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Project alliancing on a public/private partnership project

Tony Shepherd, chief executive officer of Transfield Project Development, is a firm believer that the project financing game is moving more towards a partnership approach between the private and public sectors and says it is one area where the UK is ahead of Australia by successfully exploiting its advantages. He cites the new Southern Railway project in Sydney as a classic example of this type of project delivery, with the private sector funding the development and operation of the stations and the public sector funding the construction of the railway tunnel.

As capital markets reach new levels of maturity for assessing such deals, coupled with the increasing appetite of Australian banks and investors for patronage risks even on railway projects, in this article written for *Building Australia* Tony Shepherd ponders the next big challenge - project alliancing on a public/private partnership project.

By **AF SHEPHERD, chief executive officer, Transfield Project Development**

Introduction

I believe we should drop the term 'BOOT' and adopt the term 'Public/Private Partnerships' because the role of Government in a BOOT project, even in these days of maximum risk transfer, is highly significant. In fact, the more successful BOOT projects to date have embodied some of the principles of alliancing. A number of examples from Transfield's experience are relevant and are listed below.

The Sydney Harbour Tunnel was developed more on a partnership approach. It was an 'open book' and we worked closely with the RTA on all aspects of the development of the project. There was much give and take both before and after contract which went a long way to ensuring a successful outcome for all parties.

The New Southern Railway was developed pre-contract in an open plan office with all parties represented. In many ways, this was Transfield's first introduction to alliancing on a major project. Post-contract, the relationship has become more traditional and formal.

The Melbourne City Link was developed in a highly competitive and very rigorous environment other than for the appointment of a go-between for each consortium by the Authority. The delivery has tended to be traditional and there have been well publicised contractual problems. It is this project which has encouraged Transfield to find better delivery mechanisms.

The fundamental reasons for the need to review the traditional BOOT process may be summarised as follows:

- The lack of flexibility in the evolution of the project where the host authority must juggle competing bidders and keep them on the same baseline, often while simultaneously processing an EIS.
- The current arrangements lack flexibility in operation whether it be extending or widening a tollway or converting a power station from PPA to a merchant plant.
- The high transaction costs in taking at least two fully developed and underwritten bids to the finishing line. Our external costs alone on Melbourne City Link were $24m at financial close.

Dynamics of a public/private partnership

Let me briefly examine each of the main players in such a project and identify their key drivers.

Host Authority

Value for money;
Wealth generation and job growth;
Quality asset and service;
Environmental protection;
Protect the consumer;
Social equity;
Prevent private sector excessive profit taking in relation to risk;
Receive the asset in good order and condition;
The ability to step in and rectify if the private sector fails.

Sponsor

Win the bid while minimising upfront cost and risk; Create a quality deal which

balances the competing requirements of all players; A quick transaction.

Turnkey contractor
Maximise profits, minimise risk, generous program. A similar situation applies to sub-contractors, suppliers and consultants.

Operator
Maximise long term returns;
Create an asset which more than does the job and is maintainable, expandable and easy to operate.

Equity
Maximise returns and minimise risks.

Debt
Ensure the project is sufficiently robust in all relevant aspects so that debt is comfortably repaid;

Have more than enough security so that the bank is protected in the event of default;

Have sufficient power to step in if the project looks like 'falling over' at any stage.

The above may be a little harsh and in many cases the sponsor, turnkey contractor, operator and equity are the one party (in Transfield's case this does not mean there is any less tension!).

The challenge in introducing Project Alliancing to a Private/Public Partnership Project is to overlay it on a limited recourse finance structure which by its nature is rigorous and precise in allocating risk and tough in the treatment of a default. Limited recourse finance is the traditional form of finance for such projects and, essentially, means that the recourse of lenders is confined to the project. This is achieved by very careful up-front allocation of the major project risks to the appropriate party.

Limited recourse finance is a 'universe' largely created by banks and it will be the banks which will be one of our biggest obstacles to the introduction of alliance principles to this delivery mechanism. However, the banks should be attracted to an arrangement where the level of conflict is substantially reduced or eliminated.

Another major impediment is the Australian taxation laws which at present take a jaundiced view of risk sharing and tend to regard anything but the purist model as a public sector sham. Hopefully, the Ralph review currently underway will modernise the tax laws in this regard.

Tony Shepard

Project alliance principles

I do not wish to launch into a detailed description of alliancing but let me summarise some of the key principles normally found in an alliance contract.

- Act in a way that is best for the project;
- Build a champion team which is integrated across all disciplines/organisations;
- Commit to a no-blame culture;
- Use breakthroughs to achieve exceptional results in all project objectives;
- Commit corporately and individually to openness, integrity, trust, co-operation, mutual support and respect, flexibility, honesty and loyalty to the project;
- Outstanding results provide outstanding rewards;
- Deal with and resolve all issues within the alliance;
- Spread the alliance culture to all stakeholders.

Bid process for an alliance project (public/private partnership)

Recognising that Government must always award contracts in a competitive environment, perhaps the sequence of events in a significant public/private alliance project of a BOOT type could be as follows:

The host authority goes through the conventional EOI process leading to the short listing of two bidders. However, the EOI process will place more emphasis on Government outcomes and parameters including quality and scope of solutions, Government contribution in cash or kind, and Government appetite for risk. In addition to the standard EOI data, respondents will need to identify the level of equity and debt returns they are seeking, their appetite for risk and their preparedness for gainshare/painshare in both construction and operation using alliance principles. This process should also include lenders.

The two shortlisted bidders then submit reasonably detailed bids in an alliance format but not, say, to the Melbourne City Link standard and not with final bank credit committee approval. The bids would contain the design solution, target operations price, risk allocation, and financing plan including equity and debt returns and details of the gainshare/painshare arrangements.

A preferred bidder would be selected and a brief interim agreement signed outlining the basis of selection and the key parameters. A joint integrated project office would then be established with representatives of the host authority, sponsors, constructors, operators and lenders with a view to finalising the details of the transaction. The other shortlisted bidder could be kept in reserve.

The next task would be to optimise the scope in an interactive process involving all parties including the lenders. Complete capital and operating cost estimates would be reviewed on an open book basis and run through the financial model using the pre-agreed fixed equity return and debt parameters. Through an iterative process the capex, opex, equity return, debt parameters, toll/tariff, risk allocation and Government contribution (if any) would be optimised leading to financial close.

Construction phase

This phase is where an alliance could become difficult. Under the alliance

approach, the turnkey contract is undertaken in a partnership between the host and the contractor on an open book basis with a target cost. Normally, under the gainshare/painshare arrangement the parties either win or lose with the contractor risking overhead recovery and profit on a predetermined basis. By comparison, limited recourses finance is predicated on a fixed price and guaranteed programme. One way of melding the two apparently conflicting approaches is as follows:

- The contractor guarantees a maximum price and program, which are greater than the target price and program, with the normal performance security and liquidated damages and recourse to which would be limited to those situations where the alliancing process breaks down.
- The contract is undertaken on an alliance 'open book' basis in accordance with alliance principles with the host and the contractor gainsharing and painsharing on a pre-agreed basis.
- If the contract price increases or program blows out above the guaranteed maximum price or program for any reason then the parties (host, contractor, equity, debt) get together and find a way to fix the problem using a tool or tools from the following tool box:
  - extending the debt term;
  - raising more debt and or equity;
  - extending the concession term or scope;
  - government contribution;
  - re-arrangement of scope resulting in an offsetting saving;
  - the contractor takes a reduction in margin or overheads.

We would need to develop what tool would be used in what circumstance and in what priority order.

Another alternative would be to develop the turnkey on an alliance basis and convert to a true turnkey at financial close. However this approach would lose the benefit of future flexibility.

Operation phase

This phase raises similar problems to the construction phase as, in many cases, there is a long term operating contract underpinning the operating cost in a limited recourse debt project which guarantees operating costs and standards. Once again, alliancing principles could be introduced as follows:

- The operator guarantees the maximum operating cost (which could be greater than the target cost) and key performance indicators with the normal performance security and recourse to which would be limited to those cases where the alliancing process breaks down.

- The operations are undertaken on an 'open book' basis with the host and the operator (and, perhaps, equity) gainsharing/painsharing in an arrangement which will have to be carefully set up to avoid any tax problems when the host is a non-taxpaying entity.
- If the operating costs increase or the KPI's need to be varied for any reason then the parties (host, operator, equity, debt) get together and find a way to fix the problem using a tool or tools from the same tool box described above.

Again, we would need to develop what tool would be used in what circumstance and in what priority order.

Equity

I have included above some examples in construction and operation where gainsharing/painsharing might apply under a BOOT project which could affect equity.

Another community concern is the significant 'windfall' profits made through the ownership of public infrastructure, e.g., the tollroads in Sydney and Transurban in Melbourne. Of course, they ignore:-

- The losses and problems associated with the risk on public infrastructure projects, e.g Skitube, The Sydney Monorail, Sydney Olympic Stadium and the Victorian Power Generators in the early years.
- The substantial patronage risks now taken on toll road projects which, in the case of Transurban and Eastern Distributor, have not yet been tested.
- Venture capital of this type when coupled with highly geared limited recourse debt, produces volatile returns and, normally, such investments must be predicated on 'highish' returns in a competitive market.
- Many of the recent gains in value are simply due to the significant reduction (50%) in market yields since the deals were put in place.
- Nevertheless, there is room for sharing and/or capping equity returns if, in practice, returns should exceed high side predictions and, again, this approach would be entirely compatible with the alliancing concept. There may be some form of tradeoff on the downside (e.g., capacity charges, non-compete provisions) but in all cases we would need to be careful not to offend Australian tax and competition laws.
- From a practical point of view, it is in equity's best interest to have an arrangement whereby the Government has a financial incentive to ensure the economic success of the project. Some of the ways the Government may share in the upside include:
  - a minority shareholding;
  - a reduction in toll/tariff or a delay in price hikes;
  - an expansion of the facilities or services within the same toll/tariff regime; and
  - a reduction in the concession terms.

Conclusion

There are many imponderables in the above framework but I believe that these issues can be worked through and that the alliance concept can be blended successfully with a public/private partnership delivery process.

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audited by William M Mercer Pty Limited, indicated that the base case internal rate of return (post Airport Motorway Group tax, pre equity investor tax) on the ITA Group's investment will be approximately 16%. This does not include a $5.7 million underwriting fee which the ITA Group received in 1997. The equity return is sensitive to the level of traffic using the Eastern Distributor throughout its concession period.

In the first three years of operation, traffic revenues in excess of the base case are to be paid to the Roads and Traffic Authority, up to a maximum of $6.5 million per annum in each year. Equity returns from investment in the Eastern Distributor are linked to inflation through the toll increase.

As various risks in the project are mitigated or removed, the risk premium estimated by the market for the project is expected to reduce. As with other tollroad projects, key points of risk mitigation are expected at the completion of construction and after ramp-up has occurred. At each of these points, the reduction in risk should, if the base assumptions are realised, translate into an increase in the value of the ITA Group's investment through re-rating.

The single most important factor affecting the ITA Group's return from investment in Airport Motorway Group is the traffic volume achieved. Much work has been carried out by the Group on ensuring that the traffic forecasts adopted (57,372 vehicles per day in 2011 paying a $3.00 toll in today's dollars) and these forecasts have been independently audited from National Australia Bank. However, the traffic assumptions which underlie the projections of equity returns from the project are not guaranteed and remain forecasts only.

Mr Eagar said that in many respects the Eastern Distributor will be the best of the tollroads firstly because it doesn't have an expressway running parallel to it and secondly, its market is less dependent on people just travelling to and from work.

"Thirdly, you will only pay a toll going in one direction and we think the ramp-up period will be much faster than it has been on the other tollroads.

"The Hills Motorway for example is taking a lot longer than expected to build up its traffic volumes," said Mr Eagar.

He conceded that the only constraint on future growth in revenues is that it is limited by capacity constraints in the long term due to the tunnel but that has been taken into account in ITA's revenue forecasts.

Indeed the success of projects such as the Eastern Distributor has led the ITA to examine investment opportunities in tollroads in Europe and North America, with the Trust recently signing an agreement to develop a tollroad in Rostock in Germany. The $A350 million project comprises the construction of a tunnel beneath the city's harbour, with connecting roads. The Infrastructure Trust of Australia will have 70% equity in the project with the remaining 30% coming from French company Bouygues, the latter already well known to the Australians from their involvement in the Airport Link project in Sydney with Transfield.