



COMMONWEALTH GRANTS COMMISSION

PRIVATELY FINANCED PROJECTS

DISCUSSION PAPER CGC 2003/07

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INTRODUCTION

1. Privately financed projects (PFPs) are initiatives jointly undertaken by governments and private sector consortia. The consortium commits to providing a service stream (which includes the use of capital) in return for a long term payment stream (which is dependent on service quality) from the government. Governments can benefit by accessing services on a value for money basis¹ without increasing their level of debt, and may be able to bring projects forward. The private sector operators can benefit from the relative certainty of future revenue and the opportunity for associated commercial activities². Attachment A provides a range of views on the likely benefits of PFPs for governments. PFPs can be used for economic infrastructure (where revenue is generally provided by users) and social infrastructure (where revenue is generally provided by the government).

2. The use of PFPs is growing. All States have PFP guidelines and many States are undertaking at least one such project (see Attachment B for a selection of projects and Attachment C for a range of views on the likely take-up rate of PFPs).

3. The Commission considers that PFPs are now part of the standard policy approach to capital procurement because:

- (i) all States aim to procure capital in the most cost-effective manner possible and PFPs are one way of helping to achieve that aim; and
- (ii) most States are preparing (or have prepared) guidelines for the use of PFPs and would consider this approach subject to viability.

The Commission's approach

4. In January 2003, the Commission distributed a discussion paper on PFPs³. It invited the States to provide their views on:

- (i) the appropriate classification of PFP expenses;
- (ii) the appropriate treatment of privately financed and funded roads; and
- (iii) the possible existence of scale disabilities.

5. In that discussion paper, Commission staff proposed that:

- (i) the relevant portions of PFP payments be classified as depreciation, debt charges and other service delivery expenses, with these

¹ Value for money refers to savings as well as benefits such as risk transfer and innovation.

² For example, they may be able to operate after-school care services at a school.

³ CGC Discussion Paper 2003/01 *Privately Financed Projects*.

contributing to the standards for the relevant categories (consistent with the likely future Australian Accounting Standard); and

- (ii) privately financed and funded roads be excluded from the assessments.

Both of these proposals met with a high level of support from the States.

6. On the possible existence of scale disabilities, Commission staff were unable to judge whether scale disabilities should be introduced to allow for differences between the States in their ability to access PFPs or in the relative costs associated with using PFPs. States were invited to provide their views on whether disabilities existed and how any disabilities might be measured. The States were divided on those matters.

7. The discussion paper also invited States to indicate whether a part of accommodation leasing costs should be classified as depreciation and debt charges expenses. This issue was only addressed by Western Australia which supported the continued assessment of accommodation lease costs within recurrent expenditure categories. The Commission supports this view and it is not discussed further in this paper.

8. The rest of this discussion paper responds to the views and evidence presented by the States in their rejoinder submissions. It covers the issues of:

- (i) whether needs should be assessed for differences among the States in their ability to realise savings from using PFPs;
- (ii) whether an adjustment to the administrative scale disability factor is necessary to reflect the extra fixed costs associated with States being prepared to use PFPs; and
- (iii) the classification of PFP payments in the Commission's equalisation budget.

9. Consistent with the general view that the equalisation budget should be confined to transactions that have a direct effect on the States' operating statements, we intend to exclude privately owned toll roads from the roads assessment. That issue is discussed further in the draft assessment paper on the roads assessment.

10. The remainder of this paper discusses the Commission's views on the existence of scale disabilities and the appropriate classification of PFP expenses.

POSSIBLE SCALE DISABILITIES

11. The Commission is satisfied that there is a conceptual case for the assessment of needs relating to differences among States in their ability to realise savings from PFPs. Current indications are that these needs could be material (and are likely to grow in the future). However, the currently available data would not be sufficient to assess them with a high degree of confidence.

Should a disability be assessed?

12. In determining whether a disability should be assessed for each State's ability to realise savings, the assessment guidelines outlined in the Commission staff *Information Paper CGC2002/1* were applied. These state that a disability should be assessed where a number of conditions are met.

(i) *There must be a conceptual basis for the existence of a disability — implementing the standard policy results in different per capita levels of expenditure for each State.*

- The use of PFPs constitutes a standard policy because the three most populous States are using PFPs and many of the other States are preparing (or have prepared) guidelines covering their use. The less populous States would use them if they were viable.
- The use of PFPs can provide more value for money than alternative public sector provision, in some cases.
- PFP arrangements appear to be more accessible to the larger States, resulting in different per capita levels of expenditure among the States to provide the same level of service.

(ii) *There is empirical evidence that the differences being examined affect the costs of provision of State services (through different levels of use of the service or different unit costs in providing the services). OR*

There is incomplete evidence that additional use and/or costs are incurred, but: the case is strong in logic; the Commission judges that sufficient evidence exists; and the Commission judges that including the factor will increase the likelihood that HFE will be achieved.

There is a logical case that the less populous States are disadvantaged by their lesser ability to access PFPs. The observation that they have not entered any PFPs provides some support for that conclusion. However, the empirical data available to measure the extent of the disadvantage is limited. The information that is available suggest that, depending on the project and other circumstances, potential savings could range between two and 30 per cent (see Attachment A). However, it is not clear exactly what these figures reflect. Nor is it possible in the early stages of a project to know whether benefits will be sustained over the life of the project.

Nevertheless, the Commission considers that including a factor for States' abilities to realise cost savings from PFPs would increase the likelihood that HFE will be achieved. It is also open to the possibility of adjusting the administrative scale assessment to reflect some of the costs associated with PFPs.

- (iii) *The disability factor is material, either because it is large or has a large impact on HFE based funding.*

This will depend on the take-up rate of PFPs and the average level of benefits secured by them. Neither is clear at this stage. With the information presently available any disability factors could only be estimated by judgement. Attachment D contains some illustrative calculations showing the order of magnitude of possible effects of assessing factors under a range of assumptions about the extent of benefits from the use of PFPs and the likely extent of use of PFPs (as a proportion of State capital stock).

- (iv) *The margin of error associated with the disability's application is acceptably small.* At this point, the Commission is confident about the direction of the effect for most States but the size of the effect would depend on judgement.

Before it makes an assessment, the Commission would need more evidence of the level of benefits derived for both social and economic infrastructure. At this point, the data on projected savings provide little information on the nature of projects involved, what the benchmarks were and how the savings were derived. The Commission has little information on project-specific savings in Australia, as opposed to broad estimates of savings based on British experience.

State views

13. States were asked whether some States face higher fixed costs in developing and managing PFPs or have less ability to realise savings from PFPs. There was a range of views on this matter. States were also asked to provide relevant data and proposals for assessing any disadvantage.

14. ***New South Wales.*** New South Wales argued that assessing needs for the use of PFPs would discourage efficient and innovative approaches to infrastructure provision. By redistributing the benefits of PFPs, the Commission would provide a disincentive for States to use them.

15. It also said any scale disability would be both small and declining. It noted that larger States were willing to share their expertise with smaller States. The threshold for a viable project should be falling, and packaging projects would also assist smaller States to undertake PFPs. It said that, even if there were barriers to the use of PFPs, only a small margin of savings (around five to 10 per cent) would be foregone.

16. ***Victoria.*** Victoria argued that no scale disability should be assessed because:

- (i) PFPs can be undertaken by any State (Victoria has undertaken many PFPs of between \$10 and 20 million);
- (ii) smaller States can undertake PFPs jointly with other States; and

- (iii) smaller States can use the documentation and expertise of larger States.

It emphasised that any disability should be grounded in strong quantitative evidence.

17. **Queensland.** Queensland argued that it was too early to judge whether small States would face significant disabilities in attracting PFPs.

18. **Western Australia.** Western Australia supported the assessment of a disability. It noted the high administration costs associated with PFPs, and argued that those costs were relatively fixed, resulting in a scale disability for the less populous States. It said that there would be few opportunities to undertake PFPs in partnership with other States.

19. **South Australia.** South Australia argued that the administrative scale factor should be adjusted to reflect the fixed costs involved in the development stage of projects and in ongoing contract management costs. It also argued that small States are disadvantaged in their access to PFPs, but was unsure how this could be addressed by the Commission. On a different issue, it also noted that small States would be disadvantaged in the interest component of leasing costs.

20. **Tasmania.** Tasmania argued that PFPs were likely to generate savings for governments, or at the very least, bring projects forward. Smaller States appear to have less access to such arrangements due to diseconomies of scale. Also, an adjustment to the administrative scale disability should be made to allow for the administrative costs of PFPs.

21. **Australian Capital Territory.** The ACT argued that its smaller capital requirements reduced its ability to gain savings from PFPs. For example, it requires a new school only every two to three years so it could not bundle several schools as New South Wales has done. Administration costs would also be relatively high for both government and the private sector. The private sector costs of bidding for a PFP have been estimated to be ten times that of standard construction projects. The savings from the use of other States' documentation are negligible compared with the annual savings gained by large States from PFPs.

22. **Northern Territory.** The Northern Territory argued that it faced a clear disadvantage in accessing PFPs due to its small and dispersed population, its small and less sophisticated private sector and its distance from interstate providers. It was also less likely to gain cost savings from PFPs because of the relatively high administration costs. It dismissed the likelihood of joint projects with other States because of its location and the competitive objective of some projects (such as convention centres). Documentation generated by other States would have only limited relevance for the Northern Territory due to its different economic and social infrastructure requirements.

Comments

23. The use of PFPs constitutes a standard policy because the three most populous States are using them as a means of obtaining capital and services and most of the

other States are preparing (or have prepared) guidelines for their use. Thus it is appropriate that the effect of PFPs on State budgets be reflected in the Commission's assessments and that it consider whether needs should be assessed for differences between States in their ability to realise savings by using PFPs.

24. Since the assessments would be based on the assumption that all States apply the standard policy (the assumption that underlies all the Commission's assessments), there would not be any disincentive effects to their use. Each State would have its grant share based on the assumption that it is obtaining the average level of efficiency gains from PFPs, except to the extent that the Commission decided to assess disabilities to allow for the possibility that for reasons beyond their own control some States could not access such efficiency gains.

25. The arguments advanced during this review and the evolving experience of States with the use of PFPs indicate that it is possible, and probably likely, that the less populous States would for reasons beyond their control face disadvantages in accessing competitively priced PFPs. The observation that they have not entered PFPs suggests that is the case. The disadvantages could arise in the form of relatively higher per capita administrative overheads and a relatively lower ability to realise savings, partly because the size of their markets constrains their ability to obtain an optimal allocation of risks. The case for disabilities relating to administrative scale and ability to realise savings is considered in more detail in the following sections.

Administrative scale

26. Should the Commission adjust administrative scale disabilities to reflect the impact of PFPs? There is a case for such an adjustment if it can be shown that:

- (i) PFP readiness requires a net increase in minimum fixed costs; and
- (ii) this increase is not included in the estimated fixed costs proposed for use in setting the Administrative Scale disability for the 2004 Review.

27. The administrative scale factor is intended to reflect the minimum fixed costs States need to incur to establish the policy making and administrative infrastructure needed to provide each service. It is not intended to reflect all the head office or administrative costs associated with providing each service. Many of those costs tend to vary with the size of the task being provided and for assessment purposes are included in the relevant service delivery cost components where they are subject to disabilities that reflect interstate differences in the size of the task.

28. It is logical to assume that PFP readiness will require extra expertise in the Treasury and/or State development departments and that this will result in a net increase in staff. Since the guidelines and policies established by the larger States would be available to other States and could form a base for their own work, it is possible that the minimum fixed costs associated with maintaining 'PFP readiness' could be a comparatively small number of extra staff.

29. Whether the use of PFPs would add to the fixed costs of functional departments would depend on whether the financial procedures States normally adopt centralise or decentralise work associated with financing capital acquisitions or major projects. Any project related costs arising from the actual use of PFPs would be classified to service delivery expense components of the relevant category.

30. Whether the effects on fixed costs are sufficiently material to require explicit allowance to be made in the assessments is not clear. The minimum fixed costs of State treasury and State development departments are included in the Commission's General Public Services category. That category contains a relatively large fixed cost component of \$46 million.

31. Since the assessment of fixed costs is based primarily on judgement, the Commission is hesitant to make an explicit adjustment to reflect the fixed costs associated with PFPs. However, the Commission will make a decision on this issue after considering any further arguments and data provided by the States.

Ability to realise savings

32. According to stakeholders, the principal reason for governments to undertake PFPs is to improve value for money. This is achieved through:

- (i) cost reductions (a cheaper product);
- (ii) risk transfer (reduced likelihood of unexpected expenses); and
- (iii) innovation and incentive-based payments (a better product).

33. Each of these can have an impact on State government expenses. Cost reductions enable a government to provide services more cheaply. Risk transfer provides more certainty about future costs and should result in the party best equipped to manage risk holding it (thereby reducing the likelihood of future costs). Across projects and over the long term, this should result in savings for governments. As noted in a publication by the Parliamentary Library⁴:

Risk can take many forms including those relating to construction, the size of the market (demand risk), the cost of operations and maintenance, declarations of force majeure, and changes to the law and regulations.

Finally, higher quality equates to a cost saving because it means that, for a given price, a government can provide a better standard of service.

34. Whether the Commission should assess needs for differences in States' abilities to realise savings from PFPs depends on whether it:

⁴ Webb, R. and Pule, B., 'Public Private Partnerships: An Introduction', Research Paper no.1 2002-03, Department of the Parliamentary Library.

- (i) concludes that there are differences between States in their ability to access PFPs — that is, there is a conceptual case for the disability;
- (ii) can establish that the effects are material and that it can measure them with a reasonable degree of confidence — implying that it can establish the level of savings stemming from PFPs and the extent of their use.

35. The first step in addressing these issues is to decide whether less populous States are less likely to realise savings because they are unable to generate projects of a sufficient size to:

- (i) interest the private sector; or
- (ii) result in good value for the government after all of the associated costs are considered.

36. ***Private sector viability.*** The literature suggests there is no precise threshold for private sector interest in potential PFPs. That threshold can be influenced by many things, such as the nature of the project. It is possible that viability thresholds for both parties will fall as they gain experience and trust, and a ‘pipeline’ of projects develops.

37. Bidding for projects can be very time-consuming and expensive (the tendering process for the New South Wales schools project took about 16 months). Some earlier material suggested that the viability threshold was around \$100 million⁵ but more recent discussions with financiers and developers⁶ have indicated that:

- (i) the threshold for one financier could be about \$50 million, but could be less if the project was very straightforward — a project of less than \$20 million was said to be unviable; and
- (ii) associated commercial opportunities could lower the viability threshold.

38. The transaction costs that drive viability thresholds include financial, legal, tax and accounting advice, compliance with regulation and contract management.

39. ***Public sector viability.*** To a large extent, the viability of projects will be determined by whether they generate private sector interest. However, governments also consider whether a project is sufficiently large to warrant their administrative costs. The following information is taken from the States’ guidelines:

⁵ Malone, N., ‘States’ use of privately owned assets in the provision of government owned services’, report to the Commonwealth Grants Commission, November 2002, p. 16.

⁶ A member of the Commission’s staff attended a conference on PFPs in Sydney in May 2003 at which this issue was discussed.

- (i) New South Wales's guidelines advise that projects would normally have a contract value of at least \$20 million⁷;
- (ii) Victoria's guidelines specify a threshold of \$10 million in net present cost terms for projects⁸; and
- (iii) Queensland's guidelines refer to projects where the expected capital value will exceed \$30 million or the net present value of the project will exceed \$50 million during the term of the contractual relationship⁹.

40. It is reasonable to assume that larger States will be able to meet viability thresholds more often and more easily than smaller States. For example, the New South Wales schools project involves nine schools. It is very unlikely that the less populous States would need such a large number of schools at the same time.

41. It has been argued that smaller States can enhance the PFP viability of their infrastructure needs through such measures as:

- (i) bundling projects (perhaps with other States);
- (ii) standardising contracts;
- (iii) changing procedures so that more details are resolved after financial close (reducing tendering costs); and
- (iv) facilitating third party use of infrastructure on a commercial basis.

42. The practical ability of the smaller States to adopt those mechanisms was strongly contested in submissions to this review, Commission conferences and other discussions. In addition, such mechanisms would not entirely relieve smaller States of relative disadvantage because they are also available to larger States. If the latter were also to use these mechanisms, their rate of savings could be assumed to increase further (leaving smaller States behind). If we accept that PFPs provide savings in some circumstances, it follows that smaller States will be disadvantaged in their capacity to provide services and that there is a conceptual case for assessing a disability.

43. However, it is unclear exactly which States would have positive needs. One possibility would be to assume that the States with positive administrative scale needs would also have positive needs arising from the relative inaccessibility of PFPs.

44. The second step in deciding whether to assess a disability is to establish the materiality of any disability and the extent to which PFPs give rise to savings. Participating States, infrastructure organisations and potential service providers are confident that PFPs

⁷ New South Wales Government, 'Working with Government: Guidelines for Privately Financed Projects', November 2001.

⁸ Victorian Government, 'Partnerships Victoria: Practitioners' Guide', 2001.

⁹ Queensland Government, 'Public Private Partnerships: Guidance Material', August 2002.

can generate savings, and much recent public administration theory concurs. However, it is not a unanimous view. Caution is necessary because:

- (i) it is to the commercial advantage of some parties to argue that PFPs result in value for money for governments;
- (ii) social infrastructure projects are still in the early stages, so it is not yet possible to be certain of savings for whole-of-life costs or quality comparability;
- (iii) full costing of PFP expenses (including in-house costs such as ongoing contract management) are often not made public; and
- (iv) it is not clear that cost comparisons of PFPs and traditional procurement compare like with like.

45. Obtaining details of potential savings from PFPs is difficult. For example, a recent OECD report on PFPs in the United Kingdom said:

Unfortunately, there is a lack of systematic evaluations of the results from PPP projects ...and...it is still too early to judge whether savings can be maintained in the long run as many contracts are still in their early stages. The potential for future savings could be undermined by the long time horizon of contracts.¹⁰

46. Nevertheless, Attachment A provides different estimates of savings from PFPs. Those estimates range from two per cent to 30 per cent.

47. The following points are relevant to the interpretation of those figures.

- (i) The figures are estimates and the information is often not sufficient to determine what the benchmark is in each case, what types of projects they relate to or whether the various figures are comparable.
- (ii) Many of the higher figures are based on analysis of PFPs in the United Kingdom and may not be fully transferable to Australia because the nature of the projects differs and taxation provisions in the United Kingdom may differ from those in Australia.
- (iii) There seems to be a broad acceptance that economic infrastructure projects, especially self-financing projects such as toll roads appear to offer States the highest potential gains¹¹ — such infrastructure expenses are not always subject to equalisation.

¹⁰ *OECD Economic Surveys: United Kingdom*, OECD, Paris, 2002, pp. 120-121.

¹¹ Malone, N., 'States' use of privately owned assets in the provision of government owned services', report to the Commonwealth Grants Commission, November 2002, p. 16.

48. Examples of potential savings from Australian social infrastructure projects are:

- (i) the Berwick Community Hospital project — expected to generate savings of between two and six per cent¹²;
- (ii) the Victorian County Court project — the business plan suggested savings of about two per cent and subsequent informal analysis suggested additional savings in the vicinity of five per cent from risk transfer¹³; and
- (iii) the New South Wales schools project — expected to save four per cent of the cost of the public sector undertaking the operation.¹⁴

49. ***Difficulties of assessing needs.*** Should the Commission decide to assess needs for differences in the ability of the States to realise savings, it would need to resolve the following issues:

- (i) which expenditure categories would be affected — PFPs can affect the costs of obtaining capital (implying the depreciation and debt charges categories could be affected) and in some cases service delivery costs¹⁵ (implying costs could be affected in one or more of the education, inpatients services, roads, housing, concessions and other payments, administration of justice and corrective services categories);
- (ii) what would be the standard rate of savings; and
- (iii) what would be the standard ‘take-up’ rate for projects that affect services included in the equalisation budget during the review period?

50. Attachment D provides illustrative calculations of the order of magnitude of disabilities that could be assessed under a range of assumptions relating to the rate of savings from PFPs and the take-up rate.

Commission decisions

51. There appears to be sufficient information to indicate that there is a conceptual case that, for reasons beyond their own control, the less populous States have a relatively lower access to viable PFPs. It is likely that such disabilities would result in them having:

- relatively higher non-project related administrative costs; and

¹² Comments by PWC representative at Sydney PFP conference, 2003.

¹³ Comments by Victorian Government representative at Sydney PFP conference, 2003.

¹⁴ Wainwright, R and Doherty L. ‘Public Schools in Private Hands’ *Sydney Morning Herald*, 4 December 2002. It is not clear whether these savings take account of in-house costs.

¹⁵ Value for money could be expected to apply to recurrent costs such as cleaning, maintenance and security, as well as capital costs.

- relatively lower abilities to access the savings opportunities that appear to be provided by PFPs.

52. However, before disabilities would be assessed, the Commission must conclude that their likely impact would be material and that it could estimate the effect with an acceptable level of confidence. Those tasks are made difficult by the facts that the States made limited use of PFPs in relation to services included in the equalisation budget for the years of assessment for this review and little information is currently available on the savings rates from PFPs.

CLASSIFICATION OF EXPENSES

53. States were asked whether they supported the proposal that depreciation and debt charges expenses from PFPs be allocated to those categories. The aim of this would be to avoid the application of recurrent disabilities to capital-related expenses. Most States supported this approach and the proposed approach agreed by the Heads of Treasuries Accounting and Reporting Advisory Committee would facilitate it.

State views

54. ***New South Wales.*** New South Wales supported this approach to classification in principle. However, it was no longer confident that it would be able to identify such expenses separately from other expenses (such as cleaning or maintenance). It was also concerned that, until an Australian Accounting Standard was adopted, States might take different approaches. New South Wales argued that this could lead to a distortion of grant shares and asked the Commission to rectify this.

55. ***Victoria.*** Victoria supported the proposal that relevant expenses be classified to the depreciation and debt charges categories (where infrastructure is not funded through user charges). Victoria also argued that each PFP should be considered individually and that, contrary to the view put by New South Wales, a ‘purchasing’ decision for economic infrastructure may be contingent on the use of a PFP.

56. ***Queensland.*** Queensland emphasised the importance of consistent and policy neutral treatment of infrastructure. It supported the proposal to classify appropriate expenses as depreciation and debt charges expenses, noting that this would depend on the detail of the Australian Accounting Standard to be adopted.

57. ***Western Australia.*** Western Australia supported the proposal to classify expenses as depreciation and debt charges to the extent that they are treated this way in public accounts.

58. ***South Australia.*** South Australia said that the proposed treatment of PFP expenses and privately financed and funded roads is consistent with the Commission’s general approach to defining what States do. However, it suggested that a better approach might be to measure what States do in terms of activities rather than what is shown on the

operating statement. This would discourage States from manipulating grant shares by moving expenses on or off the operating statement. Under its approach, ‘what States do’ would not be confined to transactions recorded on the operating statement. South Australia noted, this was the case with grants treated by exclusion and some Commonwealth Own Purpose Outlays (COPOs). Toll roads would be excluded if tolls were regarded as a voluntary transaction but not just because toll revenue did not pass through government accounts.

59. **Tasmania.** Tasmania agreed with the proposal that PFP expenses be classified as depreciation and debt charges to the extent that this was reflected in government finance statistics.

60. **Australian Capital Territory.** The ACT supported the proposal that PFP expenses be classified as depreciation and debt charges. However, it noted that such an approach had yet to be endorsed by the Heads of Treasury Accounting and Reporting Advisory Committee and advised the Commission to refrain from committing itself to this approach until this had occurred. The ACT also argued that revenue generated from third party use of ‘public’ infrastructure should be excluded from the assessments.

61. **Northern Territory.** In the absence of a scale disability being assessed and the absence of an Australian Accounting Standard, the Northern Territory opposed the classification of PFP expenses as debt charges or depreciation. The Northern Territory suggested that if a State exercised discretion over the classification of expenses, it might use classification to maximise its grant share. The Northern Territory also argued that PFPs relieved States of depreciation and debt charges expenses and that each PFP would have a unique set of characteristics that could be relevant to its treatment in the assessment framework (for example, a school provider could hold economic rights to activities associated with the school).

Comments

62. Most States supported the proposal that PFP payments be dissected and classified to reflect the allocations between depreciation, debt charges and other operating expenses. That approach would be supported by the proposed Australian Accounting Standard. The Heads of Treasuries Accounting and Reporting Advisory Committee has agreed on a preferred approach, Heads of Treasury have endorsed it, asked for practical guidance material to be developed and forwarded the proposal to the Australian Accounting Standards Board to consider. At this stage, PFPs represent less than 10 per cent of new capital expenditure in New South Wales (and significantly less of accumulated capital expenditure). Even if States are not classifying expenses in accordance with the proposed Australian Accounting Standard, any distortion is likely to be relatively small at this time.

63. The adoption of a standard approach to accounting for PFPs would help to ensure that expenses are classified to the appropriate GFS categories and would remove the need to consider PFPs individually. If the proposed standard does not proceed as expected, and States do not develop a consistent method of allocating expenses, the Commission would need to re-visit this issue.

64. At this point in the review process, the Commission does not support South Australia's proposal to re-define the scope of standard expenses. It intends to base the scope of the equalisation budget on the range of transactions that directly affect State operating accounts. If a significant inconsistency in the treatment of expenses or revenues across States were to be identified in relation to depreciation or debt charges, the Commission could make an adjustment. However, at this stage, there is no suggestion that States are manipulating the standard budget through the classification of expenses.

65. The Northern Territory's proposal to remove PFP related expenses from GFS would be cumbersome and would be counter to the Commission's intention of treating expenses consistently. Nor does the Commission accept the Northern Territory's argument that PFPs may relieve States of depreciation and debt charges expenses. States still incur these costs in some form. For example, strictly speaking, depreciation may not be applied until the government takes ownership of the asset. However, it will have been paying for the use of the asset since it began using it. Regardless of how capital is purchased, States will have to pay for its provision and (in the case of social infrastructure) financing.

66. The Commission also does not accept that it is necessary to net third party user charges from government expenses as suggested by the ACT. The extent to which commercial opportunities relieve States of depreciation and debt charges expenses should be reflected in States' payments to PFP providers.

Commission decision

67. The Commission expects that the adoption of the proposed Accounting Standard will result in GFS data provided to the ABS by the States including a consistent classification of expenses associated with PFPs to depreciation, debt charges and other service delivery categories as appropriate. The Commission therefore proposes to use GFS data to establish the standard expenditure on depreciation and debt charges. It considers that GFS is the most reliable source of data available and that it would be impractical to attempt to 'improve' it by making adjustments based on individual PFPs. If the proposed Accounting Standard is not adopted, the approach proposed by the Commission would need to be reviewed.

CONCLUSIONS

68. PFPs present potential challenges for the Commission because they may result in:

- (i) different costs and benefits for States; and
- (ii) different accounting treatment from traditional procurement methods.

69. On the matter of the impact of differences between the States in costs and benefits, the Commission's current thinking is as follows.

- It is standard policy to use PFPs where possible — it is what States do. Therefore, there is an in principle case for considering whether needs should be assessed for differences between States in costs that may arise for reasons beyond the control of individual States.
- There is evidence to support the conclusion that the States do not operate on a level playing field when it comes to implementing and benefiting from PFPs.
- Such differences between States could be material because PFPs can involve significant amounts of money.
- There is a conceptual case for assessing needs relating to differences in States' abilities to realise savings from PFPs. Such needs could be assessed by adjusting the administrative scale disabilities for some categories and/or including a disability for differences in the ability to realise savings.
- However, information on the rate of potential savings in Australia and the level of use of PFPs needed to make an accurate assessment of disabilities is in limited supply.
- The Commission intends to re-visit this issue in the light of further input from the States.

70. The work by Heads of Treasury on Accounting Standards suggest that the Commission does not need to change its approach to classification at this time. However, if the proposed Australian Accounting Standard is not implemented, the issue may need to be re-visited.

ATTACHMENT A VIEWS ON VALUE FOR MONEY FROM PFPS

Table A-1 VIEWS ON VALUE FOR MONEY FROM PFPS

| View | Source |
|---|---|
| Nine public schools being built and maintained by the private sector in NSW will save four per cent over the government having built them. | Wainwright, R & Doherty L. 'Public Schools in Private Hands' <i>Sydney Morning Herald</i> , 4 Dec 2002 p. 1. |
| "..smaller projects under \$100 million in bid size are at the moment doubtful as to whether they can be commercially attractive." | Dennis O'Neill, CEO, the Australian Council for Infrastructure Development. Allen, L 'Financiers fired up on future of PPPs' <i>Australian Financial Review</i> 23 May 2003 p. 69. |
| PPPs often produce optimised outcomes with better value for taxpayers. | Dennis O'Neill, CEO, the Australian Council for Infrastructure Development. <i>Australian Financial Review</i> 16 April 2003. |
| "..the partnership approach is the best prospect of considerable savings in public money." | Alan Moran, director of the Deregulation Unit at the Institute of Public Affairs. |
| The empirical evidence suggests savings of two to six per cent from the Berwick project. | PWC representative, Sydney PFP conference, 2003. |
| The business plan for the Victorian County Court project indicated savings of two per cent less than the financial benchmark, and subsequent informal analysis suggested additional savings due to risk transfer in the vicinity of five per cent . (It is not clear whether the savings consider contract management costs.) | Victorian Government representative, Sydney PFP conference, 2003. |
| The savings from using a PFP are likely to be at least 20 per cent | Macquarie Bank. |
| The Queensland Government says 20 per cent possibly up to 30 per cent , and says other State governments are working on this range. | Professor Ken Wiltshire. |
| 20 per cent over the life of the project. ¹⁶ | UK National Audit Office. |
| Around 17 per cent but higher for tollroads. | Arthur Andersen/LSE. |
| "Savings have been modest at best." | Tony Harris, quoted in Morris, L. 'A capital idea' <i>Sydney Morning Herald</i> 6 July 2002. |
| The Spencer Street Station will relieve tax payers of "\$100 million that ..(they)..would otherwise have to bear." | Brumby, J & Batchelor, P. 'Why the Spencer Street Station deal is good for all.' <i>The Age</i> . 6 July 2002. |

Note: Some of these estimates would include savings generated from projects to provide economic infrastructure such as toll roads, which are expected to be higher than savings for social infrastructure. Much of this infrastructure would not be included in the Commission's equalisation framework.

¹⁶ It has been suggested that savings may be higher in the UK due to differences such as taxation laws and previous levels of outsourcing.

ATTACHMENT B
SELECTION OF PFP PROJECTS

1. The following list provides an indication of the kinds of projects being undertaken or considered:

- (i) in New South Wales, the Cross City tunnel, Lane Cove tunnel and Western Sydney Orbital, the New South Wales New Schools Privately Financed Project and Royal Prince Alfred Hospital Car Park, Western Region Correctional Centre (approved but not in market place);
- (ii) Victoria's County Court, Berwick Community Hospital, prisons at Deer Park and Lara, Box Hill and Alfred Hospital car parks, film and television studio complex at Docklands and Spencer Street Station re-development;
- (iii) Queensland's Southbank re-development and possible projects such as the Noosa Hospital re-development, the Dalrymple Bay coal terminal, the Petrie to Kippa ring railway and the Gateway Bridge; and
- (iv) the Alice Springs to Darwin railway in the Northern Territory.

ATTACHMENT C
VIEWS ON TAKE-UP RATES OF PFPS

1. The following table outlines some views on the likely take-up rate of PFPS.

Table C-1 VIEWS ON TAKE-UP RATES OF PFPS

| View | Source |
|---|---|
| Over the ten years ended 1999-2000, the contribution of private sector funding to infrastructure provision in NSW was equivalent to 7% of the State's capital budget . | Malone, N., 'States' use of privately owned assets in the provision of government owned services', report to the Commonwealth Grants Commission, November 2002 p. 28. (Source: NSW Government. <i>Working with Government. Private Financing of Infrastructure and Certain Government services in NSW</i> , November 2000.) |
| PFPS commitments in New South Wales, Victoria and Queensland combined amount to about nine per cent of combined capital expenditure | |
| Over the next four years States expect to consider prospective projects valued at about \$13 billion — of which \$9.75 billion is in New South Wales and Victoria. | Malone, N., 'States' use of privately owned assets in the provision of government owned services', report to the Commonwealth Grants Commission, November 2002, p. 29. |
| 'University of Queensland business school professor Kenneth Wiltshire said about 10 percent of new infrastructure projects were designated for PFPS. "Many analysts are predicting this will rise to 50 per cent over the next five years", he said.' | Allen, L 'Financiers fired up on future of PFPS' <i>Australian Financial Review</i> . 23 May 2003 p. 69. |
| Tony Poulter from PricewaterhouseCoopers 'predicted the Australian market would grow from four deals last year to 15 PFPS deals by 2005 .' | Strutt, S. and Allen, L., 'Qld unions label PFPS a waste.' <i>Australian Financial Review</i> . 15 April 2003. |
| NSW announced a 10 year strategic blueprint for about 300 PFPS proposals worth more than \$20 million each. | Hepworth, A. 'NSW Labour wants private input' <i>Australian Financial Review</i> . 20 December 2002 p 4. |
| Emerging PFPS proposals for the next four years were worth approximately \$4 billion. | |
| "It is forecast that some 20 per cent of Australia's infrastructure will be managed by PFPS mechanisms in the near future." | <i>Public Infrastructure Bulletin</i> . Australian Centre for Public Infrastructure. Issue 1, March 2003 p 11. |

ATTACHMENT D

ILLUSTRATIVE CALCULATIONS OF DISABILITIES

1. This attachment outlines some calculations that illustrate possible orders of magnitude for needs associated with differences between States in their ability to realise savings from PFPs, under a range of assumptions. A possible calculation approach could proceed in the following way.

2. First, it would identify the average level of value for money benefits derived from PFPs. Ideally, the Commission would base an assessment on firm information about the particular savings achieved by PFPs. However, the use of PFPs to finance social infrastructure projects is a recent development. These illustrations apply a range of assumed savings rates.

3. Second, it would identify the categories in which to assess needs. Affected categories would include depreciation and debt charges, as well as repairs and maintenance expenses affecting a number of categories. For simplicity, the following illustrative calculations assume that needs would only be assessed in the Depreciation and Debt Charges categories.

4. Third, it would derive the percentage of depreciation and debt charges expenses that would arise from PFP needs. For simplicity, the illustrative calculations have applied the same percentage to standard expenses in both the Depreciation and Debt Charges categories. In selecting the range of take-up rates used in the illustrative calculations account was taken of the available data on the take-up rate in the past 10 years and the fact that the depreciation and debt charges assessment reflect 30 years of capital expenditure.

5. Fourth, the Commission would have to identify the States for which needs should be assessed. For these illustrative calculations, it has been assumed that these would be the scale affected States — Western Australia, South Australia, Tasmania, the ACT and the Northern Territory.

6. Table D-1 illustrates the potential grant share effects of five scenarios:

- (i) four per cent savings applied to two and a half per cent of depreciation and debt charges expenses;
- (ii) four per cent savings applied to five per cent of depreciation and debt charges expenses;
- (iii) eight per cent savings applied to five per cent of depreciation and debt charges expenses;
- (iv) sixteen per cent savings applied to ten per cent of depreciation and debt charges expenses; and

- (v) thirty-two per cent benefits applied to twenty per cent of depreciation and debt charges expenses.

Table D-1 ILLUSTRATIVE REDISTRIBUTION ARISING FROM ALTERNATIVE DISABILITIES

| Assumptions | NSW | Vic | Qld | WA | SA | Tas | ACT | NT |
|---|-------|-------|-------|------|------|------|-----|-----|
| | \$m | \$m | \$m | \$m | \$m | \$m | \$m | \$m |
| four per cent benefits applied to two and a half per cent of depreciation and debt charges expenses | -0.7 | -0.5 | -0.4 | 0.7 | 0.6 | 0.2 | 0.1 | 0.7 |
| four per cent benefits applied to five per cent of depreciation and debt charges expenses | -1.4 | -1 | -0.8 | 1.4 | 1.1 | 0.3 | 0.2 | 0.1 |
| eight per cent benefits applied to five per cent of depreciation and debt charges expenses | -2.8 | -2.1 | -1.6 | 2.8 | 2.2 | 0.7 | 0.5 | 0.3 |
| sixteen per cent benefits applied to ten per cent of depreciation and debt charges expenses | -11.5 | -8.4 | -6.4 | 11.4 | 9.0 | 2.8 | 2.0 | 1.2 |
| thirty-two per cent benefits applied to twenty per cent of depreciation and debt charges expenses | -47.7 | -34.9 | -26.4 | 47.2 | 37.4 | 11.6 | 7.9 | 4.9 |

Note: Any assessment for the 2004 Review would use the take-up rates for the five review years (adjusted to reflect the value of this capital as a proportion of all capital being depreciated). Future updates would reflect the effects of subsequent changes in take-up rates.