

The risky business of public–private partnerships¹

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Public–private partnerships (PPPs) are now a common strand of third way government policy, with better efficiency promised from the private funding of public infrastructure through the transfer of risks to private parties. This paper aims to investigate, on an empirical basis, the realities of risk transfers in PPPs and compare this experience against both the rhetoric of project proponents and the formal contract conditions. The paper outlines some conceptual frameworks underpinning PPPs and establishes the notions of risk shifting and risk sharing. The range of typical risks encountered in infrastructure projects is specially considered, and differences to traditional project delivery arrangements are articulated. Some empirical experience on the transfer of risks under PPPs is then outlined through a case study. This analysis shows the extent to which risks were shifted to the private parties as planned, or whether risks remained with government. It is argued that while commercial risks were largely well managed, governance risks were not. It is critical to understand better the nature of risk transfers in PPPs in view of the large financial implications of these deals along with long contract terms.

One of the defining characteristics of third way governments is the widespread adoption of public–private partnerships (PPPs). Some £100 billion has been committed by the Blair government for 400 Private Finance Initiative (PFI) contracts in the UK while over AUD\$20 billion of private finance may be channelled into public assets over the coming five years (National Audit Office 2001; Gray 2002:1, 52–3).

The PPP notion is used throughout the world with a range of meanings. In the United States, PPPs have traditionally been associated with urban renewal and downtown economic development, while the UK PFI has become a centrepiece of New Labour's stakeholder society. PPPs have also been viewed as a tool for providing public services and developing a civil society in post-communist regimes such as Hungary, and a mechanism for combating social exclusion and enhancing community development under European Union policy (Osborne 2001:1–5). The common ground among PPP definitions in Australasia is that government has a business relationship, it is long term, with risks and returns

being shared, and that private business becomes involved in financing, designing, constructing, owning or operating public facilities or services. While this definition will be adopted throughout this paper, the broader perspective of PPPs is that PFI is but one strand of the PPP family (Greve and Hodge 2005 forthcoming).²

Governments have wrestled for centuries with the broader question of what has been termed 'the privatisation war' (Hodge 2002a), and questions of what should be private and what should be public continue unabated. PPPs are simply the latest chapter in the book.³ And while PPPs are marketed as a superior, new phenomenon, this is not necessarily the case. Government contracting with the private sector is not new. As well, governments have for centuries provided physical infrastructure with long-term financial implications. What is new, though, is the use of private finance arrangements, the use of highly complex contracts to provide the infrastructure or services, and the altered governance and accountability assumptions accompanying this (Hodge 2004).

The foundations of the current partnership policy drive have come this time through the confluence of four factors: privatisation, competition, outsourcing and the service purchasing ethos (Hodge forthcoming).

There are a variety of partnership models possible. In concept, either of the public or private sectors can take on a range of project responsibilities and either can take on risks. As well, a range of options is possible from a simple infrastructure provision project through to a project in which both infrastructure and services are delivered (Department of Treasury and Finance 2001).

PPP performance

PPPs most frequently promise better efficiency in infrastructure provision, strengthened monitoring and accountability, along with stronger business and investor confidence. But are these claims being met? Solid evidence is sparse here and, when published, it is inevitably controversial given the policy rhetoric and salesmanship usually surrounding privatisation activities.

Looking briefly at the typical empirical evidence, the initial UK Treasury Task Force reports of Andersen and LSE Enterprise (2000) and National Audit Office (c2000) remain the most widely quoted sources. The first of these looked at 29 business cases from departments and estimated cost savings of 17 per cent compared with the projected costs under public provision, while the second report analysed seven specific PFI projects and found cost savings of 10–20 per cent. Importantly, the majority of these cost savings were attributable to risks transferred from the public to the private sectors in these business cases. The early analysis of Hall (1998) noted that clear evidence on the degree to which efficiency gains more than compensated for higher private finance costs was difficult to obtain and that PFI cost estimates may in any case be clouded by political motivations. Despite this, he nevertheless saw 'some grounds for optimism'. The more recent analysis of Pollitt (2002:67–100) also resulted in a careful pass mark being given again to PPPs. After observing dryly that the UK Treasury did not appear to know what its PFI commitments were in the late 1990s, he first cited the Institute of Public Policy Research (2001) which judged PFIs as being 'successful for prisons and roads but of limited value to date in hospitals

and school projects'. Second, he also summarised the 1999 findings of UK National Audit Office, showing that in a sample of 10 major PFI case evaluations undertaken by the National Audit Office the best deal was probably obtained in every case, and good value for money was probably achieved in eight of the 10 cases.

Also supporting the PPP case is the reality that traditional public sector infrastructure project delivery has hardly been a model of efficiency itself. Indeed, it has been one characterised by 'a history of completing investment projects over budget and late' according to the Department of Transport (2002) for the case of the London Underground (LU).⁴ Further support comes from the National Audit Office (2001) in the UK, which indicates that for PFI projects let prior to 2000, some 81 per cent of authorities viewed the value-for-money from PPPs positively, with only 19 per cent of managers seeing PPPs as of marginal (15 per cent) or poor (4 per cent) value.

Independent analyses outside the UK are limited. Walker and Walker (2000), for instance, looked at partnership activities throughout Australia, but viewed these with some concern, seeing off-balance-sheet infrastructure PPP financing deals as 'misleading accounting trickery' leading to eroded accountability to parliament and to the public. Bloomfield *et al.* (1998) in the United States also saw PPP lease purchasing financing arrangements as more expensive than conventional general obligation financing, deeming them 'wasteful and risky'. In Europe, the recent analysis of Greve (2003) painted another dismal picture of PPP failure in Denmark, with his analysis of the Farum PPP case. Here, a huge list of casualties was strewn about at the end of their PPP initiative; the Mayor was expelled from office, both the mayor and council faced possible criminal charges, the city was in financial ruin and had lost its economic autonomy and the citizenry now pays for the whole debacle through a 3.2 per cent increase in taxes. In short, Greve judged this PPP as 'the most spectacular scandal in the history of Danish Public Administration' (Greve 2003).

The most recent Australian empirical analysis was one of eight case studies by Fitzgerald (2004). Undertaken for the Victorian Department of Treasury and Finance, this analysis argued that 'the discount rate and risk adjustments were integral to the issue of whether the commercial arrangements proposed in a tender offered value for money over the public

procurement alternative'. It recommended first that base risk assessments needed to be founded, in future, on better evidence of the frequency and quantum of risk experience. As well, it argued that the current 8.65 per cent discount rate used in public sector comparator evaluations ought to be revised and a figure of 5.7 per cent adopted. Importantly, the consequence of using this smaller discount rate on a 'hypothetical' example presented in Fitzgerald's report (page 23) was that whereas the higher discount rate led to the conclusion that a 9 per cent cost saving was being achieved against the public sector comparator, the use of the smaller discount rate suggested the opposite. At a discount rate of 5.7 per cent, the PPP arrangement led to an estimated 6 per cent greater cost, and the likelihood that the AUD\$2,700 million presently being repaid by the Victorian government was around AUD\$350 million higher than it should be.

The net benefits of PPPs clearly are still subject to a large degree of uncertainty and debate.

Just look at the extremes of policy rhetoric. On the one side, PPPs are seen by some in the UK as 'yet again screwing the taxpayer', as 'public fraud and false accounting', and 'a sham ... commissioned and directed by the Treasury' with private sponsors being 'evil bandits running away with all the loot' and sons of 'Fat Cat' (see Monbiot 2002 and Bowman 2001:26–8). In Canada, PPPs have been labeled 'Problem, Problem, Problem'. The return fire rhetoric from the opposing camp labels PPPs as a 'marriage made in heaven' and an arrangement that gets the best from both sectors. Governments seem to take little notice of the critics and press on with PPPs as the top of the policy agenda.

Other dimensions of the PPP debate have been less visible. On the question of using highly complex contracts to provide infrastructure and services, PPPs to date seem to have provided only limited opportunity for meaningful levels of transparency or public participation. With limited transparency and complex adjustment formulae, PPPs have also typically led to a lack of clarity of partnership arrangements (Daniels and Trebilcock 1996). Moreover, the issue of altered governance and accountability assumptions accompanying PPPs has been a recurring theme from critics, with little independent analysis or debate. The concern here is that with contracts of up to several decades, governments now entering these arrangements may be reducing the capacity and flexibility of

the Crown to make future decisions in the public interest. Likewise, there has been little discussion about how best the various roles of Treasuries can be balanced — policy advocate, project promoter, financial steward, regulator and trusted parliamentary adviser. These are fundamental public accountability concerns.

PPP risks

The planned transfer of risks from the public sector to private parties is a major part of the forecast benefits from the private funding of public infrastructure. Ball *et al.* (2003) note that 'risk transfer accounted for 60 per cent of the total cost saving for the PFI projects' in the UK analysis of Anderson and LSE Enterprise (2000), and that for six of the 17 cases (ie 35 per cent), achieving value for money was entirely dependent on risk transfer.

Infrastructure projects involve a wide range of risks. The Department of Defence (2001), for instance, sees these risks broadly covering five areas: design and development, construction, finance, operation and ownership. But many listings of risks are available in the literature; (Department of Treasury and Finance 2001; Department of Defence 2001; Ball *et al.* 2003; Arndt 2000; Perrot and Chatelus 2000). The ethos of allocating risks in a contract is that they go to the party best able to control them. Of course risks allocated to the private sector are paid for by the government, which pays for the facility over the longer term. Alternatively, if risks are allocated to the government, this can result in a cheaper up front project price, but with risks then being managed by the public sector in the knowledge that it is essentially 'self-insuring' and can bear those risk outcomes that might eventually occur.

This capacity to formally shift risks from one sector to the other or to share risks over the long life of a contract is different from traditional construction projects, where, aside from typically the construction risks being borne by the contractor, all other risks were essentially borne by the government. A listing of these risks is presented in Table 1 (Department of Defence 2001).

Clearly, the sector bearing the risks here is paid a premium to do so. And if higher risks are borne this should, *ceritus paribus*, attract higher financial returns. In other words, the return on

Table 1 Risks and risk allocation for traditional infrastructure projects

Risk category	Risks	Comment
Finance	Securing finance Maintaining finance (including changes to loan conditions) Interest rate and tax amendments Tax rulings Price escalation in capital components	Risks mostly borne by public sector in traditional construction projects
Design and development	Design suitability Development problems Testing problems Design and development variations Delivery of design	Risks shared in traditional construction projects
Construction	Fixed time and cost to complete Delivery schedule Planning approvals Environmental issues Disruption to existing services Site preparation Transport of assets to site Design and construction variations Industrial disputes	Risks mostly borne by private sector in traditional construction projects
Operation	Asset/service performance Asset/service availability Repairs and maintenance cost variations Security Staff training Change to Defence requirements Cost of keeping existing assets operational Latent defects in existing assets Changes in demand Third-party revenue	Risks mostly shared in traditional construction projects
Ownership	Uninsurable loss or damage to the assets Technology chance or obsolescence Federal and state legislation/regulation changes Public/third-party liabilities <i>Force majeure</i> Realisation of the residual value of assets	Risks mostly borne by the public sector in traditional construction projects

Source: Adapted from Department of Defence (2001)

public funds should not necessarily always equal the return on private finds — returns to each sector will depend on the risks being borne. This is not always appreciated in public policy debates (Walker and Walker 2000:204).⁵

More important here is the need for the costs and the degree of risk bearing to be clear. There is also a need for the competitiveness of such

arrangements to be empirically tested rather than rely on the optimistic project forecasts. Additionally, a more holistic concept of risks is needed, covering both the commercial role of government through the signed contract and its overriding 'governance' role in which it protects the public interest.

How might these risks be assessed in a PPP

case study? Each of the above commercial elements is relevant, as is also the dimension of governance risks. And the political rhetoric surrounding partnership deals will need to be separated from both the legal contract specifications and the historical outcomes experienced by either sector.⁶

PPP case study: The City Link infrastructure project

The City Link road infrastructure project in Melbourne was one of Australia's largest public infrastructure BOOT⁷ projects over recent decades. It was also a conspicuous symbol of the former Kennett government's approach to public infrastructure and a significant part of the evolution of Australasian PPPs. Linking up three major freeways in Melbourne — the South Eastern, West Gate and Tullamarine Freeways — City Link comprised the construction of 22 kilometres of road, tunnel and bridge works⁸ through difficult silt conditions, as well as other associated works.

Following an Environmental Effects Statement in 1994 and the subsequent public inquiry, a brief was issued calling for registrations of interest to complete the project. Two consortia were chosen for further development of ideas for the links and following a second project brief specifying requirements in 1995, the Transurban City Link Ltd consortia was nominated as the preferred bidder.⁹ Some \$1.8 billion of private finance was to come from the consortium out of the total City Link project cost of AUD\$2.1 billion. Opened over the period 2000–2001, the consortium has leased land from the state to operate a public tollway for 34 years, with ownership reverting to the state at no cost and in a fully maintained condition (Victorian Auditor-General 1996). The forecast net present value for the project was \$1.3 billion according to economic studies¹⁰, and the project also expected investors to receive a real rate of return of 17.5 per cent after tax (Walker and Walker 2000:208).

Specific enabling legislation (the *Melbourne City Link Act 1995*) was passed to govern this project, and a statutory authority (the Melbourne City Link Authority) was established to be the state's contract manager (Russell *et al.* 2000). To approve the technical adequacy of the project, an Office of Independent Reviewer was also established. Through the Melbourne City Link

Authority (MCLA), the government entered into a series of contractual arrangements with the consortium¹¹ including leasing land and undertaking to construct \$346 million of associated works (Russell *et al.* 2000, Vol 2:86). Project risks were to be shared between the private sector, the state and users of the link under the principle that the private sector should bear the risks of all events except those that the state alone is able to manage.¹²

So, what has been the empirical experience of risks for this project? And how does this experience compare to both the contracts and the public policy rhetoric?

Risk experience

There are many levels on which risk observations could be made. The following observations begin with the broader political and policy context, and some empirical observations are then made. Risks are then assessed in terms of commercial and governance arrangements.

Policy and political context

Both the need for the project and its private funding had early bipartisan support (Russell *et al.* 2000). Several factors, though, saw this project become politically divisive. Economic forecasts varied wildly and were initially inaccessible to the public; the project was excluded from the usual Freedom of Information Act requirements (Walker and Walker 2000:216); and accusations were made that that the consortium was being favourably treated¹³ and that misleading environmental impact air quality information was provided by the consortium to the MCLA (see Holmes 2000). As well, citizens were concerned that Melbourne's drinking water was being pumped into the tunnel surrounds to ameliorate ground-water-table problems (see Das 2001a:2).

The tunnel needed to be redesigned in 1998 after cracks appeared in the walls, acknowledged by City Link 17 months later (*The Age* 2001) and further engineering problems also delayed the tunnel opening (Das 2001a:2; Davidson 2001:17). The testing of state of the art electronic technology also delayed the tunnel opening¹⁴ in the midst of observations that tolls, rather than a shadow toll paid by government based on traffic volumes, was probably diverting around 15–37 per cent of traffic into the adjacent side streets (Russell *et al.* 2000).

On top of this, a constant stream of legal controversies surrounded the project:¹⁵

- Baulderstone Hornibrook, a major consortium subcontractor, commenced legal proceedings against Transfield Obayahi Joint Venture (TOJV) in 1998 for breach of contract alleging a AUD\$200 million costs overrun. It subsequently faced another legal challenge from Abigroup Contractors regarding ongoing costs.
- In 1999, Transurban, the project owners, initiated legal proceedings against the builder, TOJV, for liquidated damages in relation to construction delays. The initial proceedings saw Transurban receiving a AUD\$50 million interim settlement, but as a result of construction faults and tolling technologies, TOJV were also required to pay a further AUD\$153.6 million to Transurban to settle the disputes.
- In a separate dispute, TOJV initiated litigation against the consortium of engineers alleging negligence in the design and construction of two faulty City Link tunnels (Das 1999:2). Damage amounts sought in this case remain confidential.
- A damages claim against the project owner and builders has also been submitted by a Punt Road family to the Supreme Court. This writ alleges negligence in relation to tunneling work that has caused structural damage to the house (Strahan 2000:7).

Other legal disputes have involved the government itself. For instance:

- The Victorian government settled an AUD\$80 million legal claim from Baulderstone Hornibrook and TOJV relating to alleged delays attributable to the government and settled through a one-off payment of AUD\$10 million.
- Transurban initiated an AUD\$37 million claim against the state government, alleging breach of contract in relation to the construction of a new public road that led to a decrease in customers and subsequent financial loss. This compensation for damage to City Link's earnings capacity was rejected by an independent solicitor, but Transurban have indicated an intention to pursue the matter (Shaw 2002:5).

- The Victorian government lodged a Supreme Court writ against the City Link consortium in 2003 alleging negligence by the builders and designers in relation to works near the publicly owned Swan Street Bridge. This dispute is part of an AUD\$3 million damages claim by the government (Gregory 2003:2) and is now in mediation.

The government's 'crash through' culture legitimised through the legal powers of the project¹⁶ combined with these colourful legal controversies in a cocktail of politics and power.

Empirical observations of risk

Substantial risks were indeed transferred to the private sector through the contract. For instance, private contractors bore almost all of the construction risks, along with most of the design, construction, operating, financing and market risks based on the contract. Only site risks and some sovereign risks (mostly from legislative and government policy) were borne by the state. Table 2, adapted from the Department of Treasury and Finance (2001), indicates that these risk allocations were essentially followed in practice as well, based on experience to date.

Assessing the City Link case study

How should we assess the City Link case study from the perspective of risks? And did the risk shifting specified in the contracts occur in practice? To answer this question, we need to separate the commercial risks under contractual control from the broader and higher level risks of governance.

Commercial risks

There is no doubt that from a commercial point of view the City Link project required large technical advances in tolling technology, real construction risks in tunnelling through soft Yarra River silt as well as considerable risks in environmental issues concerning air quality and the height of the water table around the river. In each of these cases, the private sector took on these risks in accordance with the signed contracts.

But what of the numerous legal disputes? There are several relevant observations here.

First, we ought to recognise that the majority of the legal conflicts were between private parties, with few directly involving the government.

Table 2 Risks defined in the City Link contracts and historical experience to date

Risk	Terms of contract	Historical observations
Design and construction		
Site risk	<ul style="list-style-type: none"> The state accepted the risks of any adverse impacts associated with the issue of Environmental Impact Statements by the Commonwealth government (Russell <i>et al.</i> 2000:V2). The anticipated cost to the state for the acquisition of the land was \$107 million and the state is liable for costs incurred by Transurban associated with all delays in making available any parcel of land by the agreed date (Shaw 2002:5). 	<ul style="list-style-type: none"> State government has been required to pay the builders of City Link \$10 million in a one-off payment in order to prevent the state being subject to a larger bill if the issues had been heard in court. This settled a series of claims for construction delays that were blamed on the government, such as land acquisition and industrial disputes (<i>The Age</i> 1999).
Design construction and commissioning risk	<ul style="list-style-type: none"> The agreement provided for various circumstances by which the arrangements could be terminated including: certain project defaults; uninsurable catastrophic events and failure to complete. In all circumstances Transurban has accepted the risk that the City Link will revert to the state (with no compensation payable to Transurban) (Shaw 2002:5). Transurban is responsible for the cost and execution of the project design with a manner consistent with the project scope and requirements. The risks associated with design and construction principally are borne by Transurban. Transurban and its financiers have accepted the risk of project non-compliance, with the project reverting to the state with no compensation payable to Transurban or its financiers (Shaw 2002:5). 	<ul style="list-style-type: none"> TOJV have agreed to pay Transurban \$153.6 million to settle a dispute over delays and traffic problems caused by faulty construction. The opening of the southern section of City Link was delayed a year after cracking in the Burnley tunnel resulted in serious leaks. Other delays were associated with further leaks, problems with concrete lining and the electronic tolling system. TOJV did not meet deadlines for Tunnel remedial work (Myer 2001). Tunnel leaks were caused by the failure of a joint between the arch and the floor of the tunnel; this caused the bottom of the wall to move forward by 30–40mm. The movement subsequently caused concrete to crack and and rip into the waterproof membrane, resulting in leaking water (Das 2001b or could be 2000). The \$153.6 million that TOJV will pay to Transurban settles delays and traffic problems largely attributed to: leaks, problems with the concrete lining on the Bolte Bridge and the electronic tolling system (Myer 2001). A Melbourne family has lodged a writ in the Victorian Supreme Court claiming that tunnelling work below their Punt Road house resulted in cracks (Strahan 2000).
Industrial relations risk		<ul style="list-style-type: none"> Refer to 'site risk' and government payment to builders.
Operations		
Operating risk	<ul style="list-style-type: none"> Transurban bears the key risks associated with the operation, maintenance and repair of City Link. With an operating fault, the state may step in to operate, repair or undertake maintenance to address the risk or mitigate the consequences with a default, and the state must be reimbursed for these costs (Shaw 2002:5). The key financing risks associated with the delivery and operation of City Link have been effectively transferred to Transurban. The state has not absorbed these risks, given that no indemnities have been provided to Transurban or its lenders in relation to the repayment of the project debt or the level of toll revenue (Shaw 2002:5). The state has accepted certain obligations, such as maintaining the current project operating environment (Shaw 2002:5). 	<ul style="list-style-type: none"> TOJV required to complete remedial work on the tunnel as a result of the leaks (Myer 2001). Transurban were losing \$100,000 a day as a result of the tunnel's closure; Transurban will seek damages from TOJV for tunnel repairs and further lost revenue (<i>Australian Financial Review</i> 2001).

Table 2 contd

Risk	Terms of contract	Historical observations
Economical and financial		
Sponsor and financial risk	<ul style="list-style-type: none"> Transurban is responsible for the initial project finance (Shaw 2002:5). Transurban is required to pay to the state annual fees (concession fees) to compensate the state for the financial assistance provided to the project by way of land and funding of certain works (Shaw 2002:5). The toll collection risks have been essentially transferred to Transurban (Shaw 2002:5). At the end of the specified period, ownership of City Link will revert to the state at no cost (Shaw 2002:5). 	<ul style="list-style-type: none"> Continual closure of the Burnley Tunnel resulted in Transurban shares falling another 25 cents, to \$4.01; however, commentators stated that the overall impact of the leak on Transurban's share valuation is expected to be negligible (<i>Australian Financial Review</i> 2001). Transurban's revenues in 2000 did not cover interest expense and certainly its bankers were concerned about debt service and underlying asset quality [per Merrill Lynch report] (<i>The Age</i> 2000). Abigroup Contractors are to sue TOJV in an action over costs. A writ lodged in the NSW SC by Abigroup Contractors is associated with costs overruns and unpaid money (Barrymore 1998). Baulderstone Hornbrook is claiming that it is owed \$200 million in cost overruns on its \$500 million contract for the Western link; this has been disputed by TOJV (<i>Australian Financial Review</i> 2001). Transurban sued TOJV in relation to delays in the project. Outcome of action: Transurban announced a \$50 million interim settlement of liquidated damages against TOJV for late completion of the tollway's western section (<i>The Age</i> 2000). The company will seek further damages over delays related to the tunnel's opening; Transurban will seek damages from TOJV for tunnel repairs and further lost revenue (Das 2001). TOJV have agreed to pay Transurban \$153.6 million to settle a dispute over delays and traffic problems caused by faulty construction (Myer 2001).
Market risk		<ul style="list-style-type: none"> While the southern link exceeded the 1996 prospectus traffic forecasts for the tollways, the western link was still running around 75,000 vehicles a day short. Transurban have blamed the use of Wurundjeri Way as an alternative route through the Docklands; Wurundjeri Way, used by motorists rather than the City Link route, had had a 'permanent impact' on City Link. Transurban is subsequently seeking damages from the state government (Heasley 2003:4).
Other		
Network and interface risk	<ul style="list-style-type: none"> Traffic Management Arrangements: the state has committed to certain traffic management measures. 	<ul style="list-style-type: none"> Refer to 'sovereign risk' in regards to Wurundjeri Way.
Sovereign risk (Legislative and government policy)	<ul style="list-style-type: none"> The state has accepted the risk of paying compensation to Transurban in certain circumstances where either state or Commonwealth laws or requirements ultimately prevent the completion or operation of the City Link (Shaw 2002:5). The state has assumed responsibility for any outstanding project debt in the event that the arrangements are terminated as a result of changes in state or Commonwealth legislation, which absolutely prevents Transurban from delivering or operating the City Link (Shaw 2002:5). 	<ul style="list-style-type: none"> Transurban is to take legal action against the Victorian government over the construction of the Wurundjeri Way in the Docklands. Transurban have claimed that the road was not part of the plans for the precinct when the original agreement was signed, and the construction of the road has resulted in a decrease in City Link's customers by 30 per cent. Transurban is seeking \$35.8 million dollars in damages from the state government under provisions in its concession that prevent governments taking action that damages the tollway's revenue (Myer 2001).

Table 2 contd

Risk	Terms of contract	Historical observations
Other contd		
Sovereign risk (legislative and government policy)	<ul style="list-style-type: none"> While the state has accepted the risk of absolute project prevention due to changes in law, Transurban investors have accepted the risk that, in certain circumstances, the state's compensation may be less than the investment's market value (Shaw 2002:5). <i>Force majeure</i> risk: In the event of a major disaster, the state will assume control of the project in a damaged condition, under certain catastrophic and uninsurable events, although the state is not obliged to do so and no compensation is payable. 	

Having said this, any litigation involving the government makes good newspaper copy and, as well, raises serious questions of accountability and good governance in terms of publicly funding both PPP projects and legal defences in contractual suits. In this regard, the \$10 million 'taxpayer saving' settlement to the project consortium and the ongoing AUD\$37 million compensation claim for reduced earnings (Beveridge 2001:55; Shaw 2002:5; Heasley 2003:4) both appear to have tarnished the project's political success (Hodge and Bowman 2003). But in quantitative commercial terms the risks borne by the parties were largely as agreed through the commercial contracts, and the questionable issues involving government risks were few.¹⁷

Second, we should also note that the one-off AUD\$10 million settlement in relation to alleged project delays and the ongoing AUD\$37 million claim against government for constructing a new public road nearby was small relative to the size of the project achievements. In fact, most of the risks were borne by the private sector and, as such, it could be argued that investors deserved to earn their margin.

Third, the existence of such legal actions also points to the fact that legal dispute should now be regarded as 'par for the course' and to be expected in this age of contractualised major public infrastructure delivery.

Fourth, the existence of these disputes serves as a reminder as well that, at this early stage in the life of the project, any judgment on overall merit is inherently speculative. The jury essentially is still out.

Governance risks

While from a strictly commercial perspective risks appear to have been largely well managed, this was not the case for risks in governing. Political and governance risks were overwhelming. All governments, to some extent, pursue symbols demonstrating their policy achievements. But City Link represented more than just providing priority infrastructure. It symbolised the former Kennett government's approach to the provision of public goods and services and was another crash-through example of the supremacy of executive government over traditional governance assumptions.

Not surprisingly, several major shortcomings were evident in governance around this project. No publicly available economic or financial evaluation had been undertaken prior to this project being commenced. Further, while the choice of successful tenderer was fair, no comparison had been undertaken between completing this task in the public or private sectors (Victorian Auditor-General 1996). The strong sense also was that this partnership deal was a two-way affair between business and government, rather than also directly including citizens' interests. The state's enabling legislation even provided scope to override any potential delays from the normal complications of due process (Russell *et al.* 2000). Rapid implementation was valued more highly than due process; there was no provision for the protection of consumers, and little apparent concern that the concession period may in the end be as high as 54 years in an effort to achieve profitability for the private consortia. Another

long-term governance concern to citizens was that the former State Treasurer, an ardent supporter of PPPs, took on a top job with Macquarie Bank in its infrastructure investment group, leading that corporation in becoming a key private partner for future PPPs. The year of 1999 saw the downfall of the Kennett government with the ascension of the Opposition through a 'Good Governance Charter' platform.

Discussion

Were these City Link achievements worth the price paid? And how much did citizens pay for the risks borne? Disappointingly, there has been little open debate over this issue. Dufty (1999), for one, argues that investors' interests were protected over citizens' interests. The appearance of high returns to private investors, which in practice seem to have been accompanied by minimised risks through concession deed arrangements, support this criticism. But it is tricky to make the judgment because the financial arrangements for this monopoly facility are unclear. One example of this is the annual concession fee payable to the state. This may vary by a factor of four depending on flexibility in timing options to be chosen by the consortium, and in any event these amounts may only be claimed after private investors have achieved over a 10 per cent return on their equity investment and if a reasonable cash flow is available. It is not at all clear, therefore, even when the contract documentation¹⁸ had been analysed what the 'deal' was that the state had committed itself to. Citizens of Victoria evidently paid a price in terms of lack of clarity here, as well as a high financial price for the project.

The independent review of Russell *et al.* (2000) found, in essence, that a large and complex project had been delivered on time, to meet the government's objectives. But this achievement had been accomplished at a price. They concluded that the state should in future avoid contractual obligations that impact on its discretion for up to 54 years¹⁹; that such projects should be under the regulatory powers of the State's Office of the Regulator General; and that future projects should be subject to far better parliamentary and citizen scrutiny prior to implementation. Governance was judged inadequate.

So, overall, while the commercial risks within the deal appear to have been carefully defined and managed, the same could not be said of the

state's governance in the absence of traditional checks and balances afforded major projects. We might conclude that government confused its governance role and its commercial role. At a cost of more than 10 per cent real rate of return within a flexible contract term, whether or not the purchase of this particular infrastructure was good value for money is at best questionable.

The separation of commercial and governance roles is not easy, and is clearly the challenge for governments implementing future PPPs. The private finance of public infrastructure presents government with a mega-credit card facility that is clearly attractive in the short term. But governance risks have been inadequately handled to date, and treasury departments, for instance, continue to confuse the roles of PPP policy advocate, project promoter, manager, planner, legislator, contract developer, contract regulator, financial steward, project assessor and trusted parliamentary adviser.

Citizens have the right to see project and finance details clear and explicit, including the interest rate under which government has signed, along with a clear specification of 'the deal' endorsed. In the absence of this, the political purchase of huge infrastructure projects will continue to leave citizens open to political and commercial trade-offs. If the price paid for such deals is higher than it need be, citizens inevitably pay.²⁰ Under such a scenario, it is not so much a case of risk shifting or risk sharing with PPPs, but one of shirking stewardship responsibilities in governance.

Conclusion

PPPs are the latest chapter in the privatisation of government services. Although having evolved from traditional contracts, they are quite different in that private finance is used, they typically involve complex contractual arrangements and they also assume different governance and accountability arrangements. PPPs may have the potential to provide infrastructure at more reasonable prices than comparative delivery through either the public sector or traditional contract arrangements, but experience to date has been mixed in Australia. Governments have tended to view the use of PPPs as a purchasing device, and with the objective of quick delivery, have risked due process and adequate public policy consideration in doing so. The City Link

case study analysed in this paper showed that most of the commercial risks were shifted through the contract to the private sector. Importantly as well, subsequent experience bore out the contract expectations, despite the many legal challenges mostly between private parties. The real risk associated with this PPP, however, was judged not so much to be in the commercial domain, where risks were carefully defined and managed, but in the governance domain, where government neglected traditional checks and balances afforded to major projects. Commercial and governance risks were confused. The real price paid by citizens for the private sector to bear these risks remains unclear. All purchases of infrastructure deals leave citizens open to political and commercial trade-offs. It is critical that with the huge financial resources at stake in future PPPs, and with contract decisions covering dozens of future government terms, these contracts need not only to be optimal in the technical sense, but also accompanied by a priority for democratic debate, transparency and clarity.

Notes

1. Paper submitted to AJPA (from the 'Toward Public Value?: Management and Employment for Outcomes' Conference, Monash University, 24–25 November 2003, Melbourne).
The author would like to acknowledge the research assistance of Ms Diana Bowman at the Centre for the Study of Privatisation and Public Accountability, Faculty of Law, Monash University. Diana assisted greatly in documenting risk types and analysing City Link project experience.
2. See Greve and Hodge (forthcoming). It is also not surprising that the public does not care for the fine distinctions made by some professional groups of what is and what is not a PPP or whether one type of contractual relationship is the same as another.
3. Likewise, Daniels and Trebilcock (1996) describe the private provision of public infrastructure as 'the next privatisation frontier'.
4. Experiences here included the recent line upgrade for the Jubilee Line which was six years late and 30 per cent over budget, and an analysis of some 250 projects by LU between 1997 and 2000 that revealed cost overruns averaging 20 per cent.
5. Walker and Walker (2000:204), for instance, look at the case of the Sydney Airlink BOOT project (between metropolitan Sydney and Mascot Airport), where the private project consortium was expecting to achieve a real rate of return of around 21–25 per

cent while the return to the public via government was only 2 per cent. But there is little mention of the risks being carried by either side. They also note the high (pre-tax) rate of return of 24.4 per cent for Sydney's M2 Motorway according to the NSW Auditor-General, while again not recognising the risks being borne by the private parties. If little risk was born by the private parties in these cases, then criticisms of excessive private financial returns in these projects would seem well justified, but in the absence of such information strong criticism may be premature.

6. A conceptual framework for such an evaluation is outlined in Greve and Hodge (forthcoming).
7. BOOT — Build, Own, Operate and Transfer. This project outline is based on Hodge (2002b).
8. This description draws on the previous work of Hepburn *et al.* (1997).
9. Transurban City Link Ltd is a joint venture between Transfield Pty Ltd and Obayashi Corporation.
10. See Allen Consulting Group, John Cox and Centre for Policy Studies (1996).
11. This project life had stretched out to 37.75 years by the time of the review by Russell *et al.* (2000).
12. Risks outside the control of both the state and the private sector were to be shared between users of the link and the private sector consortium (Victorian Auditor-General 1996).
13. For example, land valued at \$80 million was rented for the concession period for a paltry \$100 pa according to Costa (1997).
14. The experience of Melbourne's abysmal 'Met Ticket' debacle in the background did not help here, with public transport ticketing being regarded widely as a mess after a decade of ticket machine problems and constant criticism.
15. These controversies are taken from Hodge and Bowman (2003).
16. The often cited example here was the use of the state's infringement notice system of debt collection.
17. It would in future be desirable to evaluate these project risks in a mathematical manner using techniques encompassing expected values of economic outcomes (Ball *et al.* 2003).
18. This information was 'not readily ascertainable from the Concession Deed in the Schedule to the *Melbourne City Link Act 1995*', but Russell *et al.* report that 'the stipulation that the fee can be paid in Concession Notes appears in a separate agreement, the Master Security Deed' ... and ... 'in Exhibit W inserted by the First Amending Deed cl 3.1 (b)'.
19. The claims of policy proponents such as the Department of Treasury and Finance (2001) that PPPs provide governments with 'strategic flexibility' are hard to fathom in this light.
20. This conclusion directly parallels that of Greve (2003) who noted that 'close negotiations for long periods of time can make the relationship between public

sector organisations and private sector organisations too close and the partnership will then end in abuse towards citizens and taxpayers. As Adam Smith once noted, if you put too many people of a profession together in a room, it will not be long before they put their own interests before that of the general public'.

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