

PUBLIC PRIVATE PARTNERSHIP OR CONFLICT: IS IT TIME FOR A NEW APPROACH?

PAUL FORWARD*

I INTRODUCTION

As the public private partnership ('PPP') model evolves in Australia, the treatment of risk between the parties has received increasing attention. Two recent projects, the Spencer Street Station Upgrade in Melbourne and the Cross City Tunnel in Sydney, have resulted in public conflict between the parties over, amongst other things, the projects' risk profile. This article focuses on the provision of toll road infrastructure in Sydney where the PPP model has evolved over 20 years. It questions whether conflict between the parties is an inevitable outcome of the development and application of the PPP model, and whether a new approach is required if conflict is to be avoided for future projects.

II THE FIRST PPPs

The provision and financing of road infrastructure by the private sector is not a new phenomenon in Australia. Soon after taking office in 1810, Lieutenant-Colonel Lachlan Macquarie, as Governor of the colony of New South Wales ('NSW'), established a system of private turnpikes as a means of financing major roads, bridges and ferries, similar to the system in operation in England at the time. The right to collect tolls was sold by public auction, with the Government retaining the right to determine where toll gates or ferries could be established or continued.¹ By 1865, there were 34 toll points and five toll ferries in the colony. It was not until 1877 that the Government abolished the turnpike system.

During the early days of the colony, capital for construction and maintenance of public assets was particularly scarce. Using the private sector to fund roads, bridges and ferries, therefore, provided an injection of additional scarce resources, allowing government budgets to focus on other high priority services. The same is true today.

* Principal with Evans and Peck. From 1999 to 2005, Paul was Chief Executive of the Roads and Traffic Authority of New South Wales. The views expressed in this article are those of the author and do not necessarily represent the views of Evans and Peck.

1 See, eg, Rosemary Broomham, *Vital Connections: A History of NSW Roads from 1788* (2001).

III THE PRIVATE FINANCING OF INFRASTRUCTURE

The private sector method of funding and operating infrastructure, often referred to as public private partnerships, enables projects to be delivered many years ahead of time, compared to waiting for government funding. Motorway PPPs generate early economic activity, social and environmental benefits with reduced emissions, and provide motorists and businesses with travel time savings and reduced fuel consumption.

If these projects are financed by the public sector, pressure is placed on the State's budget. For example, the NSW Government estimates that the construction cost of Sydney's three most recently built privately funded motorways, the Cross City Tunnel, the Lane Cove Tunnel and the Westlink M7 Motorway, exceeds \$3 billion. This would have had a significant budget impact and a major reduction in other government programs if funded from consolidated revenue. Alternatively, if financed through borrowings, annual interest costs would be at least \$200 million, in addition to any principal repayments. Recurring annual maintenance and operating costs are estimated to be in the order of \$120 million. Therefore, for these projects an annual cost of about \$320 million is transferred from the State budget directly to road users and the financial risk is transferred to the private sector.

When governments are focused on debt elimination and experience fiscal constraints, privately funded toll roads are a viable method for providing new infrastructure to service a growing economy. Even when debt financing is more acceptable to government (as it is now in NSW), there is a limit to the amount of debt that can be serviced without affecting the government's credit rating and its ability to repay the debt. As a consequence, the financing of government infrastructure by the private sector is likely to play a continuing role, although not a dominant role, in infrastructure provision, as most infrastructure will continue to be financed by budget allocations.

In recent times, governments of both major political persuasions in NSW have used the private sector to finance, build and operate major road infrastructure projects. It is difficult to imagine how Sydney would function without these critical pieces of infrastructure. However, some commentators are opposed to the model and favour government toll roads (if tolls are to be employed).² Whether the NSW Government and the Treasury have the appetite to take on the sole financial and operational risk for the many PPP motorway projects built in Sydney is questionable.

The first motorway PPP in Australia occurred in the mid-1980s when the NSW Labor Government responded to an unsolicited bid from the private sector to construct the Sydney Harbour Tunnel. This was followed by a Liberal/National Party Coalition Government using a similar private financing technique for the M4, M5 and M2 Motorways. Upon returning to government in 1995, the Labor Party continued with this approach for the Eastern Distributor,

2 For example, Tony Harris is critical of the PPP model for motorways: see, eg, Anthony C Harris, *Submission to Joint Select Committee on the Cross City Tunnel* (11 January 2006).

the Cross City Tunnel, the Westlink M7 Motorway and the Lane Cove Tunnel. The procurement method for each of these toll road projects has evolved over time, particularly with regard to the allocation of risk and the breadth of the project scope.

IV ALLOCATION OF RISK

In general, the risk allocation for motorway PPPs has progressively shifted in favour of government, while the project scope has become broader, often imposed through the planning conditions, to include aspects not critical to the transport task. In this evolution of the PPP model lie the seeds for conflict between the contractual parties.

The former Auditor-General of NSW, Tony Harris, when reporting on the contract for the Eastern Distributor Motorway, noted that '[t]he arrangements proposed for the contract for the Eastern Distributor continue the improvement in the balance of risks observed in the report on the M2',³ meaning that the risk allocation was moving in the Government's favour. However, the Chief Executive of Leighton Holdings, Wal King, saw it differently with the application of risk sharing for the upgrade of Spencer Street Railway Station in Melbourne. He was quoted in the Melbourne newspaper, *The Age*, as saying 'rather than being a partnership, it has become a "master-slave" relationship'.⁴

As governments and their agencies have become more experienced with PPPs, they have developed a better understanding of the risk involved and illustrated a greater level of due diligence in relation to the quantification and allocation of risks between the parties under the contract.

Whether the balance of the risk allocation is in favour of either party, should be considered on a case-by-case basis. The current dispute between the NSW Government and CrossCity Motorway is likely to test the reasonableness and enforcement of the risk allocation profile contained in the contract and could have implications for future motorway PPPs. It is possible that the CrossCity Motorway concession may be renegotiated to resolve the dispute.

Risk management identification and planning commences from the time that a concept for a motorway PPP is defined. Over time, the risk profile allocation for each tollway project has been articulated with greater precision, together with a consequential increase in the risk allocated to the private sector when compared to earlier projects. For example, the traffic risk for the Sydney Harbour Tunnel was taken by the public sector with the concessionaire receiving a guaranteed income over the life of the concession. For subsequent projects, the traffic risk has been transferred to the private sector with no recourse to the public sector. Therefore, if traffic projections are not achieved, the financial impact is taken by the concessionaire, initially by way of a reduction in income which generally

3 Audit Office of New South Wales, *Performance Audit Report: Review of Eastern Distributor* (1997) NSW Auditor-General's Reports 19 <<http://www.audit.nsw.gov.au/publications/reports/performance/1997/edist/contents.htm>> at 17 October 2006.

4 Ewin Hannan, 'Nightmare on Spencer Street', *The Age* (Melbourne), 17 July 2004, 1.

results in a reduction in the value of equity. In some cases, an injection of equity funds is required if the traffic revenue is inadequate to service debt.

Many toll road projects have provided an associated improvement to road-based public transport, with some of the additional road space made available to buses. For example, the Sydney Harbour Tunnel provided a city inbound bus lane across the Sydney Harbour Bridge; the M2 Motorway provided dedicated bus lanes for much of its length; and the Eastern Distributor allocated additional surface bus lanes to service the central business district as well as permitting toll free use of the tunnel by government buses. All subsequent tollways allow toll free use by buses. However, some bus priority measures on surface streets associated with the Cross City Tunnel have been reversed by the Government after the project was opened to traffic.

For the M2 Motorway, improvements in public transport in the corridor are regulated by a material adverse effects clause. To obtain relief under this clause, the motorway company has to demonstrate that the actions of government to provide additional public transport facilities in the corridor had a direct detrimental effect on the profits of the company. Subsequent concessions have not contained such clauses because of the potential restrictions it could place on governments to improve public transport in areas adjacent to new motorways. This demonstrates the effects of increased experience with PPPs for the Government.

Profit sharing arrangements have also been refined so that for more recently negotiated toll roads, any super normal profits are shared between the concessionaire and the Government based on agreed formulas. This was introduced largely to deal with public perceptions that the public sector was not sufficiently benefiting from project upsides.

Construction risk for all projects has been taken by the private sector. In more recent concessions, greater emphasis has been given to 'urban design' with the concessionaire required to meet an increasingly higher standard of design and finishes. For example, the design of tunnel portals, ventilation stacks and improvements to urban amenity have received higher standards of architectural treatment, often in response to community demands, and have been incorporated in the planning conditions of approval. A contentious issue is whether this additional cost should be borne by the project or paid for by the public sector.

While recent tollway concessionaires have developed a higher media profile than exhibited by some of the earlier projects, the government of the day is vulnerable to such adverse media or community comment. Governments always retain the political risk. This is demonstrated through the initial public and media criticism that the Government has received about the user-pays principle introduced in some PPPs. For example, the introduction of full electronic tolling with no cash booths is particularly challenging. Nevertheless, public criticism has tended to diminish during the early years of operations of most toll roads in Sydney. Users and the community take time to adjust to new road infrastructure projects and changing travel patterns.

Finally, the transfer of the risk to the private sector does not necessarily transfer the consequences of the risk event occurring from the public sector, as the public will still hold the government accountable.

V PROVISION OF SERVICE

Funding of PPP projects by the private sector is not a financial loan to the government. The proponent is buying the right to operate a business over the long term on behalf of government for the public. PPPs are not just about building infrastructure, they are essentially about service provision. The concessionaire can only operate the business successfully if they have an ability to meet their own traffic and revenue forecasts and this requires a long-term commitment to the provision of service.

Governments need to consider the suitability and commitment of companies to provide the required service levels, and preferably contract with companies that are prepared to invest for the long haul and that have a track record of service provision irrespective of the industry. A company's demonstrated corporate social responsibility and service ethos should be built into the assessment criteria. By contracting with an entity that has a strong corporate social responsibility, the political and project risks for the government should be reduced. The value to the government of reducing these risks will need to be considered in the assessment process.

Since tollway concessions are generally greater than 30 years, the procuring authority needs to ensure that the concessionaire gives particular attention to toll road operations and customer service, including marketing, innovation and ongoing improvements.

The service provider and motorway operator need to be engaged early in the procurement process. Apart from addressing service levels upfront as part of the bid, community issues and matters affecting political risk are more likely to be satisfactorily addressed. For example, the WestLink M7 Motorway had the operator responsible for customer service and marketing as part of the bid team, and as an equity holder with a long-term commitment in the project.

The introduction of full electronic tolling has brought with it more complex customer service issues for toll road operators and governments to manage. A good understanding of the different market segments that the motorway services and their needs is essential, but is lacking in some motorway companies without an experienced service provider.

As a generalisation, construction companies have a poor track record of operating toll roads for the full length of the concession period. They are generally not structured or funded for long-term capital commitment. The experience in Sydney, and in other cities, is that the construction entities sell their equity early in the concession period, often seeking to obtain refinancing gains. Equity holders come and go as capital is internationally mobile.

Other service issues will emerge throughout the life of toll road concessions which will require a cooperative approach to resolve. Additional lanes, ramps and public transport facilities are inevitable as the population and business

investment grow. Debt will be refinanced as the risk profile and interest rates change. Project enhancements should be in response to community needs for improved traffic conditions. How the commercial arrangements of these improvements are funded will need to be transparent to the community. The concession deed needs to give some guidance as to how these issues will be resolved, so that improvements can be delivered quickly.

VI THE FRAMEWORK FOR A NEW APPROACH

The majority of Sydney's toll roads, (for example, WestLink M7, the Eastern Distributor, the M2, M4, M5 Motorways and Sydney Harbour Tunnel) have ultimately been well received by the community, as they have satisfied a demand for real travel time savings. As a consequence, the Government has received positive kudos for providing essential infrastructure and the concessionaire has developed a business to achieve a long-term commercial rate of return.

By comparison, the Cross City Tunnel was designed largely to reduce traffic on city streets and to provide improvements in urban amenity along William Street. As a consequence, it can be considered more as a piece of social infrastructure rather than transport infrastructure designed to satisfy a demand for travel time savings. The initial shorter Cross City Tunnel design proposed by the Roads and Traffic Authority, with the eastern portals at College Street, would have provided a better transport solution but a poorer urban design outcome.

The Cross City Tunnel has illustrated that the concept of 'partnership' falls out of the relationship when conflict cannot be resolved amicably. The concept of allocating risk to the individual party best able to manage the specific risk can generate a relationship based on conflict, rather than a true partnership. Under this traditional paradigm the focus is on shifting risks rather than proactively managing risk. If governments are to avoid more Cross City Tunnel type public disputes, particularly for social infrastructure, it may be appropriate to consider a new approach built around an alliance relationship rather than the traditional contractual model.

Alliance or relationship contracting is employed increasingly in Australia to deliver complex, large scale and high risk infrastructure projects. An alliance brings the parties under the contract together into a single entity – an alliance – for the purposes of delivering major capital works projects.

The main purpose of an alliance contract is to:

- promote innovation;
- increase cooperation between the parties;
- reduce disputes;
- share the benefits or costs that might affect any of the parties; and
- pool significant risk.

An alliance generally promotes a commitment to resolve issues within the alliance framework without recourse to litigation, except in the case of wilful default. All transactions are open book and subject to audit. Projects are governed

by a leadership team with representatives from all parties, who carry full authority to bind the party they represent. All decisions by the leadership team are unanimous. Participants are committed to developing a culture that promotes innovation and a no blame/fault ethos.

While a true alliance may not be feasible for contracts that extend over 30 years or more, particularly with some parties not wanting to stay for the full duration, that is, the design and construction companies, it may be feasible for the long-term operator and the owner (the government) to form an alliance at the outset of the project. To ensure value for money, the financing and the design/construction could be tendered separately, thereby ‘unbundling’⁵ the bid to ensure the most competitive price. The owner and the long-term operator, as the alliance, would share the risk and have collective performance obligations, thereby encouraging a ‘win-win’ culture, rather than one based on conflict.

VII CONCLUSION

PPPs have continued to evolve in terms of the traditional PPP paradigm. This evolution has been built around allocating specific risks to the individual party best able to manage the risk. This approach may be suitable for traditional contracts where long-term service provision is not a requirement. However, for some high profile PPP projects, this approach has generated a relationship between the parties based on conflict rather than a true partnership. An alternative approach, based on an alliance partnership between the government and the asset operator, may provide the framework and the incentives to provide a more satisfactory level of customer service over the long term.

5 ‘Unbundling’ refers to breaking up the motorway contract into separable parts, such as construction, maintenance, operations and customer service, and financing.