PPP-Lite: Tailoring Public Private Partnerships for the NZ Market[1]

Executive Summary

New Zealand has a significant need for increased investment in infrastructure. Both the public and the private sector are considering alternative methods for further private sector involvement in the infrastructure programmes, including greater use of Public Private Partnerships as a means of procurement.

The New Zealand Government has already commenced a pipeline of PPP projects and there is increasing interest in developing PPPs across the whole of government and local government sectors. However PPPs are generally considered better suited to high value large scale projects which justify the administrative overhead traditionally associated with PPPs. This raises the question as to how the benefits of Public Private Partnership (PPP) procurement models can be realised for smaller projects in New Zealand which are typically in the $30m to $60m capital cost range. This paper has assessed this issue and makes a number of recommendations for a PPP-Lite delivery approach targeted specifically at these types of projects.

The key findings are that the cost of PPPs can be reduced significantly for smaller value projects in New Zealand by:

- Reducing the number of bidders in competition to two (or no more than three) at the short listing stage
- Post bid involvement of lenders
- Publishing the evaluation criteria, including the weightings
- Publishing the affordability range
- Adopt a concept design approach
- Having a genuine interactive tendering process
- Using standardised documentation to lower legal and due diligence costs
- Providing bidding templates that only request needed information
- Avoiding duplicative best and final offer (BAFO) processes by selecting the preferred bidder and working with them to refine the offer
- Simplifying the Specifications and Payment Mechanisms
- Having simple hand back conditions that conclude at the end of the concession period

Other opportunities to reduce the overheads of PPP procurement include achieving economies of scale through developing project pipeline; bundling of projects; sharing best practise through centralised support agencies; and capitalising on commercial opportunities for third party revenues. Application of public debt and/or public sector guarantees on private capital can reduce the cost of finance but tend to mitigate the advantages associated with private sector due diligence and risk transfer. The cost advantages on this approach need to be considered on a project by project basis.

[1] This paper was developed by Jason Wozniak, Advisory Leader – New Zealand at Aurecon following a workshop with NZCID members in March 2011. For further information and advice Jason may be contacted at **wozniakj@ap.aurecongroup.com**

Introduction

An analysis of the published Government Policy Statements, the National Land Transport Programme, Regional Transport Strategies, Council Long Term Plans and other public documents indicates that there is a significant gap between infrastructure that is needed and the amount of public sector capital that is available. Over 80% of infrastructure investment proposals in New Zealand have a capital value of less than $100m. Private investment in the delivery of public infrastructure is a viable alternative to ensure infrastructure is delivered in a timely manner and achieve advantages of performance based term payment for services. However, a commonly held view is that PPPs are only suited for deals larger that circa $NZ100m in capital value. This rationale is based on the premise that the additional costs of procurement and monitoring of a PPP contract may not result in value for money to the public sector partner for smaller value projects. For many projects this is true. The problem is that there are many benefits to using PPP's and, if applied to the right projects, they can provide genuine value for money outcomes through risk transfer, private sector innovation, and whole of life integration of design, construction, finance, operations and maintenance. The opportunity or challenge is to modify the PPP procurement processes so that these benefits can be realised for smaller value projects typical of the New Zealand market. This is the reason for – "PPP Lite".

PPP Lite

This paper identifies a menu of options that can be used to reduce many of the costs that have traditionally led to high overhead costs associated with PPPs in other jurisdictions. These overhead costs have traditionally made PPPs less than suitable for small value projects. The options can be adopted in part or in whole, depending on the nature and form of the project under consideration. Each option is listed and briefly explained below:

Reduce the number of bidders in competition - Short listing two (or no more than three) bidders based on capability and experience prior to the Request for Proposal (RFP) stage will reduce bid costs for the private sector and reduce bid evaluation costs for the public sector. Whilst two bidders is considered to be a higher risk than having three bidders, two parties in competition maintains competitive tension and incentivises performance. Further amendments identified below limit the risk of one party not participating in the bid process.

Post bid involvement of lenders – In the Australian context it has been a traditional requirement of public authorities to require all project finance bids to be fully underwritten by lenders. This provides authorities confidence that the consortia will be able to raise the necessary capital to underwrite their proposal. However, it comes at a significant cost as it requires lenders to undertake full and detailed credit risk assessments for each bid. Where the contract value is comparatively low, and where suitably qualified and experienced bidders are selected at preferred bidder stage it can be argued that fully underwritten commitments to finance are unnecessary at bid stage. Instead, lenders could be asked to provide a "letter of support" for the project. This requires a lower level of due diligence than a fully risk assessed "letter of credit" thereby reducing bid costs for both bidders and financiers. Such an approach can also enable a funding competition to be held following selection of the preferred bidder, potentially reducing the cost of debt.

Publish the evaluation criteria – If the client's fundamental outcome is the lowest price whilst achieving the output specifications then the market should know this. If the requirement is maximum value i.e. achieving the highest ratio of output to cost then the market should know this. This ensures that the private sector invests its time on solutions that the client requires and aligns outcomes and effort.

Publish the affordability range, including risk adjustments and allowances for competitive neutrality. For smaller deals, when the quantum of transferred risks are lower, clients should consider the affordability criteria of the deal i.e. what amount they are prepared to pay. When combined with the evaluation criteria this ensures that the bidders are focussed on client outcomes that meet budget expectations.

Adopt a concept design approach - The PPP procurement model often requires developed designs to be submitted by all short listed respondents at the RFP stage. Design costs are a significant component of the upfront bid costs borne by the private sector. In an environment where there is a limited pipeline of projects and the projects coming to market are smaller in scale, these costs can be a deterrent to the private sector and can result in decreased competition for the project. In addition, where these costs are borne by unsuccessful bidders, they must be recouped on future projects. While the impact of this may not be evident in the short term, ultimately it has the effect of driving up total procurement costs in the long run, or forcing smaller players from the market. The public sector partner should consider reducing the pre contractual award design requirements to minimise the upfront costs of smaller projects as part of the RFP bidding templates.

Interactive tendering process - Traditional PPP procurement has moved reasonably quickly to improve the nature and outcomes from interactive tendering processes. There is further scope to improve this process by providing definitive feedback that is aligned to client requirements. If a solution is not acceptable in whole or in part then the private sector should be advised of this as early in the process as possible. This will save time and money for all parties and deliver a better outcome for the client.

Request for proposal bidding templates – Often clients are nervous to learn about the project design and as such request significant amounts of documentation at this stage. Preparation of this information adds significant cost for minimal additional value. The output specifications should remain as the basis for the deal. Clients must carefully consider what is requested of the bidders and simplify this process in so far as possible. Standard bidding templates which clearly spell out the information expected from bidders will assist this process greatly.

Avoid the need for a "best and final offer" - BAFO – All of the above mentioned processes during the tender phase are more likely to align the expectations of the bidders and the Client. This should lower the risk to the client of not receiving acceptable bids within the affordability range. However, accepting that the potential remains for unacceptable bids, it would be more sustainable to appoint a preferred bidder and provide a complete understanding of the requirements that they must overcome to reach a satisfactory position.

Simplify services and payment mechanisms. A general reduction in the complexity of service specification and payments mechanisms will assist with deal execution (understanding and due diligence) and contract administration. A reduction in the number of Key Performance Indicators (KPIs) during the operational phase will assist this process. Typical social infrastructure PPPs have a significant number of KPIs for hard and soft services. This number can be reduced (by grouping) with appropriate adjustments to the payment mechanism. It is preferable for KPIs to be based on outcomes rather than inputs - such as specific maintenance requirements e.g. for a water treatment plant, abatement will be made if the water is not of a certain quality, rather than requiring measurement and abatements for not regularly maintaining filtering systems.

For smaller projects, it is more efficient to keep the private sector facilities management services simple. Clients should consider including hard and soft facilities management but not services that overlap with the public sector. In a hospital PPP, for example, this might include grounds, cleaning, building maintenance but exclude porterage. It is generally preferable that help desk and administration functions remain with the private sector as they are fundamental to the management of the project.

Hand back conditions - The standard PPP model typically includes a clause that requires no significant asset failure in the 5 years following the end of the concession. This practise is inconsistent with traditional procurement. It adds a significant administrative and management burden to both the client and the private sector and offers questionable value for money outcomes. To overcome this, hand back conditions at the end of the contract life should mirror those of a normal design and construct contract with a defects and liabilities period and appropriate warranties.

Other Opportunities to improve value for money outcomes

Project Pipeline – The earlier analysis has identified a considerable project pipeline. Many projects would be suitable for delivery using an amended PPP delivery model. The benefit of undertaking numerous projects is that it develops a capability in New Zealand. Certainty about the project pipeline will enable the private sector to invest more effort in responding to opportunities with a much higher "risk reward" profile.

Bundled Projects –The opportunity to bundle projects of similar type and/or across multiple areas exists. This has been done successfully in the United Kingdom and Australia. Examples include bundling of construction, refurbishment and maintenance of multiple schools. There are opportunities in New Zealand, such as grouping wastewater or water treatment plants where client needs are similar. Similarly community facilities improvements and maintenance could be bundled together as a single PPP procurement. Bundling of projects may require inter agency collaboration.

Centralised support - A project pipeline and the bundling of projects at the local government level, should be supported by a PPP procurement framework implemented centrally. The PPP procurement model is in its infancy in the New Zealand market, but the National Infrastructure Unit (NIU) has spent considerable time developing a framework to suit the local market. Once this framework is established there is a significant opportunity to give a centralised agency, like the NIU, the responsibility for working alongside local government and other agencies to implement PPP projects.

Funding Model – In the situation where a "bundled" project is developed there are additional opportunities to consider the structure for engagement with the private sector. Opportunities such as funding competitions where banks and other funding agencies compete to provide debt will be more attractive due to the increased size of the deal.

Standardised Documentation – Transaction costs in privately financed projects are always a key point of discussion. As projects are implemented and the market improves, the development of standardised documentation will lead to significant reductions in legal and due diligence costs. This will require cross client collaboration and leadership at a Government level.

Third Party Revenues - In order to maximise value for money for the public sector partner, opportunities for commercial enterprise need to be considered as part of each project. These opportunities will vary from project to project and may constitute things such as car parks or land development on land adjacent to the project. If structured appropriately, they will ensure the risks borne by the private sector are adequately compensated and the cost of the project to the public sector partner is minimised.

Public Sector Finance and/or guarantees - The threshold for PPP viability is largely driven by the differential in the costs of public sector versus private sector capital and whether or not the efficiencies/cost savings and risk transfer delivered by the private sector are sufficient to bridge the gap. A PPP will not be viable if the combination of design, construct and operational efficiencies and risk transfer are not sufficient to overcome the higher cost of private sector capital. There are various ways to reduce the need for, and cost of, private capital including:

- Public sector capital grant thereby reducing the extent of private sector capital needed
- Public sector guarantee of project debt
- Public sector loan to the PPP consortium

All of these methods can reduce the cost of debt. However provision of public debt and/or guarantees has disadvantages. Most significantly this kind of approach removes the discipline brought by private sector debt providers to a project substantially reducing risk transfer and hence removing or reducing a key rationale for undertaking a project as a PPP.

Evaluation of the relative merits of PPP-Lite approach

In preparing the PPP-Lite model, we have given specific consideration to the potential advantages of each recommendation to meet public sector objectives. As such, we are proposing amendments that specifically focus on achieving the following outcomes that align the public and private sector goals:

- Improve Value for Money outcomes by using an alternative PPP procurement model
- Reduce the transaction costs for bidding to provide more competition and add to the potential sustainability of the procurement model
- Retain competition to achieve value outcomes and drive innovation
- Maintain the contractual rigour, additional due diligence and performance monitoring brought to the table through the involvement of private sector finance
- Transfer risk to the party best placed to manage it

Each of the proposed amendments have been assessed against the above criteria in the table below. A tick indicates that the recommendation generally contributes positively towards the outcome sought, a "–" indicates that it is comparatively neutral and an "X" indicates that it may detract from the specific outcome.

Initiative	Improve VfM outcomes	Reduce Transaction Costs	Promote Competition	Risk Transfer
Two Bidders in Competition	-	√	X	-
Post bid involvement of lenders	√	√	√	X
Publish the Evaluation Criteria	-	√	√	-
Publish the affordability range	-	√	√	-
Concept Design Approach	√	√	√	√
Interactive Tendering Process	√	√	-	√
Bidding Templates	-	√	-	-
Avoid BAFO	-	√	-	-
Simplify the Services and Payment Mechanisms	√	√	-	-
Clear Hand Back conditions	√	-	-	-
Project pipeline	√	√	√	-
Bundled projects	√	√	√	-
Standardised processes	-	√	√	-
Public sector finance and/or guarantees	√	X	-	X

Conclusion

There are significant opportunities to reduce the overhead costs associated with PPP project delivery to enable application of the model to a large number of existing and identified projects in New Zealand. The above table provides a menu of options that can be considered by public sector agencies to enable lower cost implementation of PPPs for smaller projects. The options proposed are not radical shifts in risk positions and retain the many advantages of PPP procurement. The development of a PPP-Lite approach enables clients to consider private finance opportunities for projects up to $NZ100m in a manner that ensures that public sector outcomes are achieved in a cost effective manner.