



Performance audit report

Achieving public sector outcomes with private sector partners





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Glossary

Build, own, operate, and transfer (BOOT) – A contract under which the private sector party is responsible for building and operating a facility, and owns it for the life of the contract. The private sector party transfers ownership of the facility to the public sector party when the contract ends.

Concession – An arrangement where a public sector party (the grantor) grants rights to a private sector party (the operator) to provide public services.

The rights of the operator may include having use of specified assets from which to provide the services, and the right to generate revenue, such as through tolling. The operator will also incur obligations to the grantor, such as to provide the services under specified terms and conditions, and to transfer the rights back to the grantor at the end of the concession period.

Consortium – A group of entities, generally unrelated, that combine, often through a special purpose vehicle such as a limited liability company.

These entities take part as either equity investors or financiers. Some of these entities may be contractors to the central consortium company to carry out construction, design, or facilities management for a fee.

Design, build, finance, maintain, and operate (DBFMO) – A contract to design, build, maintain, and operate a facility, involving financing by the private sector party in whole or part.

The public sector party grants a concession to the private sector party to provide services.

These contracts often involve the private sector party owning the facility, and transferring ownership back to the public sector party when the contract ends.

The public sector party may reimburse the capital cost borne by the private sector party through periodically paying for services provided during the contract period, and/or the private sector party may have the right to charge users.

Design, build, and maintain (DBM) – A contract for the private sector party to design and build a facility, and to maintain the facility for an agreed term.

The issues we refer to in this report are relevant principally to long-term DBM contracts.

Design, build, maintain, and operate (DBO or DBMO) – A contract to design, build, maintain, and operate a facility.

The public sector party grants a concession to operate the facility to the private sector party, which may receive payments directly from the public sector party and/or income through charges to users.

Franchise – An exclusive right granted by a public sector party (the franchisor) to a private sector party (the franchisee) to occupy or use facilities owned by the franchisor for the franchisee to deliver services. The franchisee pays a fee to the franchisor in return for being awarded the franchise.

The franchisee may be responsible for maintaining and improving the facilities.

Joint venture – A collaborative arrangement between 2 or more public and/or private sector parties to undertake a long-term project or enterprise for the mutual benefit of the parties involved.

The parties may commit funds, facilities, and services, and could include construction firms, operators, and suppliers.

Joint ventures generally operate through a special purpose vehicle such as a limited liability company.

Output-based specification – A document describing the scope of the contract, created by the public sector party as part of the tendering process, which describes what is required as outputs rather than inputs.

Outputs are measured by quality and quantity, whereas inputs are measured by processes and technical specifications.

Partnering – A generic term we have adopted for the purposes of this report to encompass any mutually beneficial commercial procurement relationship between public and private sector parties that involves a collaborative approach to achieving public sector outcomes.

The 2 main variables in a partnering arrangement are:

- the type of relationship between the public and private sector parties; and
- the nature of the outcome and how it is to be achieved.

We note that “partnering” has an existing meaning in the New Zealand construction sector. It refers to a process used in traditional design and construction contracts where the contracting parties agree to use their best endeavours to collaborate and resolve issues through discussion and negotiation rather than litigation.

Private Finance Initiative (PFI) – A policy introduced by the United Kingdom government in 1992. PFI contracts are long-term arrangements where the public sector party contracts to purchase services and associated assets. Contracts involve private financing, and in most cases the private sector party (usually a consortium) designs, builds, and maintains new or replacement assets.

The private sector party receives payments directly from the public sector party for services provided, and/or income through charges to users.

Project alliance – The public and private sector parties (often referred to as “participants”) work together as an integrated team to deliver a specific project where their commercial interests are aligned with actual project outcomes. The team is selected on a “best-for-project” basis, and may include designers, constructors, and suppliers. The team is provided with incentives to achieve high performance, and all members commit to working through collaboration, innovation, and mutual support.

The arrangement requires:

- performance obligations to be stated as collective as opposed to individual, with an equitable sharing of risk and reward, and adoption of a “no blame, no dispute” culture;
- governance of the project by a Project Alliance Board (or equivalent), including representatives from all parties, with agreement that all decisions must be unanimous;
- day-to-day management of the project by a project team that operates as a separate entity from each of the public and private sector parties involved in the alliance agreement; and
- a transparent and “open-book” approach towards all financial matters, including cost and profit.

The selection process for choosing alliance participants is normally based on quality criteria alone. (Recently, some project alliances in Australia have introduced price competition, though there is considerable debate as to whether this runs counter to the philosophy of selecting the best participants and working with them to agree a target price.)

Public private partnership (PPP) – A term used in other countries to describe a partnering arrangement where the parties work together for mutual benefit, usually involving private financing.

The United Kingdom uses the term to describe various arrangements, including, for example, joint ventures and franchises.

In Australia, the term mainly applies to projects where the private sector partner (usually a consortium) makes a financial investment to create or improve an asset, and is responsible for designing, building, maintaining, and operating a facility. The private sector partner receives payments directly from the public sector partner for services provided, and/or income through charges to users.

Public sector comparator – An estimate of what it would cost to undertake the project using traditional procurement methods. Public entities use the comparator as a benchmark to help decide whether an alternative procurement method using private finance would offer better value for money.

Special purpose vehicle – An entity, usually a limited liability company, created to act as the legal form of a project consortium.

Target cost (often referred to as target outturn cost) – The estimated total cost of undertaking a project, which includes direct costs (for example, investigations, consents, land purchase, design, construction, and commissioning), overheads, and profit margins.

Value for money – The best combination of whole-life cost and quality of outcome that meets the customer's desired needs.

Whole-life cost – The total cost of constructing, operating, and maintaining a project over its whole life.

Overview by the Auditor-General

“Partnering” in its various forms is gaining in popularity in other countries as a means of building new infrastructure and delivering public services. There are also signs of increasing interest in this approach to procurement in the public sector in New Zealand, particularly in local government.

Examples of partnering range from contracts where the private sector finances and owns public infrastructure to arrangements where public and private sector organisations work closely together as one team sharing risks and rewards.

It is not the purpose of my report to advocate the use of partnering. My principal aim is to inform leaders and decision-makers about the key issues they need to consider across the public sector and for individual projects. My report draws on the experience of overseas jurisdictions, mainly Australia and the United Kingdom, and provides examples of partnering arrangements that have been entered into in this country. My report is not legal advice and is only a general overview of the issues.

The experience of other countries suggests there is a need for clear government policy and direction if partnering is to be used to any great extent. Governments in other countries have also expressed clear views about certain public services that are not suitable for delivery through partnering.

New Zealand is a small market for partnering arrangements compared to countries such as Australia and the United Kingdom. Projects here may not be large enough in size or number to attract significant private sector interest. However, there is evidence that small projects have attracted interest in some service sectors, and it is possible that New Zealand could take measures to increase that interest.

In general, the Crown has executive power to enter into partnering arrangements. In each case, however, the power of a public entity to enter a partnering arrangement is subject to any procedural or substantive limits imposed by statute. There are only 2 substantive limits, which concern water and wastewater services, and prisons management.

Public entities choosing to use partnering will need a high level of expertise and a sound business case to support their decision. The business case should clearly show how the chosen partnering arrangement fits with, and helps to achieve, the vision and policy objectives of the public entity. It should also show how a partnering approach would result in better value for money than other procurement options.

A value-for-money assessment should consider the benefits of opting for a partnering approach against the costs of doing so. A key issue will be the value for money achieved by the proposed division of risks between the parties.

Public entities are ultimately accountable for delivering public services, which is a responsibility they cannot transfer to the private sector. The public entity must have robust internal arrangements in place for deciding to opt for a partnering approach, and for managing its implementation. There will need to be strong leadership from the top of the organisation to drive the process and ensure proper accountability and control. There should be a clear definition of roles and responsibilities, identification of relevant authorities and delegations, and adequate arrangements for public scrutiny of performance under the contract.

It will also be vital to ensure that the process for selecting a private sector partner is fair and transparent, and that it stands up to public scrutiny.

The public entity should be aware that its responsibilities do not end once it awards the contract, and that it will be important to set up and maintain effective contract management arrangements throughout the life of the partnering arrangement. The contract documentation will need to define the responsibilities of both parties, including responsibilities for managing relationships, risks, assets, and performance. The documentation will also need to define accountability requirements clearly.

I thank the organisations that have contributed to the research that we undertook to produce this report. These include public and private sector organisations; audit offices in Australia and the United Kingdom; and central and local government, legal, and consultancy organisations in New Zealand. I particularly thank the New Zealand public entities that willingly co-operated in providing case studies.



K B Brady
Controller and Auditor-General

7 February 2006

Part 1

Introduction

Background

- 1.1 Partnering between public and private sector organisations is gaining in popularity overseas as an approach to procuring major infrastructure projects and related services in the public sector. Our overall aim for this report was to look at the experiences of overseas jurisdictions in using partnering and to learn from them.
- 1.2 For the purposes of this report, we have adopted “partnering” as a generic term to encompass a wide range of mutually beneficial commercial procurement relationships between the public and private sectors that involve a collaborative approach to achieving public sector outcomes. These relationships can include “partnerships” in the legal business sense, and other commercial arrangements between the parties where they adopt a collaborative approach.
- 1.3 A public entity can enter into a partnering arrangement to achieve various outcomes – such as building new infrastructure or providing services – and use various means to achieve the outcomes – such as a design, build, and maintain (DBM) contract or a franchise.
- 1.4 We initially set out to identify partnering projects in this country in both the central and local government sectors. We found an increasing interest in partnering. Public entities have set up various types of arrangements for capital projects that involve partnering with the private sector – such as contracts to design, build, and operate facilities; joint ventures; and franchise agreements. There was also evidence of some interest in the public sector, mainly in local government, in exploring partnering as a means of financing and delivering new projects in the future.
- 1.5 We also found that both central and local government are increasingly interested in using “project alliances” (a form of partnering) to procure major capital projects. Project alliances have already been used, for example, to build roads, prisons, and a landfill facility.
- 1.6 Because of these findings, we decided to include within our definition of partnering projects that involve different types of long-term collaborative agreements between the public and private sectors. These include project alliances, and projects that may or may not involve private sector financing.

Our objective

- 1.7 For the public sector, partnering offers both rewards and risks. We have written this report to inform leaders and decision-makers about the partnering issues they need to consider.
- 1.8 Our interest is in the effectiveness and efficiency of partnering arrangements, as well as issues of waste, probity, and financial prudence (see section 16 of the Public Audit Act 2001). It is not for us to advocate partnering, however; nor to advocate one form of partnering over another.

The types of partnering arrangement that we looked at

- 1.9 We have concentrated on partnering arrangements for projects that involve constructing infrastructure, though many of the issues considered in this report will also be relevant to partnering arrangements where no physical works are involved.
- 1.10 Examples of contracts that can be called partnering arrangements include:
- design, build, and maintain (DBM) (the issues covered in this report are mainly relevant to long-term DBM contracts);
 - design, build, maintain, and operate (DBMO); and
 - design, build, finance, maintain, and operate (DBFMO).
- 1.11 Each of these arrangements may involve the private sector party owning or controlling¹ the facility, and possibly transferring legal ownership or control back to the public sector party when the contract or concession period ends. Contracts where ownership is transferred between the parties are often referred to as build, own, operate, and transfer (BOOT) contracts.
- 1.12 The private sector party involved in these contracts can often be a consortium or “special purpose vehicle” made up of the principal contractors and financial institutions.
- 1.13 Instead of using traditional forms of contracts to undertake the activities described in paragraph 1.10, the parties may decide to enter into a special arrangement, such as a joint venture or franchise. We describe these arrangements in the Glossary.

¹ Ownership may not necessarily be transferred – for example, the private sector party may be granted a lease or licence to occupy a property.

- 1.14 Another form of contracting may be through a project alliance (see the Glossary). Mostly design and construction projects use this form of contracting.² The governance arrangements and the way that risks and rewards are shared in project alliances differ from the other arrangements described.
- 1.15 We have identified 5 case studies as examples of different partnering arrangements, which are described in Figure 1. A more detailed explanation of each case study is provided in Appendices 1 to 5, including the reasons why the public entities involved decided to adopt this route to procurement, and the lessons learned.

Figure 1
Case studies of 5 partnering arrangements

Project	Public entity responsible	Brief description
Auckland's indoor arena (Appendix 1)	Auckland City Council	A contract to build, own, maintain, operate, finance, and transfer a major entertainment venue (a BOOT or DBFMO).
Auckland's Grafton Gully road construction (Appendix 2)	Transit New Zealand	A project alliance established to design and construct a new road in Auckland.
Wellington's Clear Water project (Appendix 3)	Wellington City Council	A contract to design, build, maintain, and operate a sewage treatment plant (a DBMO).
Papakura's water and wastewater services (Appendix 4)	Papakura District Council	A franchise agreement to operate the water and wastewater services within the Papakura district.
Canterbury's regional landfill project (Appendix 5)	Ten Canterbury local authorities set up the Canterbury Waste Joint Standing Committee, which made the decision to adopt this procurement route. Six of these councils subsequently became part of the joint venture: Christchurch City Council, and Ashburton, Banks Peninsula, Hurunui, Selwyn, and Waimakariri District Councils.	A public-private joint venture set up to establish a regional landfill facility, with construction undertaken through a project alliance.

- 1.16 We also describe the use of public private partnerships (PPPs) in Australia (Appendix 6) and the Private Finance Initiative (PFI) in the United Kingdom (Appendix 7).

² The scope of a project alliance may include meeting consultation requirements and obtaining consents. There is also evidence of other jurisdictions using project alliances for contracts for services (see paragraph 3.9).

- 1.17 We have excluded certain types of contract from our research:
- outsourcing of services – for example, corporate support services such as IT, finance, human resources, and legal; and
 - traditional design and construction contracts.
- 1.18 Our existing procurement guidelines³ cover these types of contract. However, many of the issues addressed in this report will be relevant to the types of procurement that we have excluded.

Why we looked at the subject

Benefiting from the experience of others

- 1.19 In Australia and the United Kingdom, the focus of our overseas research, partnering arrangements involving private financing have gained in popularity over the last 10 to 15 years. There are examples of both successful partnering arrangements and notable failures. New Zealand can benefit from the experience of countries that have effectively applied partnering arrangements.

Economic imperatives

- 1.20 In other jurisdictions, particularly in the early stages, economic imperatives have strongly influenced the use of partnering involving private financing. These imperatives include providing a means of overcoming funding shortages and increasing investment in public sector assets. The United Kingdom, in particular, has used the PFI to more quickly establish or improve its infrastructure.⁴

Achieving value for money

- 1.21 Our research also revealed that other jurisdictions increasingly see achieving value for money as the principal justification for entering into partnering arrangements. They see that benefits can be gained through, for example: the way that risks are allocated between the public and private sector parties; providing incentives for new and improved approaches such as innovative design, ongoing technological advances, and support; and the need for a whole-of-life approach to capital projects.
- 1.22 The United Kingdom government in particular holds the view that the public sector should involve the private sector more collaboratively in providing infrastructure and services, rather than attempting to achieve all outcomes alone.

³ *Procurement – A Statement of Good Practice*, June 2001.

⁴ An early justification for entering into these types of arrangements in Australia and the United Kingdom was to achieve “off balance sheet” financing. However, both these jurisdictions now consider that value for money, rather than the accounting treatment, should be the most compelling justification (see Appendices 6 and 7).

- 1.23 It considers that bringing in private sector market disciplines, such as a focus on customer requirements, and business and management expertise, can benefit the public sector. This is particularly so with highly specialised activities, where the necessary expertise may not exist in the public sector.
- 1.24 Another reason given for creating partnering arrangements that include providing ancillary services, such as facilities management in hospitals and schools, is that public sector managers are free to focus on core service delivery priorities.

Partnering arrangements already exist in New Zealand

- 1.25 A number of examples of partnering arrangements already exist in New Zealand – including BOOT projects, joint ventures, and franchises – although few projects exist where the private sector partners have provided finance for building public infrastructure.
- 1.26 There appears to be a particular interest in the New Zealand public sector in project alliances. Transit New Zealand has pioneered project alliances for roading schemes by constructing the Grafton Gully road (see Appendix 2) and the Northern Gateway. A project alliance has also been set up to construct the Canterbury regional landfill site (see Appendix 5), and the Department of Corrections has introduced a form of project alliance for construction projects undertaken as part of the Regional Prison Development Programme.

How we went about it

- 1.27 Our approach involved 3 stages:
- researching existing and planned partnering arrangements in New Zealand;
 - researching the experience of overseas jurisdictions, mainly Australia and the United Kingdom; and
 - identifying the main elements and risks associated with partnering that New Zealand public entities should address when thinking about adopting this procurement route.
- 1.28 In undertaking our research, we contacted a number of central government policy ministries and local government organisations in New Zealand to establish the existence of partnering arrangements, and to assess future trends.
- 1.29 We interviewed staff in New Zealand public entities that had adopted partnering arrangements, and staff in legal and consultancy organisations with experience of partnering.

- 1.30 We visited the Australian National Audit Office, relevant Australian State Audit Offices, and public and private organisations in Australia that have experience of partnering, and communicated with public sector auditing bodies in the United Kingdom.
- 1.31 We reviewed research papers produced by other jurisdictions that describe the implementation and effectiveness of partnering, along with our own past work on the subject.
- 1.32 We reviewed guidance produced by other jurisdictions, and overseas audit reports of existing partnering arrangements.

How we have structured our report

- 1.33 Part 2 discusses wider issues that governments need to consider at a national level, and describes the existing legislative framework in New Zealand.
- 1.34 Part 3 describes the issues that public entities considering a partnering arrangement need to address. We describe the main characteristics of partnering arrangements, and the matters that need to be addressed in a business case prepared as a basis for the decision. We emphasise that effective decision-making before the procurement route is determined will depend on the public entity having sound governance and accountability arrangements in place.
- 1.35 Part 4 describes the requirements for effectively managing the contract over its life once it has been awarded.
- 1.36 Figure 2 outlines the process that public entities should follow, and identifies where we discuss aspects of the process in this report.

Figure 2
Process that public entities should follow

Governance and accountability	
Strong leadership, defined roles and responsibilities, authorities and delegations, arrangements for public scrutiny	
Determine service objectives and outcomes to be achieved and identify project to achieve outcomes.	Not covered in this report
Establish internal project management arrangements for the processes for deciding which procurement route to choose, for selecting the preferred partner, and for setting up contract management arrangements when the contract is awarded.	Part 3
Consider different procurement options for carrying out the project; for example, a traditional contract or a partnering arrangement.	Part 3
If a partnering route is chosen, consider the different types of partnering arrangements that may be suitable and choose a preferred option.	Part 3
Undertake selection process to choose preferred partner.	Part 3
Negotiate with preferred partner and finalise contract documentation that describes principal contract management arrangements that will be required throughout the life of the contract.	Part 4
At the end of the contract term, implement arrangements for treating assets and continuing services, if relevant, and review outcomes against objectives of entering into the contract.	Not covered in this report

Part 2

Role of government

- 2.1 In jurisdictions where the use of partnering arrangements involving long-term contracts and private financing is well established, there is evidence of a firm commitment from government, including cross-party political support, to providing direction and guidance.⁵ Comparable levels of government commitment and support may be needed if partnering arrangements are to be used more commonly in New Zealand.
- 2.2 The key issues that our research identified as likely to affect the use of partnering in any jurisdiction are leadership, expertise, and market development.

Leadership

- 2.3 Partnering arrangements require significant investment (in monetary and non-monetary terms) on the part of both public and private sector parties. The private sector is unlikely to be attracted into investing in major, long-term public sector projects when it sees that there are significant risks arising from political uncertainty.
- 2.4 In the United Kingdom, both major political parties support the PFI, and there has been strong central control in its establishment. Evidence suggests that more PFI contracts in the United Kingdom have been entered into when the Treasury has had responsibility for providing direction. When this responsibility has been handed to quasi-government agencies, such as the Office for Government Commerce, fewer PFI arrangements have been made.⁶
- 2.5 In Australia, mainly state governments have adopted PPPs. Again, there is evidence of cross-party political support. PPPs were pioneered by the State of Victoria, which has drawn up a clear written policy⁷ that other state governments have adapted for use.
- 2.6 These governments also have a clear view about certain services – in particular, front-line services – that are not suitable for PPPs or the PFI. The States of Victoria and New South Wales have specified that responsibility for the direct delivery of “core” public services – such as clinical services in hospitals and correctional services in prisons – should remain with the state.

5 This observation is not relevant to project alliances, which have been established in New Zealand and in other jurisdictions without the need for a high level of central government direction or support.

6 Laughlin and Broadbent, *Australian Accounting Review*, Vol. 14, No. 2.

7 Partnerships Victoria policy, June 2000.

Expertise

- 2.7 Public entities need a high level of expertise to implement partnering arrangements successfully. Without this expertise, the entity faces significant risks. The United Kingdom central government and Australian state governments have taken a lead in providing central resources to be used by public entities considering entering into partnering arrangements involving private financing.
- 2.8 In the United Kingdom, Partnerships UK supports public entities wishing to undertake a PFI project by providing specialist procurement expertise. Another agency, 4ps (Public Private Partnerships Programme), provides advice and guidance to local government on PPPs and PFIs.
- 2.9 The United Kingdom Office of Government Commerce (OGC) has introduced the “OGC Gateway Process”, which provides the framework for a rigorous assessment of the deliverability of projects, including PFI schemes, throughout the procurement process.
- 2.10 The Melbourne City Link project⁸ is an example of an early PPP implemented by the Victorian state government. Because the project was seen as pioneering and high profile, a special Cabinet Committee, including the Premier, Treasurer, and Minister of Transport, was set up to oversee it. A strategy was then implemented to pull together an “A team” of government employees and advisers, and a single-purpose statutory authority was established to set up and manage the project, backed by high-quality legal and accountancy advice.
- 2.11 Since then, the Victorian state government has established Partnerships Victoria to provide guidance and support to government agencies in setting up PPPs. Partnerships Victoria has produced extensive guidance (partly based on United Kingdom guidance) on all aspects of the process, from preparing an initial business case to managing the PPP contract after it is awarded.⁹
- 2.12 The New South Wales government has produced guidelines¹⁰ (based on Partnerships Victoria guidance) and established a specialist Private Projects Branch within its Treasury to lead its Privately Financed Projects (PFP) programme, which can draw on expertise across the public sector. The Branch steers the economic and financial assessment of each project, ensures application of the guidelines, provides advice, and promotes best practice.

8 A contract to build, own, operate, and maintain western and southern bypasses that would connect 3 of the 4 highways surrounding the business district.

9 See Appendix 8 for a list of Partnerships Victoria guidance documents.

10 *Working with Government, Guidelines for Privately Financed Projects* (November 2001), New South Wales Government.

- 2.13 In New Zealand, Auckland City Council recognised the need for external expertise when it started its indoor arena project. The Council appointed an experienced project manager to represent it at an early stage of the project, and a large number of internal and external peer reviews were undertaken at each stage of the tendering process, including financial and legal reviews.
- 2.14 A number of the people we interviewed expressed the view that establishing a central resource of expertise and guidance in New Zealand would be desirable. In creating a pool of expertise it is likely that, initially, New Zealand would have to call on existing expertise in other jurisdictions (as was the case in Australia), and it would be important to retain local expertise from projects undertaken in New Zealand.

Market development

- 2.15 To ensure a competitive process, it is important that enough independent private sector companies wish to participate. There are examples of projects in other countries where it has been asserted that a competitive outcome was not achieved because there were only one or 2 private sector companies in the market.
- 2.16 One such example is the Royal Armouries contract in the United Kingdom (a PFI between Royal Armouries and Royal Armouries (International) plc for the establishment of a new museum at Leeds). The private sector party was originally allocated the operating costs and revenue risks, but when it ran into difficulties Royal Armouries effectively came to carry those risks since it could not allow the museum project to fail.¹¹
- 2.17 In a project requiring private sector capital investment, it will be important to assess the likely interest from major national and international financial institutions in providing the capital investment. In Australia, the government sees PPPs as a way of providing investment opportunities for funds (for example, for superannuation) on-shore, as a rival attraction to off-shore opportunities.
- 2.18 The Victorian state government is endeavouring to promote a consistent, Australia-wide approach to PPPs, to encourage potential private sector participants to see Australian jurisdictions as one PPP market. A National PPP Forum comprising ministers and government officials has recently been established. Aims of the Forum include:
- setting up a national database of future projects (“the project pipeline”) to enable private sector companies to assess projects in relation to the depth of the market and range of opportunities; and

11 *The Re-negotiation of the PFI-type deal for the Royal Armouries Museum in Leeds* (2001), Report by the Comptroller and Auditor General, HC 103, Session 2000-2001, National Audit Office, London.

- facilitating greater interaction between government, key industry groups, and other players, and greater information sharing across jurisdictions.
- 2.19 New Zealand is a small partnering market compared to Australia and the United Kingdom, and participants in our research raised concerns that projects here are unlikely to be large enough in size or number to attract enough private sector interest, either from New Zealand-based or international companies. However, there is evidence of a reasonable level of interest from the private sector in entering into a partnering arrangement involving private financing for roading and water projects.
- 2.20 During the course of our research, interviewees proposed several possible approaches to attracting private sector interest in New Zealand. These included co-operating with Australian governments to establish one Australia/New Zealand market for PPPs, and “bundling” small contracts (such as contracts to build a number of roads) into a larger package to make them more commercially attractive. The State of Victoria has adopted the latter approach for schools contracts, for example. Interviewees also proposed that small-scale versions of PPPs (“PPP-lite”) might be adopted in New Zealand.
- 2.21 Bidding costs for both public and private sector parties are usually high, which is also likely to narrow the bidding field.¹² The United Kingdom government and the Victorian state government have taken several steps to reduce bidding costs, including improving the quality and clarity of tender documents and drawing up standard contracts with broad market acceptance (though this takes time). The adoption of small-scale versions of PPPs might also reduce the cost and complexity of the procurement process.
- 2.22 Time will be needed in New Zealand to build a local market with clients, contractors, and financiers who are experienced in the use of partnering, especially arrangements that have the characteristics of PPPs. Establishing a market for long-term partnering arrangements, especially those that involve private financing, needs significant involvement from experienced companies, which are likely to be based overseas.¹³ However, the international partnering market is competitive, and international bidders and funders will invest their time and money in New Zealand only if they have the confidence that there is a real opportunity.¹⁴

¹² Maguire and Malinovitch, *Australian Accounting Review*, Vol. 14, No. 2.

¹³ In the case of project alliances, expertise exists within some public entities in New Zealand, such as Transit New Zealand.

¹⁴ Margaret Mabbett, KPMG, *Public and Private Sector Partnerships*, Conferenz, Auckland, August 2002.

Legislative framework in New Zealand

- 2.23 Generally speaking, in New Zealand the Crown has executive power to enter into partnering arrangements. Statutory bodies (including Crown entities) and local authorities can enter partnering arrangements to the extent that their enabling legislation permits. Crown-owned companies (including Crown entity companies and State-owned enterprises) are limited only by their constitutions and any restrictions lawfully imposed by their shareholding Ministers.
- 2.24 In each case, the power of a public entity to enter a partnering arrangement is subject to any procedural or substantive limits imposed by statute.
- 2.25 Three examples of procedural limits are:
- the duty of a Crown entity to give written notice to its responsible Minister of its intention to acquire an interest in a partnership or joint venture, and to act consistently with its statement of intent (see section 100 of the Crown Entities Act 2004);
 - the need for a local authority to adopt, and act in accordance with, a policy on partnerships with the private sector (see section 107 of the Local Government Act 2002);¹⁵ and
 - the need for Ministerial approval of any concession agreement for roading activities or for tolling roads, and for Land Transport New Zealand's approval of the procurement procedure for any transport project which it is to fund (see sections 25, 46, and 56 of the Land Transport Management Act 2003).
- 2.26 There are currently only 2 substantive limits on partnering arrangements. They concern water and wastewater services, and prisons management:
- A local authority or council-controlled organisation cannot use assets of its water services as security, and cannot vest ownership in, or lose control of, water services assets. Contracts and partnerships are permitted for any aspect of the operation of a water service, for a term of up to 15 years, but the local authority must keep control of all matters relating to pricing, managing, and setting policy on the delivery of water services (see sections 130 and 136 of the Local Government Act 2002).
 - The Corrections Act 2004 prohibits the Crown from entering into any contract to manage any prison. Even if the ongoing service provision aspect of a partnering arrangement were for other services, the Crown's retention of control over management may make this difficult in practice.

¹⁵ The term "partnership" is not defined in the Act.

Part 3

Considering partnering as a procurement choice

- 3.1 Public entities need to consider fully a range of issues in reaching a decision to take a partnering approach and in choosing the type of partnering arrangement that will be most suitable. The entity's deliberations should include comparing different procurement alternatives, including traditional approaches.¹⁶
- 3.2 When deliberating, a public entity could well need to make a conscious effort to change its culture favouring traditional forms of procurement.
- 3.3 In this Part, we discuss the characteristics that can be expected of partnering arrangements. We identify the need for the public entity to prepare a detailed business case, and describe the main factors they should consider as part of the business case. We emphasise that effective decision-making when deciding on a route to procurement will depend on the public entity having sound governance and accountability arrangements in place.
- 3.4 We also highlight the importance of robust project management, and internal and external controls, throughout the processes of choosing a procurement option and selecting the preferred partner.

Project characteristics

Do the project characteristics lend themselves to a partnering arrangement?

- 3.5 The project's characteristics will significantly influence whether it can be delivered using a partnering arrangement and, if so, which partnering model will most likely achieve the outcomes sought for the project.
- 3.6 The focus of partnering arrangements is usually on specifying the facility or service needed, leaving the private sector party to decide how best to design and construct the facility or provide the service. How outputs are defined will probably affect the opportunity for bidders to be innovative in designing their inputs. Although there are public entities in New Zealand that are experienced in this approach, it will probably be a challenge for public entities that are used to framing contract requirements in terms of inputs by way of, for example, processes and technical specifications.

¹⁶ See "Assessing value for money", paragraphs 3.36-3.42.

- 3.7 Partnering arrangements that involve designing, constructing, and operating infrastructure are usually for a long term, for up to 20 or 30 years. Partnering arrangements in other jurisdictions that involve private financing have been set up mainly for major capital projects. In Australia and the United Kingdom, governments have provided advice about the monetary value of projects that makes them suitable for this type of procurement approach (see Appendices 6 and 7).
- 3.8 Partnering arrangements involving private financing may also be suitable for much smaller capital projects, and there is some evidence in New Zealand of financing smaller projects in this way (for example, Cooks Beach Sewage Treatment Plant). Other jurisdictions have bundled projects – such as school buildings in the State of Victoria, Australia – together to make them more attractive to the private sector. However, this will present a challenge when it involves several public entities with different cultures and governance requirements.
- 3.9 Project alliances are usually set up to design and build infrastructure, often when there are many uncertainties related to the project that may result in significant risks. However, there is some evidence overseas of a move to set up project alliances to provide services. For example, in the United Kingdom a standard partnering (or alliance) contract has been prepared that is suitable for building maintenance programmes.
- 3.10 In all cases, the cost of setting up and managing a partnering arrangement needs to be assessed against the total value of the project and the benefits that will be derived from adopting this approach compared to traditional procurement approaches.

Governance and accountability

Can the public entity set up and maintain the necessary governance and accountability framework for a partnering arrangement?

- 3.11 Partnering arrangements are “not a substitute for strong and effective governance and decision-making by government, which continues to be responsible and accountable for the project or service in a way that protects the public benefit”.¹⁷

- 3.12 Public entities are ultimately accountable for delivering public services, and cannot transfer this responsibility to the private sector. It is thus imperative that a public entity considering entering into a partnering arrangement has a sound basis for:
- making the initial decision to choose this approach to procurement;
 - managing its implementation and long-term operation; and
 - effectively carrying out its accountability obligations to the public.
- 3.13 An over-riding requirement will be effective governance. A strong governance framework includes open and clear arrangements in areas such as:
- organisational commitment and leadership;
 - corporate procurement policy and guidance;
 - decision-making about all aspects of the project and procurement (for example, the procurement route to be adopted, contract specification, selection of preferred partner, and operation of the contract);
 - change management;
 - roles and responsibilities;
 - succession arrangements;
 - authorities and delegations;
 - reporting and accountability;
 - performance management; and
 - stakeholder consultation and communication.
- 3.14 Vital to setting up an effective partnering arrangement are:
- strong leadership from the top level of the public entity to maintain momentum and ensure that there is proper accountability and control;
 - clear definition of roles and responsibilities of those involved in the governance framework, including personnel involved in procuring and managing the partnering arrangement, such as the Board, Elected Members, and senior managers; those involved in the day-to-day management of the contract; and external stakeholders (project management arrangements are discussed later in this Part);
 - identification of relevant authorities and delegations in writing; and
 - arrangements for public scrutiny of performance under the contract (discussed in paragraphs 4.20-4.34).

Preparing a supporting business case

Can the public entity underpin a partnering arrangement with a sound business case?

- 3.15 A detailed business case should be prepared, with financial modelling, to support the project and the preferred procurement route.
- 3.16 The public entity should assess different procurement options either before or as part of preparing the business case. Options assessed should include traditional approaches to procurement, and the business case should set out a full justification for the chosen procurement option, including how it supports the organisation's vision and strategic plan.
- 3.17 The business case should:
- identify clear objectives for the project, including its contribution to the public organisation's vision and policy objectives;
 - assess the degree of top-level commitment that will be required;
 - show that the project and the preferred procurement route are in the public interest;
 - assess the likely level of market interest;
 - consider the risks of the preferred procurement route;
 - show an overview of the structure of the proposed arrangements, including arrangements for governance and accountability, project management, and contract management;
 - assess value for money from the preferred procurement route, including a comparison with other procurement options;
 - examine funding options;
 - consider risk allocation (which will inform the value-for-money assessment);
 - examine the affordability and financial implications of the project and preferred procurement route;
 - consider legislative compliance;
 - consider accounting issues;
 - consider the effect on employees;
 - identify key stakeholders; and
 - identify the key information that the public entity will need to receive throughout the term of the arrangement to effectively carry out its monitoring processes and public accountability obligations.

- 3.18 Most of these issues are covered in this Part. Issues relevant to contract management are discussed in Part 4.
- 3.19 The business case should also outline the procurement process, timescales, and costs involved.

Contribution to vision and policy objectives

- 3.20 The partnering arrangement should fit with, and help to achieve, the public entity's vision. This is particularly important because most partnering arrangements require considerable investment, both financially and in staff time, including that of senior managers.
- 3.21 The public entity should give special consideration to long-term partnering arrangements, where it will be important to assess how much the arrangement will contribute to future policies and plans for service delivery. A local authority will need to determine whether the project should be considered as part of its community outcomes processes, and how the project supports its Long-Term Council Community Plan.

Top-level commitment

- 3.22 To implement a partnering arrangement successfully, politicians and senior management need to commit to adopting this route to procurement. They also need to provide the necessary direction and control throughout the life of the project, which can be very long. The business case should assess the cost of providing this high level of commitment over the project term.¹⁸

Governance and accountability

- 3.23 The business case should address the proposed arrangements for governance and accountability described in paragraphs 3.11-3.14.
- 3.24 In the case of project alliances and joint ventures, the public entity will need to determine whether it has the statutory authority to undertake the project in the manner proposed, and whether it is prepared to give up its decision-making autonomy. Transit New Zealand has adopted an approach to project alliances where it gives up most of its decision-making autonomy but keeps its right to make major funding decisions.

18 "One of the lessons that emerge from PFI/PPP projects is that the public sector does not just pass them over to private sector partners without having to think about them any longer. The time and effort of senior people in departments and agencies is, in fact, not released through PFI/PPP, so this vehicle should not be viewed as a denial of responsibility, but as an engagement of continuing responsibility in a new way." Sir John Bourn (2004), in 'The new agenda: how PFI/PPP is adapting to deliver future services', PFI/PPP conference, National Audit Office, United Kingdom.

- 3.25 A project alliance is usually governed by a joint body, which is often called a project alliance board (PAB). The PAB usually includes one or 2 representatives of the public entity (the practice of Transit New Zealand is to make 2 appointments), and one or 2 representatives from each of the contractors. The PAB provides governance, sets policy and delegations, and monitors performance. All decisions of the PAB must be unanimous.
- 3.26 A joint venture usually involves forming a company in which the public entity and private sector participant(s) hold shares. The joint venture company operates at arm's length from the shareholding entities.
- 3.27 The public entity will need to consider carefully how PABs and joint venture companies are established. For example, setting up a PAB or joint venture company could result in a new "council organisation" or a new "council-controlled organisation" within the meaning of the Local Government Act 2002, entailing specific governance requirements.

Risks in adopting a partnering arrangement

- 3.28 The key risks that the public entity will need to consider at the time of preparing a business case are:
- that poor performance by the private sector party will affect the public sector party's ability to deliver core or essential public services, especially if the public sector party cannot delegate a duty of care or other statutory obligation to people receiving these services;
 - a possible change of political control of the public entity, resulting in a change of policy that may affect the partnering arrangement; and
 - poor contract management by the public entity¹⁹ (see Part 4).
- 3.29 Realisation of these risks could affect the value-for-money outcome of the project and damage the reputation of both parties.
- 3.30 In the case of a project alliance, the private sector participants are usually selected solely on their technical and quality attributes, and the budget is usually not agreed between the parties until after the selection process has been completed.²⁰ This means that there is uncertainty about the budget for a long period, and a risk that the whole process could be aborted after significant resources have already been invested in reaching this stage.

¹⁹ Partnerships Victoria guidance material, *Contract Management Guide*, June 2003.

²⁰ Recently project alliances in other jurisdictions have introduced price competition, though there are currently very few examples and much debate about whether this runs counter to the philosophy of alliancing.

- 3.31 It will be vital for the public entity to determine whether it can, and (if so) how it will, manage these risks. We discuss issues relevant to risk allocation in paragraphs 3.43-3.51.

Public interest

- 3.32 An assessment of whether or not a project is in the public interest will depend on the nature of the partnering arrangement being proposed. The types of issue that are likely to need considering include:
- the requirements for accountability and transparency, balanced against the need for commercial confidentiality;
 - the ability to ensure continuous provision of essential services, despite any breaches on the part of the private sector party; and
 - the need to safeguard the rights of disadvantaged groups in the community.
- 3.33 An overall assessment will probably be based on whether the benefits to the public interest from the project being delivered by a partnering arrangement outweigh any potential harm. Australian state governments have devised public interest tests that may be a useful reference.²¹
- 3.34 Other jurisdictions have defined limits for the types of service that a partnering arrangement may provide. Generally, a partnering arrangement is considered suitable for providing ancillary services, such as facilities management, and services where the public organisation lacks expertise (a good New Zealand example is managing entertainment events at Auckland's indoor arena, described in Appendix 1). Public sector policy may dictate that the public sector should directly deliver front-line services, which often involve a high degree of direct engagement with people, such as hospital care and teaching in schools.

Market interest

- 3.35 To ensure a competitive process, the public entity will need to decide whether there are enough independent private sector companies that wish to participate – including, for example, construction and service companies and financial institutions to provide capital investment. This will require researching the market before making a decision to opt for a partnering approach.

21 Partnerships Victoria policy, June 2000; Queensland Government State Department, *Guidance Material* for public private partnerships; New South Wales Government, *Guidelines for Privately Financed Projects*, November 2001.

Assessing value for money

- 3.36 When making a decision about the procurement route to adopt, the public entity will need to show through the business case how a partnering approach is superior to other procurement options.
- 3.37 A value-for-money assessment considers the benefits of a partnering approach against the costs of doing so. Value for money does not necessarily mean lowest cost,²² because there may be a number of benefits that justify higher costs.
- 3.38 A key issue will be risk allocation. An important question will be whether transferring specific risks to the private sector party – that it may not be possible to transfer through a traditional procurement approach, or through sharing risks – will achieve value for money. Risk allocation is discussed in paragraphs 3.43-3.51.
- 3.39 Several other factors will be important in assessing value for money – including, for example, the scale of the project relative to the transaction costs, the whole-of-life costs, the potential to free up public sector staff to concentrate on key service delivery activities, greater asset utilisation, and the scope for innovation (such as business practice and technology application).
- 3.40 Bidding costs for both public and private sector parties are usually high compared with traditional methods of contracting. Costs can be controlled through the quality and clarity of tender documents. However, many partnering arrangements are complex, and the need for lengthy procurement processes and complex contract documentation will have a significant effect on costs. In the case of a project alliance, there will also be costs in establishing the project team, and creating and maintaining the alliance culture. The overall value-for-money assessment should take these costs into account.
- 3.41 There are a number of models that assess value for money, including cost-benefit analyses and the “public sector comparator” (refer to United Kingdom and Australian models).²³ The public sector comparator defines the notional cost of delivery through the most efficient public sector method, and assesses it against the alternatives offered by a partnering arrangement.

22 Value for money “is the optimum combination of whole life cost and quality (or fitness for purpose) to meet the user’s requirement, and does not always mean choosing the lowest cost bid. It should not be chosen to secure a particular balance sheet treatment.” HM Treasury, *Value for Money Assessment Guidance*, August 2004.

23 Partnerships Victoria guidance material, *Public Sector Comparator*, June 2001, and *Supplementary Technical Note*, July 2003; HM Treasury, *Value for Money Assessment Guidance*, August 2004; and *Quantitative Assessment User Guide*, August 2004.

- 3.42 For long-term projects, assessing value for money can be particularly difficult. Inevitably, assumptions will have to be made, and the validity of public sector comparators has been challenged for this reason. It will also be important not to overestimate benefits and underestimate costs, which has been a criticism levied against partnering arrangements in other jurisdictions.

Risk allocation

- 3.43 Risk allocation between the public and private sector parties is central to partnering arrangements, and forces the parties into explicitly identifying and costing risks. How risks are allocated will depend on the characteristics of individual projects and the type of partnering arrangement entered into.
- 3.44 Among the risks associated with major infrastructure projects²⁴ are:
- design and construction;
 - operation and maintenance;
 - patronage and revenue (for example, that the demand for a service, such as a toll road, or the revenue it will generate, will vary from that initially projected);
 - technology and obsolescence;
 - legislative and political change (such as a change of government or council), resulting in a change of policy;
 - failing to obtain statutory approvals or re-approvals during the term of the arrangement, or approvals that contain conditions that will have a significant effect on the project;²⁵ and
 - financial (for example, that the financial structure is not sufficiently robust to provide fair returns to debt and equity over the life of the project).
- 3.45 The Australian and New Zealand Risk Management Standard²⁶ provides a best-practice generic framework for identifying and managing risks.
- 3.46 In the case of most types of partnering arrangement, there is a well-established principle that the party best able to manage the risks should bear them. Seeking to transfer inappropriate risks to the private sector party will probably add to the cost of the arrangement.²⁷

24 Partnerships Victoria guidance material, *Risk Allocation and Contractual Issues*, June 2001.

25 In conventional contracting, it is often better to obtain approvals before contractual commitments are made. However, in a partnering arrangement where it may be important to give the private sector partner the opportunity to be innovative with design, it may be appropriate to seek approvals after the contract has been awarded, which carries a risk.

26 The Australian/New Zealand Standard AS/NZS 4360:2004: Risk management.

27 "Public Private Partnerships, Governance and Accountability Issues", Russell A Walker, Assistant Auditor-General, State of Victoria, National Conference of Parliamentary Environment and Public Works Committees, July 2004.

- 3.47 Under a project alliance, participants collectively assume all risks associated with the project, regardless of whether these risks are within the control of the alliance and whether participants have considered them in advance. This excludes any risks that the alliance participants specifically agree to retain individually. It should also be noted that financial consequences of risks that materialise are usually shared only up to the point where private participants' profits are lost. Beyond this point, risks are usually borne solely by the public sector participant.
- 3.48 A DBMO contract may be suitable in circumstances where it is likely that value for money will be achieved through a high degree of risk transfer to the private sector party, and it is known that the private sector party will be able to manage this degree of risk more effectively than the public sector party.
- 3.49 If the project is very complex and there are many uncertainties – such as with the physical environment or the price of goods or services required – risk sharing through a project alliance or joint venture may be more appropriate.
- 3.50 In allocating risks to the private sector party, it is very important to decide whether the private sector party is legally and financially capable of accepting these risks and whether the public sector party is legally, financially, and politically capable of transferring them.
- 3.51 An example of unsuccessful risk sharing is the Latrobe Regional Hospital – a PPP entered into by the Victorian state government and a private sector consortium, Australian Hospital Care Limited (AHCL). The Victorian Auditor-General noted in a report in June 2002 that:

Although the contractual arrangements for the privatisation of the Latrobe Regional Hospital were successful in transferring financial risk to the private sector, the social responsibilities of the State meant that any threat to public health and safety or hospital service provision could not be allowed to occur. In this case, the State stepped in when it appeared that a risk to the provision of ongoing hospital services was increasing. The final outcome was that AHCL was able to avoid the full financial risk obligations embodied under the contractual arrangements.²⁸

Financing and affordability

- 3.52 The decision on the type of partnering arrangement to adopt will be directly affected by whether there are realistic options for financing that arrangement. For example, private financing to fund construction costs in whole or in part may be a realistic option only if there is evidence that financial institutions are prepared to back private sector companies in making bids.

- 3.53 Affordability will also need to be assessed as part of the supporting business case. It should be assessed over the long term, especially in view of the fact that payments under a partnering arrangement may have a significant, ongoing effect on operations budgets.
- 3.54 Other significant costs that will need to be considered are procurement costs, transition costs involved in establishing the partnering arrangement, and ongoing client-side costs of contract management.
- 3.55 Affordability will need to be managed throughout the life of a partnering project. There should be regular reporting of affordability issues to senior management and at Board or Elected Member levels.

Compliance with legislation

- 3.56 The public entity will need to assess the lawfulness of the proposed procurement arrangement (see paragraphs 2.23-2.26). Sector-specific legislation in New Zealand acts as a constraint to adopting partnering arrangements for certain types of infrastructure or services. Relevant statutory provisions also provide the context in which New Zealand public entities operate, and would need to continue to operate under a partnering arrangement.
- 3.57 Requirements to comply with statutory processes (for example, obtaining Ministerial approval, or consultation and consents required in terms of the Resource Management Act 1991) should be described, including how long these processes are likely to take. The public entity will need to determine whether these processes should be undertaken before or after the contractual agreement has been entered into, whether responsibility for obtaining specific approvals or consents should lie with the public entity or the private sector party, and how risks related to these processes should be managed.

Accounting issues

- 3.58 The public entity will need to ensure that, in entering into a partnering arrangement, it will be in a position to comply with generally accepted accounting practice throughout the term of the arrangement.
- 3.59 In preparing the business case, it will be important for the public entity to determine what is the appropriate accounting treatment that best reflects the substance of the partnering arrangement. Generally accepted accounting practice

is currently not fully established in this area, and is expected to continue to evolve over the next few years. This evolution may give rise to changes in current accounting treatment for many public entities, which are expected to include:

- increased recognition of assets subject to partnering arrangements on the balance sheets of public entities; and
- increased disclosure by both public sector and private sector parties about partnering arrangements.

- 3.60 Public entities should be mindful of such potential changes in generally accepted accounting practice when identifying information required to be provided by private sector parties during the course of partnering arrangements. Whatever the nature of the arrangements entered into, the public entity will need to provide within the contract for receipt of the necessary information, to enable the public entity to comply with generally accepted accounting practice.

Effect on employees

- 3.61 The public entity should assess the potential effect on employees of entering into a partnering arrangement, including how it might need to protect their interests. Recent amendments to the Employment Relations Act 2000 refer to how employees should be treated under business asset sales and purchases – including provisions for the automatic right of transfer for “vulnerable” employees, the requirement to consult in good faith with employees over restructurings, and the compulsory insertion of “employee protection provisions” in employment agreements.

Stakeholder involvement

- 3.62 Relevant stakeholders should be involved, and have their views considered, in the preparation of the business case. The types of stakeholder will depend on the project, but could include service users, ratepayers, employees, key players in the market, voluntary agencies, local community and other special interest groups, planning authorities, government departments, and health bodies.
- 3.63 There are likely to be statutory consultation requirements, such as those required under the Local Government Act 2002 and Land Transport Management Act 2003.

Project management responsibilities

- 3.64 The public entity will need to have strong internal arrangements to manage effective procurement of a partnering arrangement and to manage the contract once it is awarded. This will include well-defined responsibilities for day-to-day project and contract management, and internal and external audit controls.
- 3.65 Here we describe project management responsibilities covering the stages of the project from preparation of the business case to start of the contract. Contract management after the contract is awarded is described in Part 4.
- 3.66 United Kingdom²⁹ and Australian³⁰ guidance defines the following specific roles that need to be identified and designated in the case of PPPs and PFI, which are also likely to be relevant to other types of partnering arrangement.
- **Project steering committee** – To direct delivery of the project, monitor achievement of business case objectives and their continuing validity, assist with complex policy issues, and set in place appropriate project governance and reporting arrangements.
 - **Project sponsor** – This might be a chief executive officer or director, an Elected Member, or member of the governing Board who is responsible for promoting the project to other Elected Members or Board members and stakeholders, and for being involved in important negotiation meetings.
 - **Project director** – A senior manager (for example, the chief executive officer or director) who is responsible for ensuring that the appropriate project management structure and adequate resources are in place to deliver the project objectives.
 - **Project manager and project management team** – The project manager, supported by a project management team, will be responsible for:
 - preparing the business case;
 - determining a budget for project delivery;
 - preparing project and procurement plans;
 - preparing an output-based specification;
 - reporting progress to the Board, council committee, or other governance body, and other stakeholders;
 - managing project risk;
 - appointing and managing external advisers; and
 - leading negotiations with bidders.
- 3.67 The composition of the project team will depend on the type of project, but could include service managers, finance managers, and external advisers (technical, legal, financial).

²⁹ Audit Commission, *PFI/PPP Audit Guide 2001/2*.

³⁰ *Practitioners' Guide* (June 2001), Partnerships Victoria guidance material.

Use of external advisers and consultants

- 3.68 Public entities require a high level of expertise to implement partnering arrangements successfully, and face significant risks without this expertise. It will be vital for public entities to ensure that they have people on their staff with a high degree of commitment and the right level of skills and expertise before entering into this type of arrangement. However, it is likely that most public entities will have to use external expertise to manage specific aspects of the procurement – for example, to provide commercial, technical, financial, and legal advice, and to manage both the procurement process and aspects of contract management once the contract comes into effect.
- 3.69 The public entity will need to retain overall responsibility for effective project management and the major decisions that will be part of this, and external experts will need to be managed. Therefore, it is vital that the public entity ensures that:
- it has internal experts that have been adequately trained to carry out this role effectively; and
 - the terms of reference, timescales, and basis of fees for external experts are clearly defined.
- 3.70 Concerns have been raised in the United Kingdom about the variable quality of advice provided to public entities by external consultants, which can have a direct effect on the length of time and cost of implementing PPP or PFI projects.³¹ It is therefore vital that public entities employing consultants conduct a rigorous process for their selection.

Retention of expertise

- 3.71 The public entity will need to plan for the establishment and retention of skills that will be required within its organisation throughout the life of the project. One concern often raised is that partnering arrangements lead to staff who have been involved in setting up and implementing the arrangements transferring to the private sector with their new expertise.
- 3.72 It is vital that the public entity has a programme in place for skills transfer and training to minimise this risk and the public entity's possible reliance on the long-term use of external advisors.

Stakeholder involvement

- 3.73 Effective involvement of stakeholders will make a significant contribution to the quality and success of outcomes. In addition to the need to consider the views of stakeholders as part of preparing the business case, it will be important to ensure

³¹ *PFI: meeting the investment challenge* (July 2003), HM Treasury.

that key stakeholders are kept informed and involved as the project progresses. Relevant stakeholders should be identified from the outset, and arrangements for their involvement documented and given to them.

Selecting the preferred partner

- 3.74 It will be vital to ensure that the process for selecting a private sector partner is fair and transparent, and stands up to public scrutiny. Good practice guidelines for undertaking procurement in the public sector apply, including our own guidelines (*Procurement: A Statement of Good Practice*, June 2001).
- 3.75 Partnerships Victoria has published specific guidance for public organisations procuring capital works and services through a PPP.³² Australian guidance also exists for setting up project alliances.³³ These sources of guidance may provide a useful reference.
- 3.76 Partnerships Victoria guidance emphasises the need to ensure that:
- Sufficient time is invested in devising a well-thought-through selection process and high-quality bid documents.
 - Timelines are carefully managed. Failure to meet critical dates will probably increase bid process risk, and the costs of both the public entity and private sector bidders. However, as highlighted in the United Kingdom's guidance,³⁴ attempting to rush the procurement to achieve an early service start date will also be a mistake. In the case of contracts of long duration, the long-term disadvantages of such an approach are likely to far outweigh the benefits.
 - The selection process is properly resourced (see paragraphs 3.64 to 3.70).
 - The requirements of the public entity, and any constraints and hurdles to be met for the project to move forward, are well thought through, effectively communicated, and held consistent throughout the process.
 - The process is managed according to well-prepared probity principles and a probity plan (see paragraph 3.81).
- 3.77 The need for a complex and costly procurement process also raises legal risks for the process and the need for the public sector entity to ensure that it acts in accordance with any contractual obligations that the process may establish. It will be important to engage appropriate legal advice about the procurement process before the process starts.

32 Partnerships Victoria guidance material, *Practitioners' Guide*, June 2001.

33 *Introduction to Project Alliances* (on engineering and construction projects), April 2003 update, Jim Ross, Project Control International Pty Limited.

34 Audit Commission, *PFI/PPP Audit Guide 2001/2* (unpublished internal guidance).

Audit controls

- 3.78 It will be important throughout the process of making the decision to opt for a partnering arrangement, and during the partner selection process, to ensure that arrangements are in place for the involvement of internal and external audit. This involvement should provide assurance to the public entity and other stakeholders (such as Parliament) that the decision-making and selection processes stand up to public scrutiny.
- 3.79 Both financial and performance auditing will be required. Auditors will need to be able to review both the value-for-money assessment of the arrangement and the accounting treatment.
- 3.80 The evaluation of bids for a partnering arrangement will probably include a number of criteria that involve the exercise of informed judgement – such as an assessment of the extent of innovation and the ability of the public and private sector parties to establish a good working relationship – and there are significant risks that transparency and fairness may be compromised.
- 3.81 Existing overseas guidelines³⁵ recommend preparing a comprehensive probity plan (which may be part of the procurement plan), to ensure that transparent and sound processes are in place and followed. The plan should include the means of ensuring that the process is consistent and fair and that conflicts of interest are declared and managed, and define how commercially sensitive information should be handled. It is advisable to appoint an independent probity auditor to provide assurance that the selection process meets public sector probity requirements.

Part 4

Managing the contract

4.1 According to the Australian National Audit Office:

*Competent management of the contract is the public sector entity's key means of control over its outputs and their contribution to outcomes.*³⁶

4.2 The public entity needs to be aware that its responsibilities for contract management do not end once the contract has been awarded. It will be very important for the public and private sector parties to establish and maintain effective contract management throughout the term of a partnering arrangement, since inadequate contract management by either or both parties can have adverse consequences:

- for the public sector party – from additional costs affecting the financial viability of the project and, thus, the value-for-money outcome; and
- for the private sector party – from less than optimal performance and profitability.

4.3 Inadequate contract management could also result in risks being inadvertently transferred back to the public sector party.

4.4 Managing the contract over its term requires a different set of responsibilities and processes, which should be considered and planned for from the beginning of the procurement exercise. The contract management roles and responsibilities of both parties should be fully specified in the contract documentation.³⁷

4.5 How the public entity manages the contract will depend on the type of partnering arrangement being entered into. For example, in the case of a DBMO contract, the public entity will need to set up its own contract management arrangements independently of the private sector party. In the case of a project alliance or joint venture, many of the contract management activities will be shared between the parties, but it is important that the public entity ensures that it has ongoing oversight of the project, and that it meets its public accountability requirements.

4.6 The public entity will need to identify adequate resources to manage the contract. This includes experienced personnel who can manage relationships with the private sector party, service users, and other stakeholders; systems and processes; and an appropriate budget. It is good practice to designate a contract manager and staff for contract management early on in the procurement process, to ensure continuity. The contract manager may or may not be the project manager responsible for managing the procurement.

³⁶ *Public private partnerships – Are there gaps in public sector accountability?* (3 February 2003), 7th Biennial Conference of the Australasian Council of Public Accounts Committees.

³⁷ *How to Manage the Delivery of Long-Term PFI Contracts*, Technical Note No. 6, Private Finance Taskforce, HM Treasury.

- 4.7 Different contract management activities will be required at each stage of the delivery of the contract, such as design and construction, service delivery (including preparing for, and settling in, service delivery), and contract expiry.³⁸ Contract management staff will need to understand the business and have an in-depth knowledge of the project and contract documentation. Staff could also be required to have skills in design and construction, facilities and services management, and legal and financial matters, and have an understanding of statutory safety, regulatory, accounting, and accountability responsibilities.

Objectives of contract management

- 4.8 Contract management objectives that should be addressed in the contract documentation will include good governance and accountability, and sound management of performance, risks, assets, relationships, payments, and changes to the contract.
- 4.9 Contingency plans are also required for the possibility of failure of service delivery – for example, as a result of emergency events or through failure on the part of the private sector party. These should include clearly documented procedures for dealing with defaults and exercising step-in rights (see paragraphs 4.58-4.61).

Good governance and accountability

- 4.10 An appropriate governance structure for managing the contract once it has been awarded needs to be considered at an early stage of the decision-making process, and addressed in the business case (see paragraphs 3.11-3.14). This will probably be different from the governance structure used for identifying the project.
- 4.11 Roles and responsibilities of all public and private sector personnel involved in contract management (including responsibilities for decision-making) should be clearly defined, and individuals should be given appropriate authority to carry out their tasks effectively.
- 4.12 The long-term nature of many partnering arrangements means that it is inevitable that personnel managing the contract will change. Consequently, it is important that both public and private sector parties have arrangements for succession planning and the retention of knowledge. This is an important lesson highlighted in the case of Wellington City Council's Clear Water project, where the Council has recognised that its internal succession arrangements need to be improved for the future (see Appendix 3).
- 4.13 Governance arrangements will also need to cover interaction with other public sector agencies that may have an interest in the contract.

- 4.14 The public and private sector parties are contractually accountable to each other for the performance of their respective obligations under the contract. The public sector party is also publicly accountable for choosing, designing, and implementing the partnering arrangement, including monitoring the private sector party's performance and achieving the project's desired outcomes. Achieving both forms of accountability requires careful and precise contractual stipulation of the rights of each party to information, including reporting requirements, as well as the limits of commercial confidentiality.
- 4.15 In finalising the contract, the public sector party should have specific regard for the requirements for access to information – such as are contained in the Official Information Act 1982 and Local Government Official Information and Meetings Act 1987 – and audit and other public accountability requirements – such as those in the Public Audit Act 2001.

Managing risks

- 4.16 Risk allocation should have been negotiated and specified in the contract documentation. Risks are likely to change as the project progresses, and it will be essential for the public sector party to ensure that risks are regularly monitored and reviewed, not least because it may find that it inadvertently becomes responsible for risks previously not allocated to it.
- 4.17 However, the range of risks that must be considered for contract management purposes is broader than the range of risks considered by the procurement team for contractual risk allocation purposes. The *Contract Management Guide* prepared by Partnerships Victoria refers to some important contract risks:
- Project risks contractually allocated to the public sector party, including risks expressly allocated in the contract, contractual obligations implied by law, and consequences arising from statute or common law.
 - Risks arising from issues not resolved at contract execution. These risks may not have been identified, or may have been identified but not resolved.
 - The risk of the private sector party failing to adequately control and mitigate risks it has been allocated.
 - Risks arising from poor contract management by the public sector party. Mismanagement of the contract by the public sector party might not have an effect on the delivery of services, but might compromise the value-for-money outcomes of the project, damage the reputation of the public sector party or government, or affect the public entity's ability to be fully accountable to the public.

- The risk that poor performance or financial failure on the part of the private sector party will affect the ability of the public sector party to deliver core or essential public services, especially if the public sector party cannot delegate a duty of care or other statutory obligation to people receiving these services.
- Risks associated with proposed changes to the contractual arrangements.

4.18 As far as possible, the contract documentation should address how these risks will be managed, such as through default remedies available to the public sector party. The parties should also include these risks in risk registers to be monitored and reviewed throughout the life of the contract.

4.19 An issue often raised with partnering arrangements involving private financing is that private sector parties might make additional gains from refinancing after the contract has been entered into. Examples have occurred in the United Kingdom of considerable adverse publicity arising from what have appeared to be huge “windfall gains” for private sector parties resulting from their benefiting from lower borrowing cost premiums through refinancing. It is now a requirement in the United Kingdom that PFI contracts should provide for sharing refinancing gains.³⁹

Managing performance and contract review

4.20 Performance measures that are meaningful, and arrangements for reporting on them, should be considered at an early stage in the procurement process, and written into the draft and executed contracts. The *Contract Management Guide* by Partnerships Victoria recommends that performance monitoring and reporting arrangements should be based on the premise that the public sector party understands:

- The business environment and objectives for entering into the contract in the first place. Performance measures should therefore be linked to strategic objectives and outcomes.
- The private sector party’s internal operating environment. This should enable the public sector party to derive an awareness of the sustainability of the contract, as indicated by the private sector party’s strengths and weaknesses, including financial performance.

- 4.21 Performance monitoring will focus primarily on outputs, compared with traditional procurement approaches where there may also be a need to monitor inputs and processes. Inappropriate monitoring of inputs and processes (for example, availability of expert staff and technology employed) may result in risks being inadvertently transferred back to the public sector party.⁴⁰
- 4.22 United Kingdom guidance is that management and monitoring procedures should be kept as simple as possible, since over-complex systems are likely to be costly to run and difficult to enforce:
- The essence is only to monitor essentials (based on the potential significance of impact on the service and risk of occurrence of events) and to avoid being inundated with information which is not strictly relevant for the purpose of assessing service delivery.*⁴¹
- 4.23 Performance measures and standards should be both quantitative and qualitative, using both hard and soft data. Hard data is quantifiable and measurable data that can be used to make comparisons against past performance or benchmarks. Soft data is not easily quantifiable, and will probably depend on the expertise of contract management staff. A good example of soft data is the quality of the private sector party's management and operating personnel, which could provide an indication of future problems.
- 4.24 In the case of Deer Park Women's Prison, Victoria, a failed build, own, operate contract, the Auditor-General found that performance measures were primarily quantitative in nature, and focused on short-term achievements. This meant they failed to address some key qualitative areas of prison operations, such as the adequacy of the rehabilitation programme.⁴²
- 4.25 The contract documentation should specify arrangements for reporting performance, including the performance data to be provided by the private sector party and the reporting intervals. It is important that the private sector party has adequate performance monitoring systems in place to meet its obligations. The contract documentation should describe the arrangements for the public sector party to audit the private sector party's performance reporting systems, so as to provide assurance that performance is being measured and reported accurately.

40 *Contract Management Guide* (June 2003), Partnerships Victoria guidance material.

41 *How to Manage the Delivery of Long-Term PFI Contracts*, Technical Note No. 6, Private Finance Taskforce, HM Treasury.

42 The Auditor-General of Victoria's comments are in English and Walker's article, *Australian Accounting Review*, Vol. 14, No. 2, 2004.

- 4.26 The public sector party will also require financial information to reassure itself of the continuing financial viability of the private sector party. In addition, the contract should provide for the public sector party to undertake audits of the private sector party's quality management and management information systems to provide assurance that the contract continues to be sustainable. The public sector party will need to address how the requirements of the Official Information Act 1982 will be applied to the private sector party, including the type of access to be granted to both the public sector party's internal and external auditors.
- 4.27 In the case of Wellington City Council's Clear Water project (see Appendix 3), the Council considers that during the first few years it took a very arm's-length approach to contract management. However, since 2002 the Council has been in regular operational liaison with the contractor, and more physical inspections have been undertaken. The contractor's performance is benchmarked, and the Regional Council is involved because of its interest in compliance with resource consents. There is also a Community Liaison Group that meets regularly, which provides feedback on service delivery. The contractor has been instructed to commission independent reports as a means of providing assurance over the reliability of performance information.
- 4.28 The public sector party needs to keep in mind that it may have to increase its contract management and monitoring capability in circumstances of continued underperformance by the private sector party.
- 4.29 The contract documentation should also include specific arrangements for taking action in the event of substandard performance or failure by the private sector party, and the process by which the public sector party exercises any rights of intervention. These may include default provisions and step-in rights (see paragraphs 4.60-4.61).
- 4.30 An example of the consequences of failing to review performance information, even though it was available, is the contract to construct the Channel Tunnel Rail Link and operate the United Kingdom arm of the Eurostar train service. The contract had to be restructured after it became clear that overly optimistic forecasts for the operation of Eurostar UK had affected the ability of the private sector party to raise all the money from private investors it needed to build the Link. The National Audit Office in the United Kingdom found that the public sector party had not demanded all the information it was entitled to under the original contract, which had both hampered the ability of the public sector party to monitor progress and denied external financiers the opportunity to bring privatesector financial disciplines to the project at an early stage.⁴³

43 *Department of the Environment, Transport and the Regions: The Channel Tunnel Rail Link* (2001), National Audit Office, United Kingdom.

- 4.31 There are a number of examples of projects in other jurisdictions where serious failures on the part of the private sector party have resulted in the public sector party having to resume responsibility for the delivery of services at a significant cost. Examples already mentioned are the Deer Park Prison⁴⁴ and the Latrobe Regional Hospital in Victoria.
- 4.32 There are also examples where projects have failed, but the public sector party has avoided having to bear the financial consequences of the failure. The Sydney Airport Rail Link is often given as an example of this. Patronage of the airport rail link was significantly below expectations. It is said that this was caused by a number of factors, such as inadequate marketing of the new rail link and inflexible ticketing arrangements. However, the risk associated with poor patronage and the resulting poor financial performance was borne entirely by the private sector. The private sector financiers stepped in to ensure that the service continued to operate. The public sector and wider community were largely unaffected, and services continued to be provided with no additional public funding being required.⁴⁵
- 4.33 An area often neglected in contract management is contract review. Contract milestone reviews are important to determine how well the project is progressing.
- 4.34 Examples of contract performance that should be reviewed include:
- the extent to which project outcomes and objectives are being achieved;
 - the continuing appropriateness of key performance indicators;
 - the effectiveness of contract management;
 - identifying any difference between each party's expectations and project outcomes;
 - changes in the project that have happened through specific events or as a result of the project moving from one stage to another in its life cycle;
 - changes in the external environment in which the project operates;
 - changes to the risk profile;
 - community relations; and
 - budget performance.

Managing assets

- 4.35 Public entities need to ensure that assets they own or control are fit to deliver public services to a standard that meets their aims and objectives. In New Zealand, Schedule 10 of the Local Government Act 2002 sets out information

44 'Risk Weighting and Accounting Choices in Public-Private Partnerships: Case Study of a Failed Prison Contract' (2004), English and Walker, *Australian Accounting Review*, Vol. 14, No. 2.

45 'A Private-Sector Perspective' (2004), Lilley and De Giorgio, *Australian Accounting Review*, Vol. 14, No. 2.

about assets that must be included in a local authority's Long-Term Council Community Plan, and specifies the level of asset management planning required. This includes showing how asset management plans support levels of service.⁴⁶

- 4.36 The public sector party will need to seek assurance throughout the life of the contract that assets are being properly managed to agreed standards and, if relevant, that assets will be returned to it at the end of the contract in a reasonable condition. As part of the contract, the private sector party should be required to have an asset management plan that includes baseline information (such as a description of the number, type, and condition of assets, and asset life strategies) and a maintenance and renewals programme.
- 4.37 The asset management plan should address how forecast changes in demand and consumption of services will be managed, and specify how any requirements for increased asset capacity in the future will be met. The private sector party should be required to update the plan periodically, including reviewing the plan against changing levels of service.
- 4.38 The asset management plan should include key performance indicators – including targets for improving performance, and a risk management plan.
- 4.39 It is good practice for asset management plans to be independently reviewed by a third party.
- 4.40 Contract conditions should provide for the public sector party to have full access to the asset management plan, and to undertake regular monitoring of assets throughout the contract term, including receiving periodic reports from the private sector party. Contract conditions should also provide for full access to the necessary information to enable the public entity to properly account for the assets in accordance with generally accepted accounting practice (see paragraphs 3.58 to 3.60).

⁴⁶ Guidance is contained in *International Infrastructure Management Manual* (2006), Institute of Public Works Engineering Australia. This manual has been written for local government, but provides information about good practice in asset management relevant to all public entities.

- 4.41 End-of-term arrangements for assets owned or controlled by the private sector party should be included in the contract documentation. Several different arrangements are possible, such as the assets transferring to the public sector party, the assets remaining with the private sector party, or the assets being available for the public sector party to acquire through an option arrangement.⁴⁷ Each arrangement will probably give rise to commercial, accounting, and taxation issues.

Managing relationships

- 4.42 The long-term nature of many partnering contracts means that it is important for the public and private sector parties to maintain a strong relationship of mutual benefit.
- 4.43 It is also likely that a significant cultural shift from a traditional arm's-length, and possibly adversarial, approach to contracting to one of integration, collaboration, and high-performance teamwork will be needed by all parties. Working collaboratively means understanding each other's aims and objectives and how they will be met.
- 4.44 The procurement stage:
- ...should be the time to lay the foundations for the future relationship with the winning bidder. This should lead to the development of proper partnership relations during the development and delivery stages to enhance prospects for the successful provision of the services over the life of the contract. Good relations between the [public and private sector parties] should foster a climate which encourages both [parties] to suggest or make improvements in the quality of services delivered.⁴⁸*
- 4.45 A relationship where both parties are "open, share information fully and work together to solve problems" will also be important to avoid the possibility of early termination of the contract for poor performance.⁴⁹

47 *Practitioners' Guide* (June 2001), Partnerships Victoria guidance material.

48 *How to Manage the Delivery of Long-Term PFI Contracts*, Technical Note No. 6, Private Finance Taskforce, HM Treasury, United Kingdom.

49 *Ibid.*

- 4.46 Partnerships Victoria's June 2003 *Contract Management Guide* identifies the following factors that need to be considered in setting up management structures for the relationship. It is important that these relationships are described in the contract documentation.
- **Senior management support** – The relationship should be championed at senior levels in both organisations.
 - **Peer-to-peer communication** – Working relationships should be conducted between peers. If a timely decision cannot be made at one level, there should be escalation procedures so that it can be referred to a more senior level.
 - **Separation of roles** – Day-to-day contract management and service delivery should be separated from management of the overall strategic relationship and long-term strategic issues.
 - **Appropriate and clear roles and responsibilities**, with contract management staff having an appropriate level of authority to carry out their jobs effectively.
- 4.47 There should be agreed mechanisms for parties to notify each other about issues arising from the contract.
- 4.48 Disputes should be dealt with as early as possible and at the appropriate level, and dispute resolution procedures should encourage negotiation and/or mediation between the parties. Providing in the contract documentation for easy access to formal court or arbitration proceedings is unlikely to result in a timely resolution of disputes.

Managing payments

- 4.49 The contract needs to document the process where requests for payments are received, checked, and authorised, including processing times.
- 4.50 In a partnering contract involving long-term provision of services, payments are often not made until facilities have been commissioned and services have begun. The payment mechanism could contain elements that relate to:
- availability of services;
 - performance of the services;
 - usage of the services; and
 - more widely defined benefits, such as improvements in safety or community access.⁵⁰
- 4.51 The contract documentation should include conditions governing making payments.

⁵⁰ *Practitioners' Guide* (June 2001), Partnerships Victoria guidance material.

- 4.52 In circumstances where payments are made for services, Partnerships Victoria guidance⁵¹ states that:
- There should be a single charge for the service, not separate charges for elements relating to availability or performance. This reduces the incentive for the private party to cut back on less profitable services.
 - The single charge should only be paid to the extent that the service is available.
 - Payments should never contain a fixed element that the private sector party receives irrespective of performance.⁵²
 - The payment mechanism should seek to make deductions for substandard performance that reflect the severity of failure.
 - The payment mechanism should enable the public sector party to have adequate flexibility to make changes in the nature or volume of services to be delivered over time.

Managing changes

- 4.53 It is very likely that changes will occur during the project. These may have been provided for in the contract, or not anticipated – for example, changes in the law, technical advances, or changes to the requirements of the public sector party. These might entail the need to obtain new resource consents or reviews of consent conditions. Changes are both a source of risk and a potential opportunity to extract additional benefits from the project.
- 4.54 Partnerships Victoria's June 2003 *Contract Management Guide* recommends that the following change management processes be incorporated as part of contract management and described in the contract documentation:
- Appropriate protocols are in place to manage change.
 - Appropriate staff have the authority to request and authorise changes.
 - Potential changes are assessed thoroughly by suitably experienced personnel, and based on consultation with relevant stakeholders.
 - Changes are appropriately prioritised and their implementation properly resourced.
 - The implementation of changes is controlled and tested.
 - Changes are appropriately documented.
 - Changes do not compromise value-for-money outcomes.
 - Changes do not result in the unintended acceptance of risk by the public sector party.

⁵¹ Ibid.

⁵² This principle is also followed in the United Kingdom. There may be some circumstances where a fixed payment for margin-related costs could be appropriate but, as far as possible, this should be avoided.

- 4.55 A procedure for agreeing variations should be included in the contract documentation. Variations in key performance standards or payment arrangements over time should be formalised in variations to the contract. Contract variations may lead to a price variation, and the project no longer being competitive. Partnerships Victoria's June 2001 *Practitioner's Guide* states that, as a general rule, only changes initiated by the public sector party should lead to a change in price.
- 4.56 In a project alliance, the risk-sharing basis of the alliance means that situations that would be treated as variations under a traditional contract are usually not considered to be variations under an alliance. However, it is usual for certain situations to be treated as "scope variations" – for example, if the public sector party changes the fundamental function or design requirements of the contract. Project alliance participants will need to be clear on what should or should not be treated as a scope variation before the target cost is finalised.⁵³
- 4.57 A useful example of a process used to identify scope variations is described in the Grafton Gully case study (see Appendix 2).

Contingency planning

- 4.58 Contingency planning is vital, since it may not be possible to fully transfer responsibility for the risk of service delivery failure to the private sector party. It will be important for the parties to have fully assessed potential situations that might lead to an interruption to service delivery. These situations will include events occurring outside the control of both parties, such as 'force majeure'.
- 4.59 The parties should ensure that they have business continuity and disaster recovery plans to apply to potential situations that have been identified.
- 4.60 The public sector party should also have a plan for any default by the private sector party, and the contract should include default and remedy provisions to make risk allocation enforceable.
- 4.61 Under partnering contracts where the private sector party has control of facilities and responsibility for delivering services, the public sector party usually has "step-in" rights under which it can elect to take over control of the facilities and assume all or some of the service delivery obligations of the private sector party. These rights require special planning, including how and when to step in,⁵⁴ and the financial implications of doing so.

⁵³ *Introduction to Project Alliancing* (April 2003), Jim Ross, Project Control International Pty Limited.

⁵⁴ *Contract Management Guide* (June 2003), Partnerships Victoria guidance material.

Appendix 1

Auckland's indoor arena

Procurement route

The Auckland City Council (the Council) decided in April 2004 to proceed with building a 12,000-seat indoor arena (the Arena) in central Auckland that will host major entertainment and sporting events. The Arena is intended to be of iconic design and compete with similar facilities in other cities overseas.

The Arena is a project being built, and that will be operated, under a BOOT contract (build, own, operate, and transfer).

Initially, expressions of interest were sought to build and operate the Arena based on the project being fully funded by the private sector. However, it became apparent during this stage that potential private sector providers would not be prepared to undertake the project without a financial contribution from the Council. The Council therefore undertook its own assessment, which was peer reviewed, and commissioned an external consultant to undertake individual interviews with potential tenderers. The interviews led to an assessment of the financial contribution that would be required from the Council if it were to attract private sector interest in a BOOT contract.

The Council granted a concession to Quay Park Arena Management Limited (QPAM) in May 2004 through the BOOT contract. QPAM has been set up as a special-purpose vehicle owned by the company that will operate the Arena and a private sector financier. QPAM has agreed to build, own, operate, and maintain the Arena for 40 years, when it will transfer ownership of the building and the operating systems to the Council.

Construction is currently in progress. The building will cost \$80 million, and the Council has made a prepayment of \$68.2 million for the transfer of ownership of the Arena and operating systems. QPAM has invested \$11 million.

QPAM will be entitled to all revenue from ticket sales and venue rentals, and the agreement provides for the Council to receive royalties, which the Council will in part use to fund community events at the Arena.

Reasons for procurement decision

The Council officers we interviewed considered that the project would have gone ahead without private financing. However, they gave the following reasons for choosing a partnering approach:

- The Council does not understand and has no experience in operating a major events venue. Under the agreement, the private sector partner, which has the experience and skills to run this type of business, is responsible for operations, and carries the operational risk.
- The private sector partner will be responsible for maintaining the venue.
- The Council will not be required to fund depreciation because the physical asset is not on its balance sheet.

Some important lessons so far

Political commitment

Political commitment is essential to achieving a successful outcome. The Council established a cross-party Arena Working Party of Councillors to ensure that they were properly involved throughout the project. The Working Party oversaw officers' negotiations with the private sector partner and made recommendations to the Council. Senior officers managing the project also invested considerable effort in ensuring that Councillors were engaged and had the necessary degree of confidence in the project as it progressed.

Internal project management

Political commitment needs to be supported by robust internal project management arrangements. A tight, focused internal project management team was established, with the determination to make the project succeed. A Programme Manager was given responsibility for preparing an in-house project plan – including, for example, Council communications and resource consent applications. A client representative was appointed during the construction phase to look after the Council's interests via an independent reviewer engineer and independent project manager. In practice, the independent project manager is involved on a regular basis with construction decisions around the allocation of a council contingency and enhancement budget.

Financial advice

The Council recommends seeking strategic banking investment advice at an early stage about the best way to obtain capital funding for this type of project. The advice received will affect the choice of procurement route.

Peer reviews

A number of internal and external peer reviews and independent assurance were sought during the decision-making process, such as peer reviews of the business plan, arena design, technical aspects, operations, financial appraisals, and legal documentation, and probity assurance on each stage of the tender selection process. These reviews provided the Council with confidence that its approach stood up to scrutiny. However, the time required to undertake peer reviews needs to be included in the project plan, and the number of peer reviews should not unreasonably impede project progress.

Relationship management

The Council has put in place ongoing arrangements for managing the relationship with the private sector partner once the building is in use. A Relationship Manager has been appointed who sits alongside the Project Manager at all important meetings with the private sector partner, though that person does not have an official role until the opening of the Arena. Once the venue is opened, the Relationship Manager will take over maintaining the association with the private sector partner from the Project Manager, in addition to carrying out a community liaison role.

Maintenance of the asset

The agreement includes a requirement for the private sector partner to record its operating systems, including asset management arrangements, in facilities Operator Manuals, which are to be independently reviewed. Targets related to asset management service levels, which are to be reported on annually, are also included in the agreement, and the private sector partner is required to maintain a sinking fund for replacements and renewals.

Business failure

Business failure would mean that the Council would have to take over the Arena, using its step-in or termination rights included in the agreement. The Council plans to manage this risk by monitoring the private sector partner's financial viability. However, this will have to be balanced against the private sector partner's requirements for commercial confidentiality.

The Council considers that, as a partner, it has a responsibility, within reason, for ensuring the continued financial viability of the private sector partner. To this end, provisions are included in the agreement for payment of rates, and the Council has undertaken not to fund a similar venue that might compete for business with the Arena within the city boundaries during the next 20 years. The agreement also includes provisions on the amount of debt that can be carried by the private sector partner.

The Council's reputation

The Council recognised early the need to protect its reputation and the community benefits from the public investment of \$68.2 million. It also recognised that, whether or not the Council owned the Arena, the public would think that it did. Therefore, the range of events staged at the Arena might affect public perceptions of the Council. This risk is to be managed through the long-term involvement of the Council's Relationship Manager, and through provisions in the agreement.

Appendix 2

Auckland's Grafton Gully road construction

Procurement route

The new Grafton Gully road was constructed using a project alliance set up under new Transit New Zealand (Transit) policy. This procurement approach did not involve private financing or a transfer of ownership.

Grafton Gully connects the Auckland North-Western and Southern Motorways with the Ports of Auckland and lower Auckland central business district. The project was designed to reduce congestion in the area by separating motorway traffic from local traffic.

The 25-month project, completed in February 2004, cost \$67 million.

Grafton Gully pioneered the project alliancing approach for road construction projects in New Zealand. The model adopted by Transit involves integrating the owner, designers, and constructors as a single team, sharing all risks and rewards and responsibility for solving problems.

The alliance team comprised Transit as the client (or “owner participant”), Beca Carter Hollings and Ferner Limited (a design consultant), and 2 principal construction companies (The Fletcher Construction Company Limited and Higgins Contractors Limited). A project alliance board was set up with representatives of each participant (including 2 from Transit, The Fletcher Construction Company Limited, and Beca Carter Hollings and Ferner Limited, and one from Higgins Contractors Limited), with a requirement that all decisions must be unanimous.

The model⁵⁵ adopted by Transit was devised by an Australian consultancy organisation, Project Control International Pty Limited (PCI), with slight modifications to suit New Zealand's conditions. Two main stages were involved in establishing the alliance.

Selection of alliance participants

In conventional procurements, price is generally the principal determinant of decisions about awarding the contract, although selection is often on the basis of both price and non-price attributes. In this case, short-listing of private sector proponents was undertaken based on management and technical skills of the organisations and the individuals proposed for the project, as well as the experience and track record of the organisations on similar work. Consideration was also given to how team members included in the project teams – proposed as part of each tender bid – demonstrated that they could work together effectively, and how management and technical skills they possessed would facilitate an alliance-type contract.

Two-day selection workshops were held, which were designed to enable the client and short-listed proponents to get to know each other, and to assess how they responded to quasi-hypothetical issues related to the project. The objective at the end of this process was to select the team with the most potential to deliver the project outcomes desired by Transit.

The project team selected at the end of this stage, which included representatives from both the client and successful proponents (known as the “non-owner participants”), became known as the “Freeflow Alliance”.

Determining price

Once the Freeflow Alliance had been set up, a process was then followed to establish a target outturn cost for the project. This process included 3 defined activities:

- **Limb 1:** An assessment of direct project costs, including project-specific overheads.
- **Limb 2:** A determination of the usual margin or direct project costs that each private sector participant would expect when undertaking normal business activities. An expert auditor was contracted to review the books of each private sector participant for the last 5 years, and to identify the normal margin for off-site overheads and profit that each earned on their normal business activities.
- **Limb 3:** Establishment of a method for the equitable sharing of “pain” or “gain”, depending on how project outcomes would compare with the pre-agreed targets which the parties would jointly commit to achieve.

Initially, the audit process determined Limb 2, and then the Limb 3 mechanism was prepared and agreed. The participants then entered into an interim Project Alliance Agreement (iPAA) to undertake sufficient design and construction planning to make the Limb 1 assessment.

This was then combined with Limb 2 described above to become the target outturn cost, including costs associated with all risks that were carried by the alliance – for example, fluctuations in labour and materials, and days lost because of adverse weather conditions.

Transit appointed an independent industry expert who used specialist staff to verify to its Board that the target outturn cost offered value for money. Any differences between the target outturn cost identified by the private sector participants and independent expert were to be resolved between them without Transit’s involvement.

Once the target outturn cost had been agreed, all participants signed the final Project Alliance Agreement (PAA), including provisions relating to governance by the Project Alliance Board, day-to-day management by the project team, sharing of risks, payments specified in accordance with Limb 1 to 3 assessments, and processes for resolving issues.

PCI, which has extensive experience in alliancing, facilitated the establishment of the core commercial arrangements that underpinned the alliance arrangement.

Reasons for procurement decision

This was a complex project, and it was imperative that a high-performance team was recruited to undertake it. This might have been difficult through a conventional competitive procurement process.

A traditional measure and value contract would not provide incentives to contractors and designers to “think smarter”, since they would not gain from seeking innovative solutions to cut costs. Under an alliancing approach, all participants would benefit from net profit gain.

The proposal for a non-adversarial approach was attractive to Transit, which saw advantages from the client and contractors not wasting time “covering their backs”.

Transit was aware that this approach had worked well in Australia for roading projects.

Some important lessons so far

Project team building

It was a major challenge bringing together 150 people from 4 very strong organisations to form a team that was going to deliver an outstanding project. This required a change in the behaviours and attitudes of people who worked in a very tough construction industry with a traditionally adversarial approach to contract management.

An Australian consultant specialising in alliancing arrangements was commissioned at an early stage to help establish the founding principles of the alliance, and a structured team-building programme was set up with 2 phases:

- Initial team building, coaching, and training sessions, and appointing a long-term coach.
- After the team had been together for 8 to 10 months, a review of progress and performance in setting up a fully integrated, high-performance team. A

charter was written to capture the values of the team in everyday language, and initiatives were put in place to establish the culture and behaviour across the entire site.

Different mechanisms were also used to establish a team identity. For example, a single project office was established for project team staff, separate from the premises of their employers, with areas dedicated to the team relaxing away from their desks, and social occasions were arranged for the team outside work. Team-building activities were held to help foster the team identity and alignment on project objectives and “best for project” decisions.

The team was located on-site a month after the signing of the PAA, which focused the team on important outcomes and delivering the project.

An intelligent client

Transit considers that, in order for an alliancing approach to be effective, it is important for the public entity to possess expertise in this type of approach. Transit dedicated one expert member of staff full-time to the project, with 2 other staff regularly involved.

The alliance agreement required Project Alliance Board members representing the private sector participants to be empowered to make decisions on the part of their organisations. It was important that Transit staff could also make decisions without having to go back to Transit’s Board for ratification, particularly since responsiveness on the part of Transit provided confidence to private sector participants.

Time taken to establish the alliance

A great deal of work is required to establish an alliance – including agreeing the target outturn cost – as well as a need for ongoing team building. For the Grafton Gully project, setting up the alliance and agreeing to the target outturn cost took 4 months, although Transit has found that subsequent alliancing projects have taken longer to reach this stage.

Transit’s view is that, because of the “upfront effort” required, an alliancing approach would not be suitable for small projects, and that the Grafton Gully project was arguably too small. However, project size needs to be balanced against projects that might benefit from an alliancing approach, such as where a lot of stakeholders are involved, environmental issues are paramount, and superior outcomes are required.

External entities

The alliance identified a key area of risk as being anything influenced by a party or person external to the on-site alliance team. These included, for example, territorial local authorities, affected businesses and the community, and “home” organisations, including Transit’s corporate and regional offices. This risk was addressed through maintaining strong relationships with each of these external parties on issues that might affect the performance of the alliance.

Public relations

The close working relationship between the “stakeholder management team” and construction teams meant that construction activities that were likely to have a high public impact were identified and planned for well in advance. This had a positive effect on the quality and effectiveness of communication, leading to a high level of trust with the Auckland Regional Council and the emergency services.

Target outturn cost

There is a long period of uncertainty before the target outturn cost is known, and a risk that it will not be possible to agree the target outturn cost when considerable investment has already been made by all participants to reach this stage. For example, private sector participants and independent experts may have differences of opinion, which might lead to termination of the agreement.

In establishing a target outturn cost, Transit has found that assessments of private sector participants and independent experts relating to direct costs are usually closely aligned. However, costing of “preliminaries and generals” – for example, general project infrastructure and the support systems needed to deliver projects (such as project management staff, accommodation, IT, and vehicles) – and costing of risk factors can be more contentious.

There is also a risk that project costs will exceed the target outturn cost. In this circumstance the additional costs are borne by all participants in pre-agreed proportions (usually 50:50). The risk to the private sector participants will be having to work for reduced or entire loss of their profit and off-site overheads. The public sector participant will share the additional costs up to the point that the Limb 3 margin of the private sector participants is expended. After this, the public sector participant will have to bear all the additional costs. Also, there is always the risk that the reaction of private sector participants in this situation will be to revert to an adversarial approach.

Treatment of variations to the contract

In principle, there should be very limited possibility of variations to the contract in an alliancing arrangement that enable private sector participants to claim additional payments. Any variations should be limited to changes in the scope of the work requested by the client. Transit decided to organise a Variation Benchmarking Workshop to ensure that all participants in the alliance had a clear understanding of what would and would not constitute a variation. A number of hypothetical scenarios were discussed (such as changes to government legislation affecting working hours, and suppliers becoming insolvent) with an assessment of whether each scenario might result in a variation. The Project Alliance Board was required to make a unanimous decision on what would constitute variations, which were incorporated into the PAA as examples that could be relied on later if a situation arose.

Performance against programme

The project was completed 6 weeks ahead of the agreement completion date. This was achieved without compromise to the “non-production” objectives relating to environmental impact, traffic management, road safety, health and safety, stakeholder involvement, and quality and aesthetics, and despite a number of significant risks and obstacles that had to be overcome.

The alliance approach generated cost savings (mainly in relation to physical works) that were then fed back into the project as enhancements to urban design. For example, decorative panels, motifs on barriers, outdoor sculptures, and planting were incorporated into both the structures and site landscaping.

Appendix 3

Wellington's Clear Water project

Procurement route

The Wellington Clear Water project for a new sewage treatment plant has been undertaken using a contract to design, build, maintain, and operate (DBMO).⁵⁶

The Wellington City Council (the Council) was aware that arrangements for the treatment and disposal of sewage were unsatisfactory. A long process of public consultation took place, resulting in a decision that there was a need for a modern sewage treatment plant with potential for expansion, designed to meet environmental standards based on legislative requirements and public expectations.

Expressions of interest were sought on a traditional procurement approach to designing, constructing, and operating the new plant. One proposal was received from a United Kingdom-based company proposing an alternative approach, including designing, building, and operating the plant for 25 years, with the right of renewal of the contract after 20 years.

A contract was awarded to this company in 1996 on the basis that the Council paid the company a lump sum to design and build the plant, followed by an annual operating fee. The new plant was commissioned in 1998.

The contractor operated the plant until June 2004, when it set up a subsidiary company to take over managing the contract. Since then, ownership of the subsidiary company has been transferred to a third company that now manages the contract.

Reasons for procurement decision

Council officers identified the following reasons for choosing this procurement route:

- The treatment plant required construction by a contractor with specific experience, and the Council did not possess the necessary skills or experience in-house. Therefore, the Council decided to prepare an output-based specification, and seek proposals from companies with significant experience and international expertise to determine the best means of achieving the outputs.
- The risk of achieving the outputs was transferred to the contractor.

⁵⁶ Since Wellington City Council entered the contract with the private sector provider, the Local Government Act 2002 has imposed restrictions on local authorities' ability to make arrangements with other persons (except other local government organisations) for providing or operating water services. The Act prohibits any arrangement that has a term of more than 15 years, or that involves any transfer of pricing, management of services, policy development, or ownership of infrastructure. The Wellington Clear Water contract would have required significant modification had it been settled under these provisions. The requirement for a shortened term (that is, 15 years rather than 25) would also, very likely, have affected the economics of the arrangement.

- A contract to design, build, and operate the plant would provide an incentive to the contractor to establish a good-quality, low-maintenance facility, and so minimise maintenance costs. A company contracted to design and build the plant, but not operate it, would wish to maximise its profit margin at this stage, with the risk of future increased costs of maintenance.

The Council also identified reasons why it might not be appropriate to choose this procurement route:

- If different companies had been selected to design, build, and operate the plant, each company would have acted to assure the quality of the others' work (though note the bullet point above that puts forward a contrary point of view).
- The ownership of the provider company has changed, and the people managing the contract on behalf of both the client and contractor at the early stages of the project are no longer involved. This is not surprising considering the long-term nature of the contract. Although this potentially weakens the case often put forward for long-term contracts of this nature – that they offer stability and continuity – in this case there is evidence of remarkable continuity. The chairman of the current provider company was previously chairman of the original provider company, and he has been involved for 10 years in the Clear Water project. Some of the private sector party's operational staff have also been involved for a long time.

Lessons so far

Clearly specified outputs and outcomes

It is very important to specify clearly the outputs and outcomes required, and how these will be measured. In this case, it was found that the need for an environmentally acceptable solution, with a minimal effect on the local community, was open to different interpretations, leading to a number of disputes between the 2 parties during the construction and commissioning stages.

Long-term nature of the contract

When drawing up the specifications and contract documentation, it is very important to think about what might go wrong during the contract period, where risks should lie, and how contract terms might be interpreted in the future.

The contract also needs to be flexible enough to take account of potential changes to legislation, resource conditions, and community expectations, and of the different personalities who will be managing the contract on behalf of both client and contractor in the future.

Client contract management

In the first few years, the Council adopted a very arm's-length approach to contract management. In 2002, a process for regular liaison about operations was introduced. Benchmarks have been set for performance, the contractor has been asked to write an operations manual, and the Council is undertaking more physical inspections. The contractor has also been asked to commission an independent report of its performance.

An Executive Review Group has also been set up, which meets every 2 months. This includes representatives of senior management of both the Council and the contractor, and addresses high-level issues. A community liaison group has also been established, which meets 3-4 times a year.

It is important that the Council retains knowledge and expertise internally to manage these types of contracts effectively. The Council manager who took over responsibility for managing the contract 2 years ago had to spend a great deal of time searching for documents related to the history of the contract. It is therefore important to ensure that contract documentation is properly stored and easily retrievable, preferably through a quality control system.

Appendix 4

Papakura's water and wastewater services

Procurement route

The Papakura District Council (the Council) entered into a franchise agreement in 1997 with a private company (the franchisee) to operate the water and wastewater services within the Papakura District for an initial term of 30 years, with provision for renewal for a further 20 years. The franchisee paid the Council a franchise fee of approximately \$13 million.⁵⁷

The franchisee is responsible for:

- providing the supply of water to the customers in the district; and
- managing the local wastewater collection systems.

The Council continues to own the water and wastewater assets, and the franchisee has responsibility for maintenance and enhancement of the water and wastewater systems.

The franchisee is required, at its own cost, to maintain the water and wastewater infrastructure to an overall standard better than its initial condition and in good operational order. The intention is that, on the expiry or earlier termination of the agreement, the infrastructure should be in a better condition than at the start of the agreement.

The franchisee bills customers directly, and is entitled to all of the revenue generated from water charges.

Reasons for procurement decision

From the information available, the following appear to have been the benefits that the Council sought in 1997 from the franchise agreement:

- Lower-cost services – It was considered that costs would be controlled through linking water charges to the Auckland Average Price for water and wastewater services, and through competitively priced infrastructure charges, such as connection charges.
- High-quality services – Dedicated staff would be responsible for operating the franchise, with a high level of ownership and commitment to providing a good quality service.
- A better management mechanism – The Council would not be burdened with the responsibility of direct management.
- The opportunity to bring in international expertise.

⁵⁷ Since the Council entered into the franchise agreement, the Local Government Act 2002 has imposed restrictions on local authorities' ability to make arrangements with other persons (except other local government organisations) for providing or operating water services. The Act prohibits any arrangement that has a term of more than 15 years, or that involves any transfer of pricing, management of services, policy development, or ownership of infrastructure.

- A means of improving the condition of the existing asset and addressing future growth requirements.
- A means of transferring the risks related to direct water supply and management of wastewater collection to a third party.

Lessons so far

The following sets out the lessons we identified in a report published in April 1998⁵⁸ and from a follow-up audit in September 2000 (reported on in June 2001),⁵⁹ together with the views of the Council's representatives.

Changes to legislation

The Council believed that the ultimate responsibility for, and therefore the risks of, running the water supply and wastewater systems were transferred to the franchisee. However, new provisions of the Local Government Act 2002 specify that local authorities have entrenched responsibilities for water supply.

The Council also considers that it may find it difficult to comply with new requirements for consultation in the Local Government Act, since much of this information is held by the franchisee. The franchise agreement inadequately documents the franchisee's obligations to release such information to the Council.

Change of political ideology

A Council composed of members strongly committed to taking this procurement route entered into the franchise agreement. Since then, a great deal of time has had to be spent working through concerns held by newer Council members.

Alignment with the Council's strategic objectives and plans

A number of issues have arisen around decisions that the franchisee has made, or may make in the future, that appear to conflict with the Council's strategic objectives and plans – for example, issues about water conservation, development planning, and providing support to local businesses. These types of issues could have been addressed in a business plan documenting what the Council wished to achieve for the delivery of water services, before considering how they should be delivered. The plan should have included identification of entrenched principles, including the need to protect the long-term interests of ratepayers and users of the service.

The business case for the franchise could have been used to set objectives for managing and operating the services concerned, and been included as part of the selection criteria in conducting a tender for franchising the service to ensure that the preferred tenderer could meet the strategic objectives for service delivery.

⁵⁸ *Papakura District Council: Water and Wastewater Franchise*, April 1998.

⁵⁹ *Local Government: Results of the 1999-2000 Audits*, parliamentary paper B.29[01a], June 2001.

Need for community consultation

Water is seen as an essential commodity, and the control and supply of water and wastewater can arouse strong emotions. The Auditor-General identified a need for the Council to carry out sufficient consultation to assure itself that it had identified the needs, issues, and any concerns the community might have, to be used in the decision-making process.

Need for internal expertise

The Council relied on limited internal expertise and local solicitors when setting up the franchise agreement, and an external expert did not review the draft agreement. The Council now considers that it should have sought external expertise at an early stage, and has contracted a firm of professional consultants to assist in the day-to-day management of the agreement on its behalf.

Performance management

The Auditor-General highlighted that it is important for the Council to establish the necessary systems and allocate suitable resources to manage and monitor the franchise from its start. This monitoring should include a programme of auditing the performance of the franchisee to provide the level of assurance it requires.

The performance monitoring systems should specify the role of Councillors and include specific mechanisms for identifying and managing poor performance.

The franchise agreement focused on performance indicators related to price and quality. The Auditor-General identified 2 other indicators – customer service, and asset management and development – that needed to have been better defined.

The 30-year term can be extended by an additional 20 years, but an extension is not linked to a performance agreement.

Council representatives expressed the view that the costs of providing for internal contract management, including performance management, should have been identified as part of the initial decision-making process for choosing this procurement option.

Asset management

The Auditor-General identified a number of lessons related to asset management.

There should be agreement between the parties about how the condition of the infrastructure is to be measured over the duration of the franchise. As a baseline, an Infrastructure Condition Assessment should be undertaken, so that both parties have a shared understanding about the state of the infrastructure at the start.

There should also be a requirement on the part of the franchisee to produce and make available an Asset Management Plan for protecting the water and wastewater asset throughout the life of the agreement, and to enable the Council to manage and monitor the agreement effectively.

The Asset Management Plan should establish clear benchmarks for existing asset condition and service levels, and standards for the maintenance and enhancement of the infrastructure. The Asset Management Plan should also provide a sound basis to establish clear procedures for:

- dealing with poor performance or non-performance by the franchisee;
- assessing the required condition of assets before they are returned to the Council's control at the end of the franchise;
- dealing with a range of extreme events; and
- communicating with the franchisee as a basis for ongoing administration of the franchise.

The requirement for a suitable Asset Management Plan to be produced should be included in the franchise agreement. In this case, although the franchisee was required to produce an Asset Management Plan, the Council has been in dispute with the franchisee over the right of access to its contents for management and governance purposes.

Appendix 5

Canterbury's regional landfill project

Procurement route

The Canterbury regional landfill project is being undertaken by a combination of a public-private joint venture set up to create a regional landfill facility, and a project alliance responsible for construction of the landfill site. We previously reported on the project in our March 2001 report *Local Authority Governance of Subsidiary Entities* (pages 67-78)

The Canterbury region had 52 landfill sites in 1995, all but 2 of which had resource consents expiring within 10 years. The project reflects the recognition by the Canterbury territorial local authorities involved of the need to adopt a strategic approach to waste management, including meeting modern environmental standards.

The joint venture company, Transwaste Canterbury Limited (TCL), was formed in 1998 as a local authority trading enterprise under the Local Government Act 1974. It is now a council-controlled organisation under the Local Government Act 2002.

It is 50% owned by 6 Canterbury local authorities: Ashburton, Banks Peninsula, Hurunui, Selwyn, and Waimakariri District Councils, and Christchurch City Council. The remaining 50% is owned by Canterbury Waste Services Limited (CWS), in turn a joint venture between 2 waste companies, Enviro Waste Services Limited and Waste Management N.Z. Limited.

The role of TCL is to select the site, obtain consents, build, own, and operate the Canterbury regional landfill. CWS was contracted by TCL to obtain all necessary consents, and to design, build, and manage the new regional landfill for TCL. The landfill has a predicted life of 35 years.

The initial capital outlay of \$16 million was funded half by the 6 Councils and half by CWS. The balance of the \$36 million total capital required for the consenting process and establishment of the landfill to operating stage is to be funded by debt. Construction will be ongoing, once the site is operational, to provide for the continual waste stream, and it is planned that these costs, estimated at \$20 million, will be met from income received.

CWS set up a project alliance involving 3 further companies to construct the landfill by 30 June 2005.

Reasons for opting for a joint venture

Economic

The annual combined total waste produced by the districts of the 6 participating councils was about 277,000 tonnes in 1997. There was only enough waste to justify one new landfill site equipped to meet the new standards. A number of private companies already owned potential landfill sites in Canterbury, and the councils believed that if they competed directly with these companies to provide landfill, the councils would lose. The private sector companies also understood that waste volumes were sufficient for only one economic facility, and saw the advantage in a joint approach.

Political

The councils recognised early on that the site would have to be located in one of their districts, and the council of that district would inevitably face local opposition. A joint venture company could operate at arm's length from the councils involved, including the relevant council, and be able to choose the best site from an environmental perspective, removing potential for political influence to override inherent site suitability.

The site finally chosen was in Hurunui District, and the local political pressures on that Council to stop the development were immense. However, the project was able to continue through the joint venture arrangement. In a subsequent local election, the Hurunui mayor lost his seat, and a new mayor and group of councillors from the main group opposed to the landfill were elected.

Environmental and technical

In entering into a partnering arrangement with the private sector, the councils involved could benefit from the private sector's greater technical knowledge of the requirements of modern landfills, without having to relinquish ownership of the landfill site or influence over the way it operated.

This benefit was particularly important because a comprehensive regional waste strategy had been prepared by the Canterbury Waste Joint Standing Committee, to which all the councils belonged. This strategy integrated residual waste disposal by landfill with waste minimisation measures. The councils therefore considered there was a strong public sector interest in remaining involved to ensure that they could influence what happened throughout the whole of the waste chain.

Reasons for choosing an alliancing approach

With the joint venture established, the consent process ended in March 2004. The landfill had to be in operation by June 2005 at the latest to provide a service following the closure of the Burwood landfill in Christchurch. The final design of the landfill could not be started until the consent decision was obtained, as the appeals related to critical design aspects.

The demanding timescales meant that construction had to begin well before final designs were ready, leading to considerable unknown factors, especially relating to earthworks quantities on the site. This meant the work and therefore the price was difficult to specify under a traditional contract tender process. An alliancing approach offered the flexibility to begin work before designs were finalised, but with a focus on the end date, an agreed target cost, and quality standards.

Lessons so far

Political commitment

The political commitment and leadership of all Canterbury councils⁶⁰ were essential to establish the project. However, the project is long-term, and political opposition was likely to transpire during its course. The arm's-length arrangements and delegated decision-making mean that the original decisions cannot be influenced or rescinded through political action.

Experience of alliancing

The project management company had been involved in alliances for major projects, and its experience and reputation were important in giving the other alliance participants the confidence that they could make this approach work. However, it took time and continuing effort to ensure that all the participants, including subcontractors, were able to operate in an alliance. In CWS's view, a particular mindset is necessary and this had to be created. For example, some of the subcontractors had to learn that the usual practice of claiming for extras did not fit with the "joint gain/joint pain" approach.

⁶⁰ Ten Canterbury councils were involved in establishing the project, though only 6 decided to participate in the joint venture. The others have reserved the option to join later.

Monopoly

The councils and waste companies that are party to the joint venture have undertaken to send all their waste to the Canterbury regional landfill. This undertaking, together with the difficulty and high cost of securing resource consents, and the waste volumes dictating only one economically viable facility, will probably result in a monopoly position, with no competitors to influence the pricing structures. Independent checks and audits, including the appointment of independent legal and financial probity and financial auditors, have been instituted, to ensure that the landfill company acts as though it were in a competitive market.

Appendix 6

Experience in Australia

Background

Public private partnerships (PPPs) have become an important form of procurement in Australia, although mainly state governments have adopted their use. The term PPP is used in Australia mainly to describe projects that involve private investment or financing, and the provision of public infrastructure and related services.

The total value of Australia's PPP market is currently about A\$20,000 million. Prominent examples of PPPs include the Sydney Harbour Tunnel, Melbourne City Link (an A\$2,000 million, privately funded toll road), and the introduction of privately owned and operated prisons.

PPPs⁶¹ first emerged in the State of Victoria during the late 1980s and early 1990s. At the time, the main reason was to achieve "off-balance sheet" financing. The PPPs entered into principally involved the use of private investment to provide and maintain infrastructure, with limited involvement of the private sector in service delivery. There was little transfer of risk from public to private sector partners, with the State Government providing indemnities and guarantees to private parties, so that they had an assured rate of return. This led to a key objective of the State Government of bringing forward the provision of infrastructure being achieved, though there are examples of a number of projects failing, resulting in a significant cost to taxpayers.

From 1993 to 1999, with the introduction of the Infrastructure Investment Policy for Victoria (formally issued in 1994), the scope of PPPs in the State of Victoria was expanded to encompass design, construction, ownership, operation, and service delivery. PPPs were characterised by:

- a high level of risk transfer;
- private sector partners being responsible for full service provision – including custodial services in prisons and clinical services in hospitals;
- private sector partners receiving payments from public sector partners only on the start of services; and
- public sector partners not guaranteeing returns.

Examples of projects where this approach was adopted include Melbourne City Link, the Latrobe and Mildura Hospitals, public transport franchises, prisons, and water and wastewater treatment plants.

61 This account of PPPs in Australia is mainly based on an article by Glenn Maguire and Arseni Malinovitch, 'Forum: Public-Private Partnerships, Development of PPPs in Victoria', *Australian Accounting Review*, Vol. 14, No. 2, 2004.

Although there are examples of successful projects during this period, there were also some notable failures. External audit identified a number of concerns, including:

- the quest for maximum risk transfer and challenging service delivery outputs from the private sector led to some contracts being unsustainable;
- benchmarking performance levels involved only limited comparisons;
- an economic evaluation was not undertaken as part of the decision to enter into a PPP arrangement in some cases, and was not comprehensive in others; and
- unnecessary secrecy surrounded some of the major contracts.

Current position

In the State of Victoria, PPPs currently make up about 10% of the capital spending on infrastructure. The Victorian state government has established Partnerships Victoria to provide guidance and support in using PPPs to government agencies. The current Victorian government policy on PPPs is outlined in the Partnerships Victoria policy (June 2000) and accompanying guidance. The Policy is based on the premise that governments should not presume that either the public or private sectors can deliver projects more efficiently or effectively than the other, and it applies to projects where the present value of payments to be made by the government or users of services will exceed A\$10 million during the period of the partnership.

The principal objective stated in the policy for entering into PPPs is to achieve value for money, including meeting public interest requirements. A rigorous public interest test is applied that examines the potential impact of adopting a PPP approach on effectiveness in meeting the government's objectives, accountability and transparency, affected individuals and communities, equity, public access, consumer rights, security, and privacy.

The government now retains direct responsibility for the delivery of "core" public services – including, for example, teaching in government schools, clinical services in public hospitals, and correctional services in prisons. PPPs are mainly set up to provide public infrastructure and related ancillary services. Projects where a PPP approach has been adopted cover a range of industry sectors, from built-for-purpose buildings and specialised treatment plants to information technology.

The main focus is on whole-life costing and optimal rather than maximum risk transfer to the private sector.

The New South Wales and Queensland state governments have also established PPPs. These have been modelled on the Partnerships Victoria policy and guidance, although the New South Wales policy for privately financed projects specifies that projects should normally have a total contract value of A\$20 million or more. There is a desire by state governments to create a consistent Australia-wide approach to PPPs, which it is believed will enable potential private sector participants to see Australia as one PPP market.

A National PPP Forum was established in 2004, which includes ministers and government officials. The main aims of the Forum are to:

- increase awareness and understanding of PPPs;
- promote common PPP practices and procedures;
- facilitate greater information sharing across jurisdictions;
- set up a national database for a “project pipeline” (that is, future projects planned by government agencies); and
- facilitate greater interaction between government, key industry groups, and other players.

Reasons for choosing this procurement approach

The State of Victoria originally adopted PPPs as a means to achieve off-balance sheet financing that would not be caught within the borrowing limits set by the Australian Loan Council. However, this objective has now been replaced by the principle of achieving value for money in the public interest.

The set of infrastructure projects put forward in the State of Victoria’s investment programme does not depend on the choice between public and private financing. Rather, the programme is determined and the possibility of private financing of particular projects is then evaluated against a public sector comparator, to establish whether value for money would be achieved. Projects included as part of this programme proceed regardless of whether private financing is approved following this evaluation.

Partnerships Victoria policy, June 2000 (extract)

The Government will develop partnerships under this policy framework with the following objectives in mind:

- to maximise the level of infrastructure spending through a responsible use of the resources of both the public and private sectors;
- to ensure that infrastructure and related ancillary services are provided in accordance with best practice, and where appropriate, to relevant international standards;
- to promote growth and employment opportunities for the whole of Victoria;
- to deliver significantly improved services to the community;
- to encourage innovation in the provision of infrastructure and related ancillary services;
- to maximise the social and economic returns from Government expenditure;
- to pass through the benefits of Partnerships Victoria to customers, businesses and the Victorian community; and
- to clearly articulate accountabilities for outcomes.

In undertaking partnership projects, regard will be had also to industry development, investment, recruitment, and skill development and transfer.

Appendix 7

Experience in the United Kingdom

Background

In the United Kingdom (UK) the term public private partnership is used differently from Australia. PPP in the UK is much broader and refers to an ownership structure.⁶² According to the Treasury:

*Public Private Partnerships bring public and private sectors together in long-term partnership for mutual benefit. The PPP label covers a wide range of different types of partnership...*⁶³

In addition to the Private Finance Initiative (PFI) these schemes include the sale of a majority or minority stake in an enterprise which the government previously owned; joint ventures, franchises, concessions; and other partnership arrangements where private sector expertise and finance are used to exploit the commercial potential of government assets.

The PFI was launched by a Conservative Government in 1992, and adopted by the incoming Labour Government in 1997. It is essentially a procurement tool. In the Treasury definition:

*...the public sector contracts to purchase quality services, with defined outputs, on a long-term basis from the private sector ... including maintaining or constructing the necessary infrastructure.*⁶⁴

PFI corresponds in general terms to the way the term PPP is used in Australia.

Both major political parties support the PFI and PPP (or PPP/PFI as the approaches are often referred to in the UK). The PFI has a “small but important role in the delivery of the Government’s investment plans for public services”.⁶⁵ It constitutes just over 10% of total public sector investment in infrastructure, and covers almost every aspect of public services – including hospitals, prisons, transport infrastructure, and schools. However, the general view – and certainly that of the Treasury – is that PFI is “inappropriate for frontline services”, such as clinical health services and education.⁶⁶

The support arrangements for PPP/PFI have improved considerably, and there have been regular reviews. After expected benefits from early PFIs were not achieved, a dedicated task force was established in the Treasury in 1997. It produced standard contract conditions in 1999.

62 *PFI: meeting the investment challenge*, HM Treasury, July 2003.

63 *Public Private Partnerships: The Government’s Approach*, HM Treasury, 2000.

64 *Ibid.*

65 *PFI: meeting the investment challenge*, HM Treasury, July 2003.

66 Geoffrey Spence, Head of the Private Finance Unit, HM Treasury, 2004 National Audit Office PFI/PPP Conference.

The task force disbanded in 2000, with its support responsibilities going partly to the Office of Government Commerce (OGC), and partly to a new organisation, Partnerships UK. This organisation was itself a PPP – a joint venture company with a majority stake held by the private sector “...managed on commercial lines but with a public interest mission”.⁶⁷

The aim of Partnerships UK is to “support and accelerate the delivery of infrastructure renewal, high quality public services and the efficient use of public assets through better and stronger partnerships between the public and private sectors”. It is a central resource of professionals drawn from the public and private sectors with PPP/PFI procurement expertise, and it works solely on behalf of the public sector, providing an improved client capability. In addition to providing advice, it works as a PPP/PFI developer, such as through entering into agreements with the public sector to jointly procure PFI projects.

In April 2003, PPPs were transferred from the OGC back to the Treasury – the lesson was that control from the centre of government is necessary if PPPs were to be implemented widely.⁶⁸

A local government agency, 4ps (public private partnerships programme), has also been established to provide advice, guidance, and skills enhancement to local authorities on procurement, PPPs, and PFIs.

Current position

The PPP/PFI programme has achieved the “small but significant role in the delivery of public sector investment plans” quoted earlier.⁶⁹ The Treasury expects it to continue to be “limited in scope”. Over the period 1998-99 to 2003-04, PFI investment has remained relatively constant at between 10% and 13.5% of total public sector investment in infrastructure. It has involved over 600 deals incorporating future payments of over £100,000 million.

Recently, Partnerships for Health (PfH), a joint venture between the Department of Health and Partnerships UK, and Partnerships for Schools (PFS), a joint venture between the Department of Education and Skills and Partnerships UK, have been established. Part of the remit of these joint ventures is to devise a standardised procurement approach for the health and education sectors respectively, and to create a sustainable, predictable flow of transactions (including bundling of smaller projects) to enable the private sector to plan future capacity to bid for and implement such schemes.

67 *Public Private Partnerships: The Government's Approach*, HM Treasury, 2000.

68 ‘PPPs: Nature, Development and Unanswered Questions’, Jane Broadbent and Richard Laughlin, *Australian Accounting Review*, Vol. 14, No. 2, 2004.

69 *PFI: meeting the investment challenge*, HM Treasury, July 2003.

Concerns have been raised about the variable quality of advice provided to public entities by external consultants, which can have a direct effect on the length of time and cost of implementing PPP/PFI projects.⁷⁰ A scheme has recently been introduced for accreditation of advisers to the public sector, based on their demonstrated expertise and performance in PFI projects in fields such as law, finance, and commercial structuring.

The PFI has been less prominent in information technology projects, where the mainstream PFI focus on defined outputs may conflict with the greater need for project flexibility in a fast-moving area.

New areas for PFI investment are being considered, such as:

*...moving in the prisons sector from the construction and management of new build prisons to management of the prisons estate, urban regeneration, waste management and social housing.*⁷¹

Reasons for choosing this procurement approach

At a national level, PPPs and the PFI are seen as a significant way of achieving:

*...a key priority for this Government ... to increase investment in Britain's public services after many years in which the public sector asset stock was allowed to deteriorate.*⁷²

The way the PFI approach draws on private sector capital means that departments do not need to find all the money for new capital assets at the outset of their construction. This can make PFI attractive to departments and enable them “to undertake projects which they would be unable to finance conventionally”.⁷³

Future maintenance is a particular priority:

*In the past, capital has often been invested without a clear commitment to adequate future spending on maintenance, leading to poorly maintained assets, high running costs, inefficient service provision and premature replacement. In contrast, PFI invests in the future because it ensures that assets are maintained properly and can revert to the public sector at the end of the contractual period in good condition.*⁷⁴

⁷⁰ Ibid.

⁷¹ Ibid.

⁷² *Public Private Partnerships: The Government's Approach*, HM Treasury, 2000.

⁷³ *Examining the value for money of deals under the Private Finance Initiative*, UK National Audit Office, August 1999.

⁷⁴ *Public Private Partnerships: The Government's Approach*, HM Treasury, 2000.

There have been concerns about “the risk that departmental priorities may be distorted in favour of those projects which are capable of being run as PFI projects”⁷⁵ – for example, the risk that PFI schemes are favoured as a procurement process that keeps down what is seen as public expenditure by being “off-balance sheet”, or because they qualify for PFI credits (available to local government).

However, the Treasury is firmly of the view that the decision to undertake PFI investment must be taken on value-for-money grounds alone, and whether it is included in the balance sheet is not relevant to the choice of procurement route. It maintains a commitment to ensuring that there is no inherent bias in favour of one option over another.⁷⁶ The National Audit Office supports this view.⁷⁷

Value-for-money considerations that have been quoted include a focus on customer requirements, incentives for new and innovative approaches, and business and management expertise. These benefits derive from the way the private sector market exerts a powerful discipline on private sector management and employees to maximise efficiency and take full advantage of business opportunities.⁷⁸

However, this needs to be balanced against a review by the Scottish Parliament’s Finance Committee that found some evidence that public sector project management skills had matured enormously over the previous 10 years, and that generally none of the potential value-for-money benefits were uniquely available from a PFI, since other procurement routes could potentially offer those benefits.⁷⁹

The Audit Commission has also found, in relation to a review of schools that had been traditionally funded against PFI schools, that not all the value-for-money benefits cited by the Government are yet evident, apart from the fact that the PFI achieved long-term committed funding for maintenance over the life of the schools.⁸⁰

The Association of Chartered Certified Accountants has also questioned the value of the public sector comparator, maintaining that it quickly becomes out of date, making it impossible to compare the actual costs of PFI, and consequently value for money, against the original public sector comparator.⁸¹

⁷⁵ *Examining the value for money of deals under the Private Finance Initiative*, UK National Audit Office, August 1999.

⁷⁶ *PFI: meeting the investment challenge*, HM Treasury, July 2003.

⁷⁷ Sir John Bourne, Comptroller and Auditor General, National Audit Office, 2004 National Audit Office PFI/PPP Conference.

⁷⁸ *Public Private Partnerships: The Government’s Approach*, HM Treasury, 2000.

⁷⁹ *Report on Public Private Partnerships*, Scottish Parliament Finance Committee, 5th Report, 2002, Volume 1.

⁸⁰ Summary, *PFI in Schools*, Audit Commission, 30 January 2003.

⁸¹ *Evaluating the operation of PFI in roads and hospitals*, Edwards, Shaoul, Stafford, and Arblaster, ACCA Research Report No. 84, 2004.

Finally, the track record in relation to PFIs in the UK is also quoted as a reason for opting for this approach to contracting. Research commissioned by the Treasury concludes that the PFI is delivering savings of 17% over traditional forms of procurement, and that PFI projects are being delivered on time and on budget, significantly outperforming non-PFI projects on both grounds.⁸²

This research needs to be qualified by findings of the Treasury in relation to smaller projects (capital values below £20 million), where it has found that procurement times for small projects were broadly similar to that of larger projects, “meaning that times were disproportionately long” and costs “disproportionately high”.⁸³

Conclusions

Because of the long-term nature of PFI projects and the complexity of the arrangements, it has proved very difficult yet in the UK to arrive at uncontroversial judgements on the extent to which PFI has achieved the benefits claimed for it. However, as the Audit Commission commented on its review of schools:

There is important learning from these early PFI schemes ... learning from experience should strengthen the skills of PFI procurers and improve providers' understanding of client needs, leading to faster delivery and lower costs...

In other words, PFI needs to be allowed “to come of age and prove its potential to ... [improve] value for money”.⁸⁴

The Treasury also acknowledges that further research will continue to be needed as projects have longer periods of operation. It identifies that, in the early performance of the PFI, expected benefits did not eventuate, and its review in 2000 brought a new focus to “learning the lessons of the past”.⁸⁵

82 *PFI: meeting the investment challenge*, HM Treasury, July 2003.

83 *Ibid.*

84 *Summary, PFI in Schools*, Audit Commission, 30 January 2003.

85 *Public Private Partnerships: The Government's Approach*, UK Treasury, 2000.

Appendix 8

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