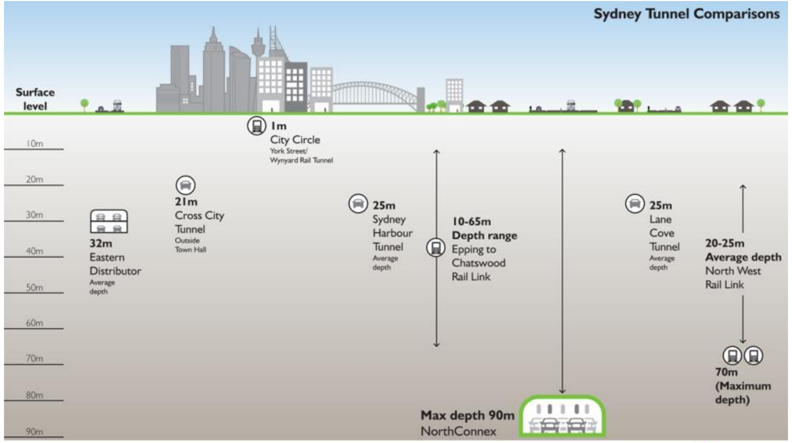
- Disaggregated procurement approach involves the State selecting the best individual aspect of the project. Eg – WestConnex.
- Permits the State to select the best element, removes cross subsidy potential, allows for staggering of bidding processes and for the staging of the project.



NorthConnex

NorthConnex – a 9km dual tunnel tollroad in North West Sydney linking M1 and M2.

- NSW Unsolicited Proposal process.
- Project Sponsors were Transurban, CPPIB and QIC.
- Capital contributions from Federal Government and NSW Government.
- D&C competition conducted by Transurban (with RMS oversight / input).
- Ultimately will be a complete PPP long term traffic based concession – but currently no debt financing.
- Innovative approach to planning approvals.



WestConnex

WestConnex is the largest transport project in Australia, linking Sydney's west and south-west with the CBD, Sydney Airport and Port Botany.

The 33 kilometre WestConnex motorway will run from Parramatta along the M4/Parramatta Road corridor to Rozelle, before heading south through Camperdown to St Peters and Sydney Airport, and then west to Beverly Hills.

It will be delivered in three stages, with the final stage to open to traffic in 2023.

WestConnex is being procured through Sydney Motorway Corporation, a NSW Government owned but not guaranteed subsidiary, with separate procurement processes for each of the key elements of each of the stages.

Northern Beaches Hospital

In 2014, the State awarded the contract to the hospital operator, Healthscope, to design, build, finance, operate and maintain the new Northern Beaches Hospital at Frenchs Forest.

- The nine-storey hospital - to be built on a 6.5 hectare site at Frenchs Forest - will contain 488 beds and 1,400 car spaces.
- Healthscope will provide public patient clinical services for 20 years.
- At the end of the contract period, the public portion of the hospital can be handed back to the NSW Government at no additional cost to the State.
- Healthscope then has a further 20 years to provide services to private patients before the remaining part of the hospital can also be returned.

UK – Mersey Gateway

A £500m availability-based PPP Project following SOPC/PF2 principles.

The Project included a range of features which stood out from the run-of-the-mill, including:

- the imposition of user tolls by Halton;
- a unique dual contract/SPV structure, combining a PPP contract for the bridge's construction, finance, maintenance and operation, with a shorter-term operational service contract for the toll-collection functions;
- a multi-source financing package, including a combination bond and bank financing;
- the first example of a government wrapped bond under the UK Guarantees scheme; and
- a unique arrangement provided by Her Majesty's Treasury (HMT) to the project vehicle, to support Halton's payment obligations.

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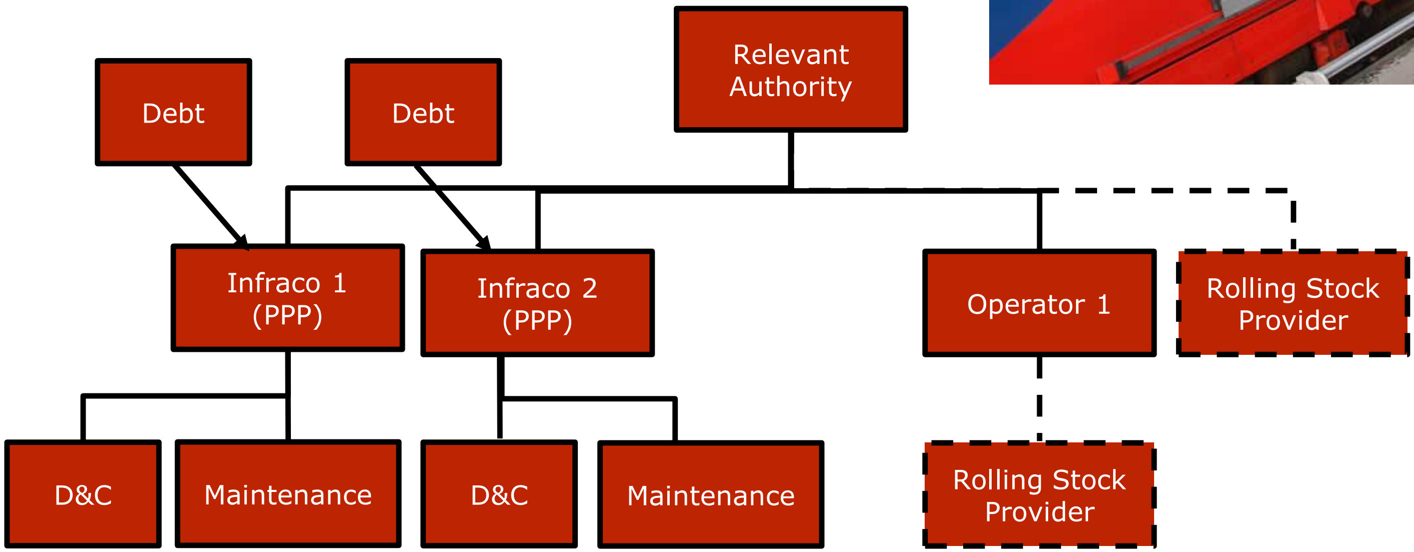
UK - Docklands Light Rail

- Docklands Light Rail evolved over many years to include a number of projects as the system expanded.
- The structure accommodated multiple infrastructure PPPs with a separate operations franchise.
- An overview of the structure is below.



Consequences for PPP financing

- Increased involvement of financiers and financial advisers in "understanding the model".
- Complexity from needing to re-visit how standard concepts apply in this project – eg termination compensation regimes.
- New areas of analysis, such as service provision and operational risks.
- New capital structures and increasing contributions from State and Federal Government, both during and after construction phase. This includes debt pay down structures.
- Limits on the commercial ability of governments to participate in capital structures – intercreditor / inter-funder issues.
- Focus on the traditional issues and risk allocations – refinance risk, patronage risk.
- Ability of the financing structure to expand with the project (rather than just be paid out).

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Key legal issues

- Complexity - Understanding the underlying project structure and rationale – you cannot assume that just because it is an infrastructure project all the participants are acting under a Traditional PPP framework.

- Termination rights – Limits on the ability of the State to terminate, compensation structures for project co defaults.

- Assignment / unwind provisions – protections to equity investors on subsequent sales.

- Hedge providers – swap close out rights, timing of setting the hedges during the bid phase and assumption of interest rate risk by the State during operations.

- State "value" protections – including option to purchase equity (as opposed to voluntary termination rights).

- Standardisation of documentation – how far is it away?

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Barangaroo Delivery Authority v Lend Lease (Millers Point) Pty Ltd [2014] NSWCA 279

- Facts – Lend Lease was the developer of the Banargaroo area in Sydney under a development contract with the land owner – the Barangaroo Delivery Authority (**Authority**).
- The contract sought to share development profits by reference to a very detailed and specific profit sharing formula which sought to define the Current Market Value of the land.
- Lend Lease structured a sale of a part of the development to an investor via Nominee in a manner which it contended did not trigger the development profit share. That approach involved structuring the sale price of the building as contributions to the development cost.
- At first instance, Lend Lease was successful on its interpretation of the contract.
- The New South Wales Court of Appeal dismissed an appeal brought by the Authority.
- The key contractual issue was whether the payments made by the Nominee to the Developer to fund the development were to be included in a cash flow calculation determining the Current Market Value of the land.
- The Court of Appeal held that payments made by a Nominee were not to be included in the cash flow calculation determining the Current Market Value.
  - The Court of Appeal placed weight on the "structure and purpose as well as the text" when interpreting the contract and preferred the interpretation that avoids "commercial absurdity."
- This case demonstrates the importance of obtaining confirmation from the client of the commercial effect of the contract and the need to avoid ambiguity.

Conclusions

- Innovation and the need to deliver increasing large projects and complex services provides the drive for different approaches to infrastructure procurement.
- Which procurement model will deliver the best results depends on the features of each project – not a one size fits all approach.
- Financiers will need to be adept, undertaking bespoke risk allocations for different approaches and ensuring that the end results is a bankable deal.
- Legal advisers will need to maintain extra vigilance as the procurement and delivery models change, providing advice to clients which recognises the underlying complexity of the project.
- Expect more innovation!

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