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**Public private partnerships:
A procurement device to
manage public sector debt**

By

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ABSTRACT: Australian governments are amongst the leading advocates of Public Private Partnerships (PPPs) as a public procurement policy. After two decades of experience, it is timely to evaluate the effectiveness of the policy. At the aggregate level, PPPs were launched to induce private participation in public infrastructures to covertly contrive the removal of visible public debt. Drawing from the social dynamic framework of interests (Broadbent & Laughlin, 2002), this paper shows that PPPs are a powerful procurement device to legitimise the social existence of the state. This article explores the experience of the first hospital (the Port Macquarie Base Hospital) and a recent toll road (the Cross City Tunnel) delivered under the Public Private Partnerships (PPPs) model in the State of New South Wales, Australia. The study shows that the policy has effectively established the market of PPPs in a variety of sectors. Lessons to be learnt from this paper include the need for policy makers to be wary of the interest that dictates the policy. Failing to take into account the interests of the community would impeach the democratic legitimacy of the state.

KEY WORDS: *Public private partnerships, social dynamic framework of interests, public procurement policy, Port Macquarie Base Hospital, Cross City Tunnel*

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1. Introduction

Public Private Partnerships (PPPs) have seemingly gone through two distinct but inter-related phases. Initially PPPs emerged as a procurement technique within the macroeconomic policy agenda. Subsequently they evolved into a microeconomic procurement policy. This ‘macro/micro’ interface is established through the accounting treatment of PPPs and the notions of value for money (VFM) (Broadbent & Laughlin, 1999: 102).

Many argue that PPPs originally emanated from a macroeconomic policy agenda that was underlined by a desire to control visible levels of public debt (cf. Heald & Dowdall, 1999; Walker & Walker, 2000; Broadbent & Laughlin, 2002). Others suggest that in later stages the focus has moved away from the concern with public borrowings (cf. Broadbent & Laughlin, 2002) to the microeconomic level, with the spot light trained on the trait of VFM through efficient assignment of risk (cf. Broadbent *et al.*, 2003; Edwards & Shaoul, 2003; Quiggin, 2005a; Ismail & Pendlebury, 2006; Ball *et al.*, 2007). This paper contests this widely accepted view of the functionality of PPPs and the opinion that the desirability of PPPs was only an ideological preference (cf. JSCCCT, 2006a: 58). It argues that the inherent functionality of PPPs remains static over these two distinct phases. PPPs are a powerful device for fostering capital accumulation. In so doing, the defence of the state’s social legitimacy is continuously solidified. This self interest of the state is materialised in two stages. At the outset, PPPs were embarked on to amplify the private sector’s interests in the operations of large scale infrastructure-based services. The purpose was to covertly bring in the private finance strategy to accomplish its fiscal policy objective of minimising levels of public debt. This effort has witnessed the surrender of the public interest in order to have recourse to private finance (Mills, 1991; Shaoul *et al.*, 2006). To date, the macroeconomic policy agenda underpinning the pursuit of PPP schemes remains a strong force circumscribing the implementation process; the promise of VFM through appropriate risk transfer is nothing more than legitimising PPP procurements.

This paper investigates both an early and a recent experience of PPPs in Australia. It presents accounting data to uncover the putative financial motives dictating the *ex ante* appraisal process that was designed to defend the choice of PPPs over public finance options. The cases examined are the Port Macquarie Base Hospital (PMBH) and the Cross City Tunnel (CCT) in the State of New South Wales (NSW). The PMBH represents the first PPP hospital in NSW and the CCT is the most recent toll road project in the history of Australian PPPs to be seen as a failure by many pundits. The lesson of the hospital demonstrates that the effort to entice greater private provision in the public hospital services has ceded public funds to the concessionaire for the financing of profitable services. The experience of the toll road illustrates that compromising the community’s interest to shelter the public sector from cost exposure, has rendered the unlikelihood of the public’s acceptance of the policy.

The remainder of this paper is organised into four parts. The following section conceptualises PPPs. This is followed by Section Three that reviews the international proliferation of PPPs as a macroeconomic technical tool to manage public sector debt. In particular it will examine contextually, within the social dynamic framework of interests, governments’ infatuation over the ‘prudent’ levels of public debt. Given this groundwork, the investigation of the PMBH and the CCT in Section Four exemplifies PPPs as a political instrument to uphold the legitimisation of the state. The paper concludes its findings in Section Five.

2. Public private partnerships

Public Private Partnerships¹ are public procurement policies that encourage the public sector to supply asset-based services to the public by purchasing them from the private sector rather than by direct provision (Broadbent & Laughlin, 2002: 622). They encompass a range of financial and organisational relationships between the public and private sectors (Edwards *et al.*, 2004: 17). These relationships are established by a concession contract which enables a separate legal entity in the form of a ‘special purpose vehicle’ (SPV) created under private ownership to finance, build and operate an asset for an agreed period. The SPV is also the legal owner of the project related assets during the concession term (Kozarovski, 2006: 309). One of the distinct qualities of the PPP package is that there is a minimum interface between the government body and other parties including the users of the PPPed service in the relationship cobweb. Once the project reaches financial close, most aspects of the contract’s execution and management are facilitated directly by the SPV.

The concession can take many forms (for the commonly used forms, see Duffield, 2001: 28). The most popular form is the Design, Build, Finance and Operate (DBFO)² where the SPV is contracted to supply a bundling product. This product comprises two provisions: the provision of assets, such as buildings, roads and equipment; and the provision of services, such as asset maintenance, and cleaning and catering (Hellowell & Pollock, 2007). The underlying concept is that the public sector purchases a service instead of an asset, albeit the periodic payments over the length of the concession explicitly contain a significant proportion to cover the price of the asset plus a profitable margin, whereas the purchase of the service provision is specifically dealt with by a considerably smaller proportion. The length of the concession period is determined on the basis that the sales of the bundling services are sufficient to discharge construction, financing, operation and maintenance costs plus a generous profit for private capital investors (Duffield, 2001: 27). At the conclusion of the concession, the ownership of the property will normally revert back to the public sector at no charge³.

PPPs are in themselves a capital accumulation process to profit a small class of powerful capital owners. The above periodic payments are formally known as the “unitary charge” (Hellowell & Pollock, 2007). It is structured into two tiers to ensure borrowings of the SPV are duly protected: the availability charge pays for the provision of assets; the service charge remunerates the provision of services. The predetermined level of the availability charge must be sufficient to: (i) recompense interest and principal payments on the debt taken out by the SPV; (ii) pay dividends to private capital owners; and (iii) deposit into the cash reserve held by the SPV for the purpose of covering the asset’s lifecycle costs, any surplus in the reserve will be passed over to the private capital owners at the end of the concession period (Hellowell & Pollock, 2007: 351-352).

¹ It is also termed Privately Financed Projects (PFPs) by the NSW Government (WWG, 2006). The early generation of the British equivalent is named Private Finance Initiative (PFI). In this study, these terms are interchangeable, while PFIs refer specifically to projects undertaken in the UK

² The use of terminology varies between countries. In the UK, DBFO in transport involves the transfer of ownership at the end of concession period (Glaister *et al.*, 2000) while the similar arrangement in Australia is termed BOOT (Debande, 2002: 380).

³ The zero reversion cost should not be seen as buying a property at no cost. Financial commitments from the public purchaser to the private owner during the concession period, as argued by Heald (2003: 359), were in fact paying for the post-concession life of the property.

The most innovative idea related to the DBFO is the built-in incentive mechanism contained within the payment structure. Both charges are linked to the requirements set out in the output specification and the results of the risk assessment (Akbiyikli *et al.*, 2006: 72). They are payable only when the service meets required standards (Debande, 2002: 359). The objectives are to motivate the private proponent to deliver VFM over the whole length of the concession. Because the recoupment of costs and future profit rely on a flow of suitable quality services from the asset, the private proponent is thus encouraged to build the required asset with agreed costs, and of high quality (Debande, 2002: 360). Further, the revenue receipts flow to the SPV only when the construction of the asset has been completed and the service is fully operational, thus the concessionaire is incentivised to finish the construction element sooner. Evidence suggests that the PPP contractual mechanism has better facilitated the integration between the asset creation and its ongoing management compared with contracts delivered under the traditional method (NAO, 2003). Figure 1 depicts the incentive scheme established through the interdependence of these core elements in an archetypical DBFO contract. The dashed line connecting the “payment mechanism” and the “asset” iterates the principle of DBFO, that is, the purchase of the service not the asset itself.

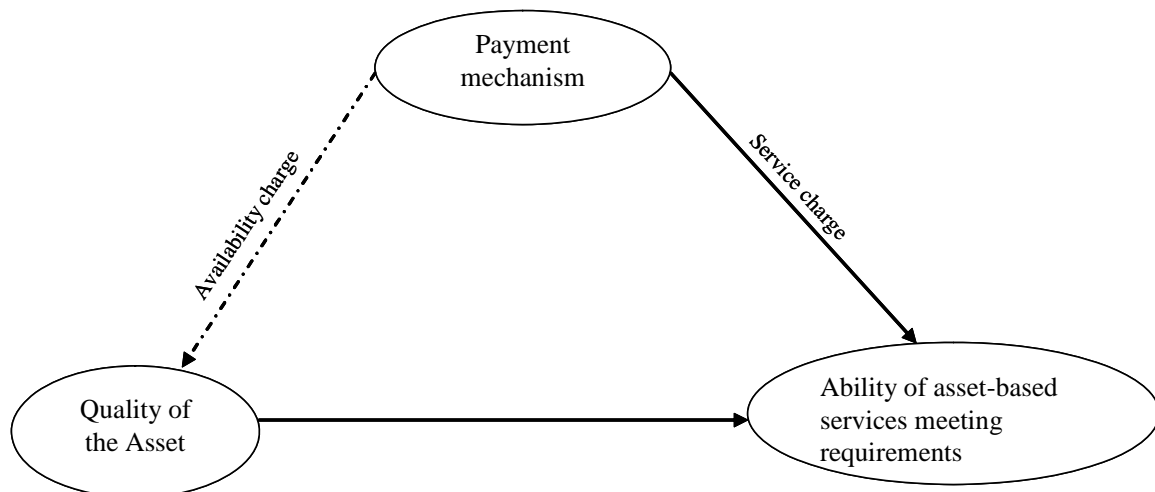


Figure 1: Relationship between the payment mechanism, quality of the asset and asset-based services

The role the private sector plays in the second element of this bundling product varies between social infrastructure and economic infrastructure projects. Social infrastructure projects, such as hospitals, schools and prisons, where the state retains demand risk (NSW Treasury, 2007: 1) are normally funded from state revenue (English & Guthrie, 2003: 503). The private sector’s role is limited to managing the physical facility to a specified level that is suitable for delivering the required service (Grimsey & Lewis, 2005: 346). The delivery of front-line services, i.e. clinical or educational services to the community, is outside the scope of the DBFO (cf. Broadbent & Laughlin, 2004; English & Baxter, 2007).

Economic infrastructure projects, such as toll roads and railways, where the private sector bears the market risk (NSW Treasury, 2007: 1), are capital-intensive. Thus, the creation of assets is likely to dominate (WWG, 2006: 8). The responsibilities for ancillary assets vary between railway and road projects. In DBFO railways, the

operation and maintenance of stations and rolling stock are the responsibility of the private proponent, while the operation of the railway remains in the hands of the public sector⁴. In DBFO roads, after the construction is complete, the provision of the associated service, e.g. toll collection, roadwork and lighting maintenance, is a relatively minor component of the arrangement (Walker, 2005). The public sector's involvement is limited to monitoring the adherence to the contract and renegotiation of changes to services supplied (Debande, 2002: 367). In exchange, the private operator negotiates a concession right with the government for a period (English, 2005) that warrants the rate of return to private equity (Arndt, 1998; Glaister *et al.*, 2000).

3. A device in the macroeconomic policy agenda

Since the early 1990s, the thrust of meeting a chronic need for infrastructure development and an associated desire to restrain the measured level of public sector borrowings (Broadbent & Laughlin, 2002: 629; English & Guthrie, 2003: 494; Rutherford, 2003: 373; Quiggin, 2005a: 446) have proliferated the procurement policy. The following discussion examines the political agenda underpinning the evolution of PPPs in the UK and Australia. These two countries all use the British style of PPP-PSC (Public Sector Comparator) VFM approach.⁵

The PPPs policy was first formally introduced in 1992 by the UK Government. At the time, curbing inflation was the paramount economic objective in the public policy agenda at the global level. Such a macroeconomic climate necessitated tight controls over public spending. The British HM Treasury launched a control total in 1992 setting a fixed level for all public spending each year (Broadbent & Laughlin, 1999: 97). Australian state governments' spending was capped by 'global limits' imposed by the Loan Council⁶ (Walker & Walker, 2000: 190). It appears that these countries were keen to reduce the level of public debt, but the attention was targeted only at debt appearing on governments' balance sheets. PPPs have become a convenient technical accounting device for this hidden agenda. The service delivery mechanism is most appealing to infrastructure-based services because their asset construction consumes significant amounts of capital, while PPPs involve no new asset appearing on the public sector's balance sheet (Heald & Dowdall, 1999:243).

In both countries, PPP costs were excluded from being set against the given level of public capital provision. In the UK, only the annual lease cost for operational services counted against the controlled total. The dominant financial element associated with the use of these facilities would not enter into the relevant accounts. This was justified and supported by the steering mechanism⁷ (Rutherford, 2003: 380) that defined the nature of such capital expenditure as being only a component of a bundling service (Broadbent &

⁴ See for example the London Underground (Debande, 2002: 375), and the Sydney Airport Link (Chung, 2003).

⁵ Although PPPs increasingly become an international phenomenon, not all countries adopted the PPP-PSC value-for-money approach, such as the US and France. See for example Grimsey & Lewis (2005). Evidence in other countries, however, remains unexplored (Broadbent & Laughlin, 2004: 8).

⁶ A 1928 referendum approved constitutional amendments to empower the Commonwealth to co-ordinate borrowings by state governments. The maximum sums were established by agreements amongst the Commonwealth and State governments, and allocated by the Loan Council. The Council assigned each state government a 'global limit' via a formula based on population (Walker & Walker, 2000: 191).

⁷ Steering mechanisms are laws, regulations, and other pronouncements that define and operationalise PPPs (English & Guthrie, 2003: 494).

Laughlin, 1999: 98), therefore all payments should be charged to the operating account and stay off the government's balance sheet (Rutherford, 2003: 379). In Australia, PPPs have since become a popular avenue for borrowings by state governments to escape the global limits assigned by the Loan Council (NSWPAC, 1994: 41; Walker & Walker, 2000: 5-7), because spending associated with PPPs did not "qualify" as an asset in the public sector's financial accounts (English & Guthrie, 2003: 494; Quiggin, 2005a: 445). The approaches adopted by the British and Australian governments are not consistent with the accrual-accounting logic, because to deliver the related services, the profit-seeking private provider requires financial commitments, in some cases financial guarantees, from the responsible public sector purchaser (cf. Mills, 1991). Thus in substance, government purchases of assets or goods and services through PPP arrangements are public debts, and should be accounted for as liabilities.

Ostensibly, the initial engagement in PPP commitments was driven by political rhetoric aimed at removing visible public debt. Shielded by PPPs, governments effectively transferred financial burdens to taxpayers. Seemingly, more recent developments have been promoted on the basis that PPPs allow for more efficient allocation of risk, hence offer better value for money in the public interest. The benefit of VFM is challenged in Broadbent & Laughlin (2002) as being at odds with the Treasury's firm stance in accounting PFIs as off-balance sheet transactions. Contrary to the VFM claim, in later developments where the private sector has showed promising interest in the market of DBFOs, the pursuit of the macroeconomic benefits (meeting ongoing public needs for infrastructure-based services without incurring on-balance-sheet debt) remains the strong force influencing the policy implementation process.

Resistance to debt is seen to be legitimate in the view of the state as the custodian of a capitalist class society. The social dynamic framework of interests views "the interests of individuals and groups [as being in] part structurally determined by forces that are outside their control and part moulded by them in their outworking in particular social actions" (Broadbent & Laughlin, 2002: 625). "The state", represented by the institutional form of government (Broadbent & Laughlin, 2002: 628), is the political organisation of society in which its members associate and organise "for the purpose of reaching and implementing collective decisions" (Abelson, 2003: 3). Herein, the interests of the state are structurally determined by the democratic legitimation and socially moulded by the interests of the hegemonic capitalist class (Broadbent & Laughlin, 2002: 625).

The social interest of the state moulded by the hegemonic capitalist class magnifies the regulatory role to enable and defend the capital accumulation process (Broadbent & Laughlin, 2002: 628). This particular role of the state proliferates in the rapidly globalising capital market. Increasingly, containment of public debt is perceived by international capitalists as a prudent approach to fiscal management. Thus it pressures the state to defend its legitimation at the macroeconomic national and international levels (Broadbent & Laughlin, 2002: 626). Within these inextricable social dynamics, the use of private capital has become the dictating financial strategy to meeting the contradictory demands for prudent level of public debt and replacing the severely underinvested public infrastructure that required substantial government subsidy (NSW Treasury, 2005: 9, FN5). The excessive reliance on the bonding with the capitalist class to legitimise the state's existence is not without repercussions. The lack of reference to the community's interest can dissipate support for the state's democratic legitimation. When this occurs, the bonding between the state and the capitalist will become fragile

causing a breakdown in the social contract within the PPP relationship (Johnston & Gudergan, 2007).

The following section traces the rise of the PPPs as the public procurement strategy to foster the capital accumulation process via a study of PMBH. The section finishes off with the unveiling of the peril of PPPs through an examination of the CCT.

4. Case studies

4.1 The Port Macquarie Base Hospital

4.1.1 Background

Being one of the first PPP projects in NSW, the PMBH was an experiment to induce the private sector to partake in service deliveries which had been traditionally supplied by the public sector.

Since the mid-1970s, there were some suggestions by various elected governments (Labor and Coalition) that a new public hospital was needed to replace the existing Hastings District Hospital which was considered severely under-resourced to cope with the fast growing region around Port Macquarie (NSWPAC, 1993). These suggestions continued intermittently for over a decade. The struggle between the shortage of funding and the need for an upgraded hospital would have been prolonged and the hospital would still have been under proposal if the former NSW Premier, Nick Greiner heading the then Coalition Government had not put forward a privatisation program for government owned facilities. The Government claimed that the private option offered the Port Macquarie community advantages in terms of certainty and timing.

In December 1992, the Department of Health NSW (DoH) entered into a 20-year, non-cancellable contract with Mayne Nickless Limited (the Mayne Group), whose subsidiary, Health Care of Australia (HCOA), subsequently formed the hospital management. Being the first PPP hospital, the PMBH differed from the archetypical DBFO discussed in Section Two in two ways. First, is the perpetual private ownership of the hospital asset. The contract stipulates that at the end of the 20-year period, the owner of the hospital (the PMBH PL) has the right to sell the hospital to any interested parties. The second important difference lies in the delivery of core services supplied by the private provider. The hospital was contracted to treat a mix of 80 percent public and 20 percent private patients (NSWAGO, 1996). The DoH, in turn, promised to purchase health care services from the private hospital for a span of 20 years. The PMBH established a landmark in health services for NSW. The government's role changed from that of traditional health service provider to health service purchaser.

The terms of the project constituted two streams of payments. Through the availability charge, the private sector would recover construction costs and all other related expenses incurred in the course of building the hospital. In addition, under the 20-year service contract, the DoH would pay the service charge to the HCOA covering the operational costs of the provision of public hospital services. The hospital was built on a parcel of land owned by the public sector, the Hastings Council.

In August 1993, the builder, Fletcher Constructions commenced construction. The hospital was commissioned in November 1994 (NSWAGO, 1996). In October 2003, the Mayne Group proposed selling its entire Australian Hospital business, including the PMBH, to another private consortium. In April 2004, the State Government commenced

legal proceedings against the Mayne Group in relation to the novation of the PMBH contract to Affinity Health (part of the buying private consortium). On 31st January 2005, after paying 10 years of unitary charges, the Labor Government bought back the hospital for \$35m⁸ (price as of 2006).

4.1.2 Funding choices

An implicit motive attached to the idea of DBFOing the PMBH is that the recourse to private finance will have no visible impact on public sector capital spending. The DoH alleged that public finance was unavailable. To make its case for the private finance option, in 1990, the DoH prepared an assessment of the cost of building a new public hospital for Port Macquarie, compared with the option of allowing private sector provision. The results of the assessment are presented in Table 1.

*Table 1: PMBH Costs assessment^{(a)(b)}
Comparison of public and private options*

Options	Public	Private	Savings
Total Capital Costs	\$64	\$49 (c)	\$15
Recurrent Costs^(d)			
Year 1			
Operating	\$30	\$28	\$2
Finance and Capital	\$6	\$4	\$2
TOTAL	\$36	\$32	\$4
20 year contract (NPV @7%)			
Operating	\$335	\$306	\$29
Finance and Capital	\$93	\$65	\$28
Residual Value	-\$11	\$0	-\$11
Total Recurrent Costs	\$417	\$371	\$46

- (a) Costs are in millions of dollars.
- (b) All costs are in 1991 prices.
- (c) No information is provided for this calculation.
- (d) These are costs of maintaining and running the hospital.

Source: NSW Health Department, 1992: 8; quoted in Collyer (1997: 30)

Table 1 indicates that the private option would save \$15 million in capital and \$46 million in recurrent costs over the 20-year period. However, why the initial capital outlay was \$15m higher under the public option than the private option was never fully disclosed. In the absence of information to the contrary it was possible but implausible to argue that it was based on the assumption of greater efficiency on the part of the private constructor. More plausibly, the \$49m estimate for the private option was merely the figure upon which the availability charge was based and did not reflect the full cost of building and equipping the private hospital (NSWPAC, 1992: 36). In fact, there are better grounds for believing that the publicly financed option would have been the lower cost option. In 1992, the NSW Treasury Corporation 10-year bond rate (9.7%) was 2.55% lower compared to the market rate of 12.25% (indicator rate supplied by Westpac – one of the major private financial institutions in Australia) (Gain, 1992:

⁸ Information obtained from media releases from the Department of Health, NSW www.health.nsw.gov.au and the Mayne Group www.symbionhealth.com, accessed on 24th August 2007.

1). In other words, government bond financing would have saved State taxpayers 2.55% in interest expenses. As is revealed below, in fact the PMBH offered the private concessionaire a much better deal than the market could afford.

The DoH also produced figures to demonstrate that the private option would be less expensive, as shown in Table 2⁹. Both tables were constructed to support a perception that the private sector was more cost efficient. It can be argued that this cost advantage stems from the favourable terms of the contract offered to the private contractor rather than any inherent cost efficiency. By way of illustration, the 'availability charge' compensated the private sector for all the tax expenses, a calculation based on a 45% corporate income tax rate. In this sense the \$2.2m taxes (see Table 2) from the private sector are arguably phantom cash receipts to legitimise the private option.

Table 2: PMBH Comparative Costs to the Department of Health and State budgets

<u>Options</u>	<u>New Public</u>	<u>New Private</u>	<u>Savings</u>
Number of beds	160	160	
Costs (\$m p.a.)			
Total Operating Costs	27.8	27.9	
Less State Income (Payroll tax etc)		-2.2 ^(a)	
Net Operating Costs to State	27.8	25.7	2.1
Availability Charge	5.5 ^(b)	3.8 ^(c)	1.7
Total Costs to Government	33.3	29.5	3.8

(a) The State Government would receive \$2.2m in taxes from the private sector.

(b) The reason why the availability charge under the 'New Public' option was higher than that under the 'New Private' option was not disclosed.

(c) The DoH would pay \$3.8m per annum 'availability charge' to the private sector for the provision of public health services provided by the private hospital.

Source: NSW Health Department, 1992: 87, quoted in Collyer (1997: 30)

4.1.3 Funding source

An astute analysis reveals that the hospital's assets and running costs were entirely subsidised by taxpayers. The availability charge was contrived to burden the DoH with most of the financial risks associated with the entire life of the project. It recompensed all the costs incurred in relation to the construction of the hospital, including the design and the development of the building, repayment of borrowings, purchases of land, payment for legal fees, finance fees, administration fees and taxation expenses, together with interest costs on all of these items. Expenses incurred as the result of ordinary repairs and maintenance to the hospital carried out by the operator were also factored into the availability charge. To make the Government's accounts look better, the DoH purchased the land from Hastings Council for \$550,000 in 1989 and then onsold it to PMBH for \$1.2m. In fact, the DoH reimbursed PMBH the price of the land through its availability charge. Effectively, the Department was borrowing \$1.2m from PMBH and repaying it plus interest. The availability charge included an allowance for the payment

⁹ Differences in the savings presented in Table 1 and Table 2 are largely due to tax effects. The State Government has the power to impose taxes on profits generated by the hospital.

of PMBH's tax liability. The calculations assume a company tax rate of 45%. In the event the tax rate fell, the benefit to the PMBH PL would increase.¹⁰

The total repayment over the term of the contract (20 years) was \$143.6 million (in constant dollars). A discount rate of 13.71% p.a. equates the present value of the total 20 payments to the value of the hospital at the date of commission (Chung, 2008 *forthcoming*). At the time the contract was signed (1992), the NSW Treasury Corporation 10-year bond rate was 9.7%, proving that private finance cost the residents of NSW 4.01% more in interest payments. The DoH was locked into a long term financial commitment to guarantee the private consortium an annual risk free and tax free return of 13.71%. NSW taxpayers would have at least gained substantial savings in interest payments if they had been calculated using variable rates in accordance with movements in the market.¹¹ Moreover, after paying off the availability charge, the DoH would not own the hospital at the conclusion of the agreement unless it purchased it at market value. As noted before, it cost the State Government \$35m to buy out the contract.

The service charge paid the HCOA a private hospital rate for the public hospital services provided. It was determined on the assumption that the PMBH PL *financially* owned the hospital and needed to repay the capital even though this portion has been well covered by the availability charge (evidence given by Tony Harris, the former NSW Auditor-General, in FPARC, 1997: 10). The service charge was made to PMBH based on a set fee per service and the number of bed days, irrespective of the actual number of services incurred during the year, and up to the budgeted amount (NSWAGO, 1996: 404). The budget can only escalate. This is because the number of services was set by the DoH annually and it was not to be less than the total service charge paid in the previous year (NSWAGO, 1996: 403). Under this condition, the DoH retained a downward demand risk. Fluctuations in real demand would have no net effect on the operator's revenues. This situation gave the operator an incentive to curtail the quality and quantity of services it provided, since fixed revenue was guaranteed by the DoH each year. This 'incentive' arrangement had 'enabled' the PMBH to deliver substantially higher costs of service at observably lower levels of quality (Chung, 2008 *forthcoming*).

4.1.4 The rise of the procurement device

The Greiner Government was keen to build a private-public hospital as a model for subsequent expansions of private participation in the health sector. The Treasury was also pushing the deal. It argued that the private sector could bring greater competition as well as cost-efficient services to the health industry. It insisted that the PMBH be modelled to achieve the role separation of the funding source from the provider in the delivery of hospital services, despite the high cost. The net present value of the hospital's 20 annual payments of availability charges (\$67 million)¹² is 27.7% higher than the initial capital outlay (\$52 million).

¹⁰ The company tax rate has been falling since. As of the 2004-05 fiscal year (during which the hospital was bought back), the company tax rate was 30%.

¹¹ As of September 2003 (around the time the Mayne Group proposed to sell the PMBH), the 10-year NSW Treasury Bond rate was 5% p.a. Even the most recent rate was only 5.5% (Data obtained from the NSW Treasury Corporation website, www.tcorp.nsw.gov.au, accessed in September 2003 and on 23rd August 2007).

¹² This is calculated using a discount rate equivalent to the 1992 NSW Treasury 10-year bond yield 9.7%. See Chung (2008 *forthcoming*).

At the same time, the partnership deal was a useful political strategy to avoid accountability. Several requests were made to the DoH about the contract terms. These were refused on the grounds that “details are bound by ‘commercial-in-confidence’”. This removes a possible source of support for any contrary argument and leaves it far from clear what is the true cost of the PPP experiment. Such a secrecy component not only removes public accountability in the expenditure of public funds, but also proper oversight in achieving appropriate standards of care and service for the community the hospital was intended to serve. The contract was structured in a way such that any succeeding Health Minister or government would never be able to disclose the true cost to taxpayers (NSWLAH, 1995).

4.2 The Cross City Tunnel

4.2.1 Background

If the inexperience of the government in contract negotiation is to blame for the poorly executed PMBH (evidence given by Tony Harris, the former NSW Auditor-General, in FPARC, 1997: 10), it is the government’s aggressive chase for the cost saving strategy to fund public infrastructure which sets up the CCT to fail.

After a decade of State Government effort in promoting the PPP concept within its constituents, the procurement policy has started showing promising effectiveness in establishing a flourishing PPP market. Private provision of public infrastructure has become a ubiquitous form of infrastructure financing and has acquired a strongly institutionalised status (Johnston & Gudergan, 2007). By the time of entering into negotiations for the CCT, the NSW Government was candid about its position on public debt. It considered that at the time of very low levels of general government debt, “go[ing] into debt to have the budget deficits...would...have been quite reckless” (evidence given by Michael Egan, former NSW Treasurer, in JSCCCT, 2006a: 55), because borrowings will mar the state’s capacity to meet expenditure demand in the long term arising from the aging population (evidence given by Kerry Scott, Executive Director of Private Projects and Asset Management, NSW Treasury, in JSCCCT, 2006a: 55). The decision that private finance was the only option to provide the CCT was made to fulfil the government’s key commitment of “no public money going into this [project]” (evidence given by Bob Carr, former NSW Premier, in JSCCCT, 2006b: 43).

4.2.2 The project

The DBFO contract was awarded to CrossCity Motorway Pty Ltd (CCM) in 2002. Table 3 highlights some of the attributes of the tunnel project. The cost funded by CCM is just over \$1 billion (NSWAGO, 2006: 20). In principle, for every 6-month period, the CCM is required to pay rents to the Roads and Traffic Authority (RTA, the public agency that lets the contract) for the land leased, and the right of operating the asset and charging road users. Rent payments comprise two components: (i) a nominal base component of \$3.50 plus 35% of the actual gross revenue from non-toll business less taxes (other than income tax); and (ii) an incentive rent, which is RTA’s share of toll revenues (RTA, 2003: 36). The incentive rent is payable to RTA when the actual revenue receipts are 10% higher than those forecast in CCM’s base case financial model. The Government’s share of incentive rent increases in proportion to the

percentage of excess revenue. The excess falls into four bands running the gamut from 10% to 50% plus. At the lowest band of 10%, the government's share of the excess revenue is 10%. Its share is capped at 50% (RTA, 2003: 36, Table 2). The "banding" concept is consistent with economies of scale prevailing in road infrastructure where the marginal cost of providing road service is negligible. There is no evidence of rent receipts by RTA. In fact, rent income is highly unlikely given the tunnel's poor patronage and the financial difficulty confronting the tunnel operator.

Table 3: Attributes of the Cross City Tunnel

Opening to traffic	August 2005
Contractual Date for opening	18 October 2005
Projected Date for handover	December 2035
Concession Period	30 years
Capital Cost	\$1 billion
Upfront Payment to RTA	\$96.8M + gst (RDF + BCF)
Other charges payable to RTA	Land rent (basic + incentive)
Annual Average Daily Traffic	30, 000 at June 2007 ^(a)
Present Toll (full length cartrip) ^(b)	\$3.56 full tunnel; \$1.68 for SJYC exit; both directions
Consortium Partners (major equity holders)	ABN Amro, Leighton Holdings from June 2007; previously CKI, Bilfinger Berger, SAS Trustee Corporation, JPMorgan Nominees Australia
Operator	CrossCity Motorway subcontracting to Baulderstone Hornibrook

Clegg & Poljak (2007).

Current as of January 2008.

BCF: Business Consideration Fee; RDF: Reimbursement for Development Fee; SJYC: St John Young Crescent

Source: NSWIG (2005); NSWAGO (2006); RTA (2003; 2007)

The CCM has no financial recourse to RTA. To maintain its commitment to deliver the project at 'no net cost to government', the RTA sought an upfront payment from the private tenders to cover the project development costs (NSWAGO, 2006: 33). Rather than the ability to provide the CCT at the lowest toll for motorists, the capacity to afford this upfront payment was the decisive advantage to the tenderer who wished to win the concession (NSWAGO, 2006: 25).

4.2.3 Key attributes

One of the remarkable differences of the CCT is the ‘unprecedented’¹³ concept of the Business Consideration Fee (BCF) auctioned by the RTA. In contrast to the disclosure in RTA’s Contract Summary issued in 2003, where the payment of \$96.8m was for the “right to undertake the project” (RTA, 2003: 19), the audit office contested that the payment comprised a fee of \$54m to reimburse the RTA the costs incurred with respect to the project, and a BCF component of \$46.1m for the right to operate the tunnel. Both concepts were communicated to bidders in the tender documents and they were invited to bid for both components (evidence given by Danny Graham, NSW Treasury, in JSCCCT, 2006b: 73). This payment increased the cost to the concessionaire, who was expected to recoup it through imposing higher tolls on tunnel users. The CCM was selected because it offered the highest upfront payment.¹⁴ To showcase its capacity to earn greater revenue sooner and to offer the BCF (JSCCCT, 2006b: 81), CCM modelled unusually optimistic traffic forecasts that exceeded the ceiling capacities in its competitors’ and RTA’s estimates (NSWAGO, 2006: 5). Clearly, the BCF has overshadowed this abnormality.

Another unparalleled concept of the CCT promoted by the RTA was its ‘no net cost to government’. In the absence of thorough public interest evaluation (JSCCCT, 2006b: 35) and representations of tunnel users in the negotiations (NSWAGO, 2006: 47), this means no net cost to the RTA and that all cost increases would be passed on to motorists by way of toll increases. To avoid \$110 million in capital spending arising from changes that would maximise revenue to the operator (JSCCCT, 2006b: 75), RTA negotiated two separate deals with CCM to recover subsequent cost increases. One was to change the toll escalation formula (originally toll variation was linked to CPI increases) which would have an impact on the toll being 35% greater than originally planned by 2018. The other was to allow CCM to raise the base toll by 15 cents (30 cents for heavy vehicles). The combined effect of these two deals results in an increase of up to 51 cents in the toll on tunnel opening (NSWAGO, 2006: 6). The impacts of these two deals on tolls are outlined in Table 4.

The RTA’s insistence on capping its capital spending has overridden the tunnel’s primary objective. Originally, the CCT was part of the integrated transport networks planning. The purpose was to funnel traffic bypassing central Sydney into an underground tunnel in order to improve the public domain by reducing surface traffic and reallocating road space to public transport, pedestrians and cyclists (NSWAGO, 2006: 18). The planning focus soon changed to making the tunnel a viable business proposition to private capital providers and not costing government money (NSWAGO, 2006: 63).

The most significant change to the original plan is related to the nature of the tunnel. The RTA settled a non-conforming bid that proposed a longer tunnel than the original design, which would cost the government \$42 million (RTA, 2003: 11), for a \$96.8 million financial package paid to the state. The revised scheme was considered “more environmentally damaging and impos[ing] unacceptable impacts on local residents...with a tenderer benefiting from the changes designed to maximise revenues” (evidence given by Clover Moore, the Lord Mayor of Sydney, in JSCCCT, 2006b: 75).

¹³ The concept of selling the right to charge toll is not new in Australia. In the 19th century, the Governor of the colony of NSW Lachlan Macquarie implemented a system of private turnpikes as a means of financing transport infrastructure. The right to collect tolls was publicly auctioned by the Government (Forward, 2006).

¹⁴ Other bidders sought a payment from the RTA (NSWAGO, 2006: 24).

To make the tunnel a financially viable business that would interest the private sector, the RTA changed the plan further and added the Harbour Street exit to the tunnel albeit this would significantly increase congestion in the central business district of Sydney. It successfully persuaded the Department of Planning to pass the proposal of opening up the exit by arguing that removing the exit would reduce traffic by 23% thus eroding the tunnel's financial attractiveness (NSWAGO, 2006: 63).

Table 4: Changes to the CCT toll compared with the original project concept

Toll Component	Original Project Concept	After the Change	Reason for Change
Toll Escalation Formula	CPI adjusted toll escalation	<u>Opening – Dec 2011^(a):</u> Greater of 4% and CPI <u>Jan 2012 – Dec 2017^(a):</u> Greater of 3% and CPI <u>After Dec 2017^{(a), (b)}:</u> Greater of CPI and 0%	To avoid the RTA paying an extra \$75 million costs following the Supplementary Environment Impact Statement (EIS) and associated additional Conditions of Approval
Base Toll Level	<u>Cars:</u> \$2.50 for main tunnel \$1.10 for exit at SJYC <u>Heavy vehicles:</u> \$5.00 for main tunnel \$2.20 exit at SJYC	<u>Cars:</u> \$2.65 for main tunnel \$1.25 for exit at SJYC <u>Heavy vehicles:</u> \$5.30 for main tunnel \$2.50 for exit at SJYC	Allowed in return for CCM carrying out \$35 million of additional work identified for the RAT
<p>Source: NSWAGO (2006); JSCCT (2006a)</p> <p>Quarterly adjusted. Effectively, the adjustment is greater than 4%. If the CPI was treated as an annual figure then the toll charged at 31 December 2005 would have been \$3.45 not \$3.56.</p> <p>If CPI is negative during any quarter, the toll will remain at the same level until the CPI is positive.</p> <p>SJYC: Sir John Young Crescent</p>			

4.2.4 *The breakdown in the social contract*

Restricting access to surface roads was perceived by the public as profiting the tunnel operator at the cost of motorists. Resistance to excessive tolls and road changes (67 road changes had been planned or implemented (JSCCCT, 2006b: Appendix 5)) signalled the strong public disapproval of the CCT. At this stage, the bonding of the PPP relationship started to rift. The dynamics between the government and the CCM became strained (Johnston & Gudergan, 2007) and disagreements soon intensified when both parties were brought into disrepute by media exposure.

Avoiding public debt was the factor dictating the government's decision to procure the CCT through DBFO. This background consideration has reduced the possibility of public control over this major infrastructure (JSCCCT, 2006b: 42). The tunnel was placed in receivership in December 2006, a year after its opening due to poor patronage. It was sold to another private consortium (ABN Amro and Leightons) in 2007 for \$700 million. By that time actual patronage had been under a third of the CCM estimates (Clegg & Poljak, 2007). The unprecedented BCF, a price auctioned for the license to collect a monopoly toll, was disparaged as the worst expedient of public finance (Quiggin, 2005b: 26).

5. Conclusion

After two decades of experience, the government has successfully launched PPPs as the procurement method to manage its levels of public debt. However, it is contestable whether VFM can be materialised by this innovative financing strategy. The above analysis identified a couple of significant factors that militated against the success of PPPs. As clearly seen in the PMBH, the dedication of the government to the private provision of services for operating the hospital has failed the government's stewardship function of ensuring that financing was channelled through appropriate risk sharing arrangements. Nevertheless, it opened the infrastructure market for PPPs. In a more recent PPP venture of the CCT, the government defended its rigid adherence to restraint in capital spending as being necessary because of the growing demand on government funds by the aging population. To date, no assets and liabilities related to the PPP toll roads are recognised in the RTA's balance sheet¹⁵ (RTA, 2007), albeit the promises of returns to private equity are explicated in the concession contracts (cf. NSWAGO, 1995; RTA, 1998). This observation further confirms that PPPs contrive to remove visible debt off the government's books.

Within the social dynamic framework of interests, PPPs are a powerful device to balance the state's role as the legitimiser of global capital accumulation processes and as the insurer of the adequate supply of national public services. They alleviate the famine for funds for public services without lifting the fiscal gauge beyond the 'prudent' level. The interest of capitalist class has dictated the state's societal functionality within these inextricable social dynamics. In this process, the government acts without being accountable to other members of the society.

The recent CCT lesson demonstrates that the rhetoric of debt containment has not only distorted the PPPs policy but also imperilled the legitimacy of the state. It is timely for

¹⁵ Except for the Sydney Harbour Tunnel in which revenue guarantees are legalised by the *Sydney Harbour Tunnel (Private Joint Venture) Act 1987*.

policy makers to rethink their role in the democratic legitimation. One way to strengthen this position is to segregate the oversight function of the scheme (a function that carries the power to approve projects or reject PPPs that are not designated as being in the public interest) from the Treasury. Currently, there is a clear conflict of interests within the Treasury as the endorser of the policy and as the oversight authority.

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