Controller and Auditor-General
Tumuaki o te Mana Arotake

Discussion paper

Managing the implications of public private partnerships

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Managing the implications of public private partnerships

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Auditor-General's overview

There has been a lot written internationally about public private partnerships (PPPs). Much of this has focused on the upfront structural and contractual arrangements involved, which are central to organising the process and the parties. There have also been many appraisals of PPP projects but their findings are highly specific to particular countries, remarkably polarised, and, taken as a whole, inconclusive.

There has been less focus on understanding the diversity of the approach, the implications for innovation, and what is needed to manage the effectiveness and efficiency of an ongoing programme of PPPs.

Recent events have tested how effective and efficient PPP programmes are. Reports from the United Kingdom's House of Commons Treasury and Public Accounts Committees on Private Finance Initiatives (PFIs are a type of PPP) recognise the added rigour that comes from relying on the private sector to efficiently finance PFIs and manage risk from PFIs. However, these reports also note that "At present, PFI deals look better value for the private sector than for the taxpayer"[1] and that, within the current environment, the assumed private sector efficiencies may not be compelling and until they are, PFIs should be used "as sparingly as possible".[2]

The global financial crisis has taught us that, ultimately, the fortunes of the public and private sectors are mutually dependent. This is also the case with PPPs, the success or value of which depends on whether each sector has the capability, capacity, and institutional structures to support and sustain the venture, the participants, and the process.

Supporting the environment for public private partnerships

In line with the Government encouraging agencies to be innovative in delivering public services effectively and efficiently, it has indicated that it wants to use PPPs as an option to help build infrastructure.

The work of the Treasury's National Infrastructure Unit to marshal expertise and needed resources provides good support for these new central government PPP initiatives. Appropriately, the work, supported by two pilot PPP projects, has focused on developing specific policies, governance, and structures to help achieve the Government's strategic objectives and support the growth of the PPP market.

Part 4 of this paper summarises a review of the PPP environment. It shows that, although the use of PPPs is maturing, a sound platform for an ongoing programme of PPPs still needs to be built. There remain:

1 www.publications.parliament.uk/pa/cm201012/cmselect/cmpubacc/1201/1201.pdf, page 3.

2 www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1146/1146.pdf, page 3.

- limited understanding in wider stakeholder and community groups;
- only partial guidance and support for local government;
- fragmented public sector skills, knowledge, and information flows;
- limited diversity in the capital markets and funding base; and
- a lack of some domestic private sector expertise and capability.

If more PPPs are entered into, careful attention is needed to ensure that innovation continues to be encouraged and the challenges and opportunities that these partnerships present are fully understood, managed, and accounted for. For the public sector, this means broadening oversight and control of the PPP programme to ensure that the public's interest is effectively represented, supervised and, ultimately, satisfied.

Along with managing the risks identified in my Office's 2006 report, *Achieving public sector outcomes with private sector partners*, and informed by the observations of my Auditor-General colleagues from other jurisdictions, I consider that:

- public entities involved in PPPs must:
  - properly understand and manage these partnerships strategically, tactically, and operationally; and
  - establish and maintain good ongoing relationships and processes with stakeholder and community groups; and
- central agencies should consider how best to:
  - provide more co-ordinated guidance and support throughout the public sector, particularly with monitoring and managing these partnerships when they become operational;
  - build a co-ordinated reporting strategy that provides regular and transparent performance information on the portfolio of PPPs; and
  - comment on, and manage if needed, the strategic, sector-wide, issues that could affect the PPP programme, such as perceived limitations in local funding markets and the lack of domestic private sector expertise.

I hope that this discussion paper helps readers to understand the opportunities and challenges that a programme of PPPs brings to the public sector, and encourages discussion and informed debate about that programme. I thank Deloitte for its contribution to this paper.

Lyn Provost
Controller and Auditor-General

10 November 2011

Part 1
Introduction

1.1 Our 2006 report, *Achieving public sector outcomes with private sector partners*, discussed ways the public and private sectors could partner with each other, including public private partnerships (PPPs). Commenting on the principles for encouraging good public sector governance when partnering with the private sector, page 8 of that report noted:

> *Public entities are ultimately accountable for delivering public services, which is a responsibility they cannot transfer to the private sector. The public entity must have robust internal arrangements in place for deciding to opt for a partnering approach, and for managing its implementation. There will need to be strong leadership from the top of the organisation to drive the process and ensure proper accountability and control. There should be a clear definition of roles and responsibilities, identification of relevant authorities and delegations, and adequate arrangements for public scrutiny of performance under the contract.*

1.2 The 2006 report outlined three key risks to a public entity adopting a partnering arrangement:

- poor performance by the private sector party affecting the public entity's ability to deliver core or essential public services;
- a possible change of government resulting in a policy change that might affect the partnering arrangement; and
- poor managing of contracts.

What has changed since 2006

1.3 The cost of providing public sector services has become a major focus worldwide. Potentially, partnering (particularly PPPs) is one way to manage these costs more effectively and efficiently. Compared with collaborative (joint) procurement practices, which are expected to deliver "the same for less" in the short term, PPPs offer the potential to deliver "more for the same" in the long term.

1.4 Partnering arrangements have been used to deliver public sector services for some time but compared with Australia, Britain, and Ireland, PPPs have been used sparingly, with little co-ordination or organised guidance.

1.5 In 2008, the Government's announcement of its infrastructure policy and support for the use of PPPs changed this. Cabinet agreed to use PPPs to build infrastructure and support them in a more centralised and formal way (see paragraph 2.25). This raised the profile and potential extent of PPPs in the public sector.

The audience for and scope of this discussion paper

1.6 We have written this discussion paper to inform public sector leaders and decision-makers considering partnering with the private sector about the general features of PPPs and the factors that are seen as important in sustaining an appropriate "enabling" environment for all PPPs.

1.7 This paper builds on our 2006 report, discussing PPPs as part of a partnering spectrum that is being used to respond to the future costs and needs for public services. We explore how PPPs are being used to capture innovation and change by sharing the risks and responsibilities in performing a particular public service.

1.8 As the public sector looks to expand its use of partnering arrangements, we need to learn from our own and others' experiences about the innovative responses that PPPs are expected to generate. Better understanding about PPPs and their place in the partnering spectrum will help agencies more effectively and efficiently respond to the changing needs of the public sector. The paper is supported by:

- international observations and literature about PPPs;
- the experiences of public and private sector participants; and
- a review and analysis of this country's PPP market.

1.9 The paper does not:

- provide an audit or review of any individual PPP activity or associated entity;
- advocate the use of PPPs as an instrument of public policy, or conclude on the success or otherwise of a particular PPP or PPP policy; or
- audit or review the structures, mechanics, or economics of PPPs.

Part 2
Introducing public private partnerships

2.1 In this Part, we consider the worldwide use of PPPs, where they sit on the partnering spectrum, and what general features are apparent in all PPPs. We summarise the environment, outline the history of the current PPP approach, and describe the Government's recent focus. We then compare the approach's advantages and disadvantages and discuss the implications for achieving value for money.

The spectrum and general features of public private partnerships

2.2 PPPs are a type of partnering arrangement between the public and private sectors but there is no overarching definition or common approach.

2.3 Across the world, different PPP models exist. These include the British "contractual" model, which prioritises the contract over the partnership, and the continental European "relational" or "institutional" model, which prioritises the partnership over the contract. Names used to describe the partnering approach include Public-Private Interaction, Public-Private Co-operation, Private Finance Initiative, and Private Sector Participation. There is even a variant used by the Scottish Government called the Non-Profit Distributing Public Private Partnership, where no dividend-bearing private sector equity is used.

2.4 One reason for this diversity is that few common features distinguish PPPs from general procurement. A recent international review[3] of 19 definitions of PPPs listed five common elements:

- a contract or an arrangement;
- the provision of public infrastructure or services;
- the transfer of risk from the public sector to the private sector;
- a reward system based on performance or output; and
- a focus on service delivery.

2.5 Governments that have moved towards a more centrally co-ordinated PPP programme recognise the diversity but usually tailor their approach to a particular context, adopting formal and standardised definitions.

2.6 The United Kingdom's Treasury describes PPPs generally but recognises a common form involving private sector investment in infrastructure:

> *Public private partnerships (PPPs) are arrangements typified by joint working between the public and private sector. In the broadest sense, PPPs can cover all types of collaboration across the interface between the public and private sectors*

3 Credit Rating and Information Services of India Limited Infrastructure Advisory (January 2010), *Defining PPPs: A cross country review*, which is available at http://ppp.rajasthan.gov.in/newsevents/Pratyush_Prashant.pdf.

> *to deliver policies, services and infrastructure. Where delivery of public services involves private sector investment in infrastructure, the most common form of PPP is the Private Finance Initiative (PFI).*[4]

2.7 The New Zealand Treasury's National Infrastructure Unit (NIU) notes that the term PPP can refer to many different kinds of relationship between the Government and the private sector but that generally it refers to:

> *… a long term contract for the delivery of a service, where the provision of the service requires the construction of a new asset, or the enhancement of an existing asset, that is financed from external sources on a non-recourse basis.*[5]

2.8 Figure 1 shows a core set of PPP examples, including those supported by the NIU, within the spectrum of possible partnering approaches.

2.9 The core PPPs are not all new. Many involve large, new, capital investment and use conventional contracts with private financing.[6]

2.10 Looking across the spectrum and considering other PPP literature and practice, there are three general and common features of these core PPPs:

- a focus on providing and performing a public service through a particular project or programme – a PPP's ultimate objective is delivering a project or programme that performs a public service;
- a material transfer and acceptance of risk by the parties – each partner taking responsibility for some of the future uncertainty in performing the service; and
- an expectation of mutually beneficial and mutually dependent organisational or project/programme change – a common responsibility helps each partner to deliver services more creatively, effectively, and efficiently.

2.11 These features allow PPPs to create a platform that brings together the public and private sectors in a way that if successful, encourages both partners to be more creative and innovative in meeting the evolving needs of public sector stakeholders.

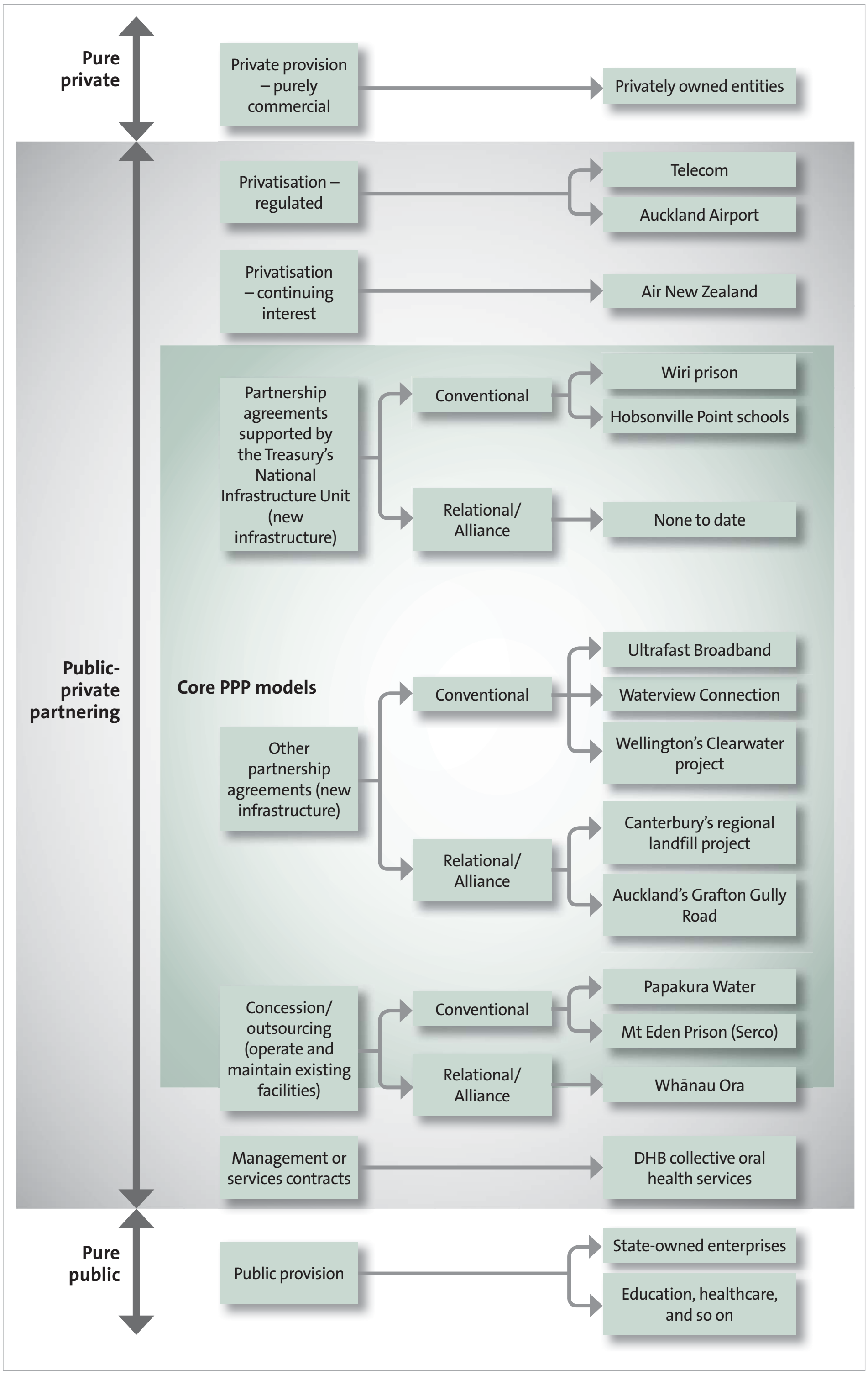
2.12 The enabling function is sometimes expressed as PPPs providing a "catalyst for change" and the expectation of innovation has become a fundamental feature of the PPP approach.

4 See the United Kingdom Treasury's website, www.hm-treasury.gov.uk.

5 NIU (2010), *Draft Public Private Partnership (PPP) Standard Contract – Version 2*.

6 See our 2006 report, *Achieving public sector outcomes with private sector partners*, for more details about some of these projects.

Figure 1
The partnering spectrum



Adapted from World Bank and the Public-Private Infrastructure Advisory Facility (2007) *Public-private partnership units*.

2.13 The following case study shows how Whānau Ora, an inclusive approach to providing integrated services and opportunities to families, sits on the edge of the PPP boundary.

Case Study: Whānau Ora

Whānau Ora is a new approach to working with whānau to provide services and opportunities to help them define and achieve their goals and objectives. In May 2010, the Government at first allocated $134.3 million for Whānau Ora. In May 2011, it allocated a further $30 million. Whānau Ora's focus is to invest in whānau capacity and capability. It helps providers change their business models, trains Whānau Ora practitioners, and improves their systems.

As well as the new funding, existing provider contracts can be integrated. This means combining complex, multiple contracts into a single, simple contract that focuses on results for whānau and families, allowing providers to focus more on the whānau they work with.

In 2011, 350 external providers (most working in collectives of up to 17 providers) submitted 130 expressions of interest to deliver Whānau Ora projects, programmes, and initiatives.

Whānau Ora has characteristics of a PPP:

- it generates and delivers innovation and change in the way public services are delivered, using arrangements with organisations outside the public sector; and
- there is material acceptance and transfer of risk between the parties – some provider collectives have made significant investments using their own resources in, for example, leasing/buying new buildings in which to work.

However, the process of generating this innovation and change is co-operative rather than competitive. Whānau Ora is an umbrella concept that guides and co-ordinates a new way of thinking about service delivery, rather than being focused on any one project or programme.

This umbrella concept resembles two British initiatives: the Local Improvements Finance Trust (or LIFT) and the Building Schools for the Future programme. The latter has been described as a "super structure PPP" and the LIFT initiative as a "long term, strategic PPP partnership".

The main lessons learned so far from this innovative Whānau Ora process include:

- the importance of a strong public accountability and decision-making framework to support trust and encourage working with the community and other stakeholders; and
- the importance of community involvement and perspectives in encouraging innovation.

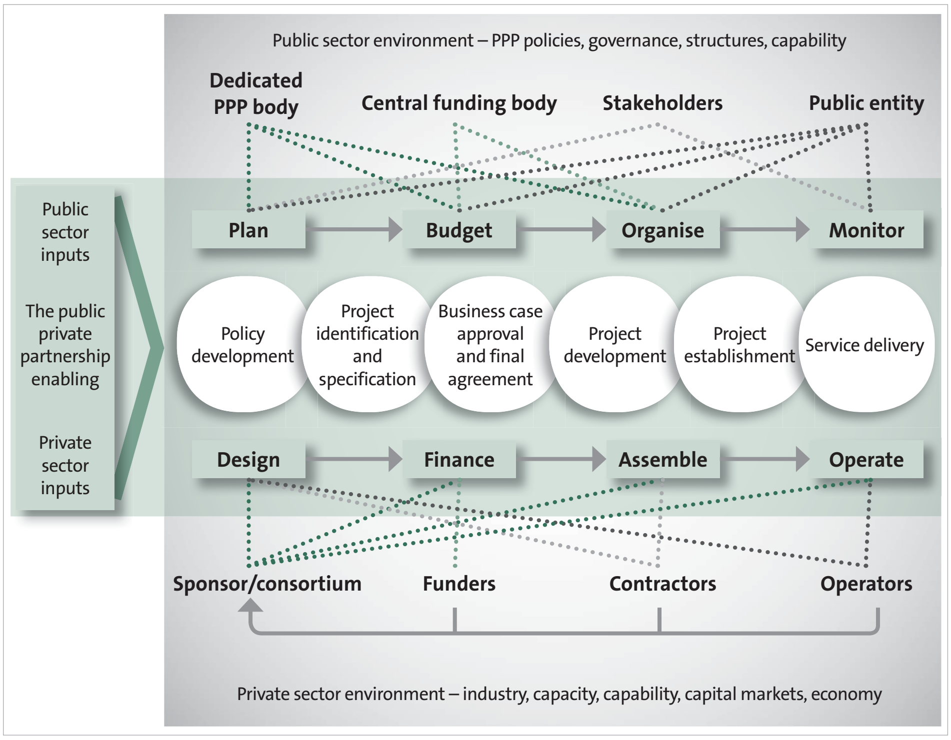
The environment for public private partnerships

2.14 PPPs bring together many participants and activities in an inter-related and mutually dependent way.

2.15 Figure 2 provides a general overview of the public and private sector participants and activities that can surround a PPP project or programme. It shows each sector's inputs into the process from policy development to service delivery.

2.16 Figure 2 is based on a contemporary New Zealand form of PPP. This involves a consortium of private sector participants contracting with a public sector body, and where there is a clear separation of ownership and financing. Professional consultants are used as needed throughout the process.

Figure 2
The public private partnership environment



2.17 Figure 2 shows that although some form of contractual arrangement will be central to organising the process and the parties, the ultimate success or value of these partnerships will depend on whether each sector has the capability, capacity, and institutional structures to support and sustain the project/programme, the participants, and the process.

A brief history of the policy environment

2.18 The public sector has always contracted with the private sector. The idea of encouraging and using partnering arrangements with the private sector to deliver services began to emerge in New Zealand in the late 1980s.

2.19 In 1989, although the then Government's focus was on privatisation and corporatisation, the Local Government Act 1974 was amended to allow councils to establish standalone entities as partnerships that could carry out certain council-related activities. A number of these partnerships (an early form of PPPs) were set up to carry out roading and other maintenance contracts.

2.20 The new Local Government Act of 2002 provided new possibilities for local authorities to work in partnership with other institutions, including central government, other councils, the private sector, and communities. The 2002 Act allowed the greater use of PPPs and required a PPP policy to be prepared and adopted as part of the long-term council community plan (now called long-term plan).

2.21 One year later, the Land Transport Management Act 2003 allowed public road controlling authorities to enter PPP-style concession agreements (see Figure 1) with third parties to build or operate roads. The term of the concession could not exceed 35 years and the responsible Minister had to approve any such agreement.

2.22 Large infrastructure PPPs were entered into during the last two decades, with most involving local authorities or transport projects. Apart from the transport projects, there was little central government involvement and no centralised policy or guidance.

2.23 The Mangawhai EcoCare case study summarises a PPP carried out by a local authority.

Case study: Mangawhai EcoCare Wastewater Treatment Scheme Project

In the early 1990s, the Mangawhai EcoCare Wastewater Treatment Scheme Project began when the water quality in the Mangawhai estuary, north of Auckland, became noticeably degraded because of the cumulative effect of sewage disposal, geographic features, the number of people in the area during peak seasonal periods, and the use of septic tanks and long drops.

After the 1998 local government elections, Kaipara District Council engaged project managers who had Australian expertise in PPPs. The initial plan envisioned a "Build Own Operate Transfer" PPP model, with the assets being transferred to the Council in 25 years.

However, the initial plan was changed when the Local Government Act 2002 came into effect. In late 2005, from a short list of three companies, tenderer Earthtech Engineering Limited (now Water Infrastructure Group) won the contract to provide wastewater services to Mangawhai for up to 15 years, including providing a wastewater collection, treatment, and disposal system.

In January 2007, work on the $65 million EcoCare Scheme began. In July 2009, the first house was connected. The scheme includes 21 kilometres of sewers, 15 pumping stations, six kilometres of rising mains, a small water-reclamation plant, an 11-kilometre reclaimed-water transfer pipeline and a 180 megalitre reclaimed-water storage facility and irrigation system. Today, more than 2000 properties are connected to the scheme, which has the capacity to service 4500 properties.

The Council sought innovation from the market, long-term certainty in wastewater treatment, affordability, and improved water quality in the Mangawhai estuary. A major achievement of the project was the ability to change the scope of the works during the project development and construction stages.

Some of the lessons learned from the project include:

- there is a clear need for expertise and experience with PPP projects to ensure success;
- flexibility is important, particularly where changes in demand are expected;
- frequent and effective communication with the community and other stakeholders is essential; and
- a PPP education programme throughout the Council's organisation was needed.

The project has attracted much local comment. The last two lessons could have helped mitigate some public concerns that the Council faces.

The Government's recent focus

2.24 In 2008, the then opposition party's pre-election policy on infrastructure expressed the need for more investment in infrastructure through more private sector involvement and "greater use of public private partnerships for the development and management of infrastructure assets".[7]

2.25 Since then, government initiatives have encouraged private sector involvement in infrastructure. These initiatives include:

- appointing a Minister for Infrastructure to reshape, co-ordinate, and oversee infrastructure objectives;
- setting up the NIU within the Treasury;

7 National Party (2008), *Infrastructure: Building for a brighter future* www.national.org.nz/files/2008/infrastructure_bluesheet.pdf.

- establishing a National Infrastructure Advisory Board to advise the NIU and the Minister for Infrastructure;
- releasing a National Infrastructure Plan (NIP) and guide to PPPs;
- drawing up a draft standardised PPP contract; and
- instigating two PPP "pilot" projects, which are still in progress.

The Treasury's National Infrastructure Unit

2.26 In 2009, the NIU was established. Among other things, the unit was tasked with providing support and guidance to government agencies when preparing PPPs. This includes supporting the growth of a market for PPPs, establishing the expertise needed, and encouraging local authorities to use PPPs.

2.27 The NIU is working on further guidance publications.[8] Entities exploring partnering arrangements are encouraged to refer to such guidance for help with developing and assessing their projects.

National Infrastructure Plan

2.28 The NIP is designed to reduce uncertainty for businesses by outlining how the Government intends to develop infrastructure during a 20-year period. The NIP provides a framework for developing infrastructure, rather than a detailed list of prospective activities.

2.29 The NIP is updated every three years. Two plans have been published, the newer in July 2011.

The public private partnership guide

2.30 The purpose of *Guidance for Public Private Partnerships in New Zealand* is to outline for government agencies, potential bidders and the public the general direction and principles that will be adopted for PPPs, the processes that are to be followed, and the rationale for them.[9] This guide provides a framework for assessing whether a PPP is to be preferred over other forms of procurement. The NIU's *Better Business Cases for Capital Proposals* has further guidance.[10]

8 These will be available at www.treasury.govt.nz.

9 National Infrastructure Unit (2009), *Guidance for Public Private Partnerships in New Zealand*, available at www.infrastructure.govt.nz/publications/pppguidance.

10 National Infrastructure Unit (2011), *Better Business Cases for Capital Proposals*, available at www.infrastructure.govt.nz/publications/betterbusinesscases.

The public private partnership contract

2.31 The *Draft PPP Standard Contract* is meant to streamline and improve the consistency of the public sector's approach to PPPs. Its objectives include "achieving value-for-money, optimal risk transfer and standardisation".[11] The draft includes "model terms" and does not deal with matters that are specific to individual projects/programmes or sectors.

Two pilot public private partnership projects

2.32 The NIU supports two active pilot projects. These are Wiri prison (begun in 2010) and two schools at Hobsonville Point (begun in 2011). The Wiri prison PPP is an "all services" project where the private sector designs, builds, funds, maintains, and operates the prison. The Hobsonville Point Schools project is a much simpler asset-based PPP in which the private sector designs, builds, funds, and maintains the school facilities but does not provide any educational services.

2.33 The following case study summarises the Hobsonville Point schools PPP, which has used the NIU's standard project agreement as the basis for structuring a PPP on a smaller, less complex, scale compared with the Wiri prison PPP.

11 National Infrastructure Unit (2010) *Draft PPP Standard Contract Version 2*, available at www.infrastructure.govt.nz/publications/draftpppstandardcontract/dpppsc-v2.pdf.

Case study: Hobsonville Point schools

In early 2011, the Government announced that it intended to commission two new schools under a PPP framework. The schools at Hobsonville Point, in north-west Auckland, are a primary school for 690 students and a secondary school for 1500 students. The schools will be built on separate sites owned by the Ministry of Education (the Ministry).

The Ministry intends to engage a private sector partner to design, build, finance, and maintain the two school properties. The contract is for 25 years after completing the secondary school. An Establishment Board of Trustees has been appointed to prepare the education vision for both schools. This helps to define the output specifications for the project.

In March 2011, the tender process began. The primary school is expected to be built by January 2013 and the secondary school by January 2014. Because the focus of this PPP was on the property aspects, the procuring process was shorter and faster, saving bid costs for the private consortia, compared with the Wiri prison PPP. The Request for Proposal (RFP) time frame was 12 weeks, whereas the Wiri prison RFP time frame was 20 weeks.

This project has benefited from learnings from the Wiri prison PPP documents and process. This sharing of knowledge between projects is a core objective of the PPP programme because it helps streamline the procurement processes.

A Ministry project team that includes staff from throughout the Ministry manages the PPP. External consultants support the project team. Every month, the team reports progress to a steering group chaired by a Deputy Secretary of the Ministry and made up of representatives from the Ministry and the Treasury.

The PPP is expected to be marginally better value for money than traditional procuring, but new design, financing, and maintenance techniques are expected to provide large qualitative benefits. Further, the project aims to reduce the amount of time spent by school principals and boards of trustees on property issues, allowing them to concentrate on improving educational outcomes for students. This should flow through to the wider education property portfolio and public sector.

The main lessons learned so far from the process include the importance of:

- considering carefully the PPP's objective and the particular service needs it seeks to address;
- an engagement strategy that reflects the private sector's ability to manage risks and costs effectively;
- expertise to lead and manage the project; and
- getting the contract documents right for the objectives and specifications of the projects.

The advantages and disadvantages of public private partnerships

2.34 Many publications and reviews list potential advantages and/or disadvantages of PPPs. These lists are usually based on long-term infrastructure contracts, which include a large element of private financing. In many cases, these are used to debate the perceived value-for-money differences between the PPP approach and traditional ways of procuring. However, working out which factors are most important to the value-for-money outcome is difficult and open to interpretation.

2.35 In 2010, reflecting on the polarised debate, Graeme Hodge and Colin Duffield noted:

> *Internationally, much has been written on PPPs, although this has often amounted ... to little more than blatant policy salesmanship and stinging critical rhetoric. International studies show widely varying results, with some studies claiming high VfM* [value for money] *compared to traditional infrastructure delivery approaches and others claiming just the opposite.*[12]

2.36 Much of this variation arises from the diversity of the PPP approach, but there is often little recognition that an advantage can have related disadvantages. Figure 3 lists the advantages commonly used by commentators to promote PPPs and shows how many have related and sometimes significant disadvantages for the public sector.

Figure 3
Advantages and disadvantages of public private partnerships

Stated advantages for the public sector	Related disadvantages for the public sector
Greater risk transfer to those parties best able to manage that risk	Difficulties in specifying, pricing, and the ownership of risk A monetary cost to the public sector in transferring that risk Ultimately, the public sector is responsible for delivering core or essential services
Related to the greater risk transfer, there can be more certainty in costing and timing of projects or programmes	Longer, more detailed, and more costly procuring
Not having to find the money to pay for the project or programme immediately	Need to pay for the project or programme cost over the operational stages
Being able to spread the cost of services over the lifetime, meaning greater intergenerational equity	Less flexibility through a long-term contract to manage the overall business in response to agreed or changing needs and policies Future users could be disadvantaged if the level of service quality changes over time
Greater third-party scrutiny and accountability through funders, sponsors, and stakeholders	More complex contract, higher procurement costs Different parties with differing motivations and incentives (greater overall governance needs)

12 Hodge, G, Greve, C, and Boardman, A (eds) (2010) *International Handbook on Public-Private Partnerships*, Edward Elgar, Cheltenham UK, page 420.

Stated advantages for the public sector	Related disadvantages for the public sector
Brings together (bundling of) various activities (such as design, construction, maintenance, and operations) to allow a whole-of-life perspective	Reduces the options available to manage the project or programme in discrete steps over time Can create difficulties when the service quality (or outcome) requirements cannot be defined clearly Can encourage upfront choices that reduce future costs at the expense of future service quality
Less project or programme management required	Greater contract and performance management required
Potential innovation and change in the way the project, programme, or service is planned, structured, and delivered (from private sector involvement)	The potential risks in achieving innovation and change will depend on the maturity of the sectors and the relationship between the parties

2.37 The net effect of these trade-offs means that, in most cases, it should be expected that the main value for money difference compared with traditional procurement arises from the potential of the private sector to deliver innovation and change in the PPP's service delivery objective. The public sector uses the private sector to help achieve this innovation and change but must also support the relationship and the process by clearly specifying these innovative benefits, how they are rewarded, and then by monitoring their progress in a transparent and accountable way.

2.38 This potential for innovation is a major benefit and point of difference between PPPs and many traditional or conventional procurement practices. In most traditional procurement, the main aim is to achieve the most competitive price for a fixed or known product or service. The PPP model developing in New Zealand is aimed at achieving the most competitive or innovative product or service for a fixed or known price.

2.39 The following case study summarises the NIU-supported Wiri prison PPP, which shows some innovative ideas for planning, structuring, and delivering services.

Case study: Wiri prison

In early 2010, the Government announced that it intended to commission a new prison at Wiri (in South Auckland) to be designed, built, paid for, and operated by a private sector consortium. The proposed men's prison at Wiri in Manukau will have the capability to hold up to 1060 prisoners. It will be built on land owned by the Department of Corrections (the Department). The project is still being procured. The full custodial contract will run for 25 years from the time the prison becomes operational, which is expected to be in 2015.

The Department is seeking to make use of international experience and to drive innovation in addressing the higher rates of reconviction and re-imprisonment, particularly for Māori offenders.

At the heart of the Wiri prison PPP is a requirement for the private sector partner to consistently deliver better performance than the Department over the long term. To do this requires contracting with the private sector to deliver certain social outcomes (for example, ensuring sentence compliance and reduced reoffending) and linking these outcomes to an incentive payment mechanism. The Department places minimal constraints on how outcomes are delivered but, if outcomes are not achieved, then the payments to the private partner will be reduced accordingly.

This contracting-for-outcomes approach is highly innovative and means that private sector performance can be used as a yardstick for the Department's own performance, driving further changes across the wider prison network.

A PPP project team within the Department includes staff who bring PPP expertise gained from other jurisdictions as well as staff from the Department who bring the required areas of expertise about the custodial element of the project. The NIU has been directly involved in providing resource into the project.

Lessons learned so far from the process include:

- the need for clear project outcomes;
- the importance of PPP expertise in leading and managing the project;
- the need for senior managers to support and invest their time in the project; and
- the need for clear communication about the outcomes being sought.

Part 3
Providing an environment to support public private partnerships

3.1 In this Part, we discuss the rationale and importance of supporting and sustaining the environment for the public and private sectors to work together and outline some international experiences and lessons learned in expanding PPP markets.

The rationale and importance of providing a support environment for public private partnerships

3.2 PPPs offer the potential for mutual benefit by encouraging and realising the possibility for innovation in delivering public sector services effectively and efficiently.

3.3 However, to successfully achieve this mutual benefit, each partner relies on the other. As the range of PPPs expands, that reliance grows. The public sector relies on continuing competition, capability, and contestability throughout the private sector to maintain efficiency and an innovative spirit. The private sector relies on continued governance, stewardship and accountability throughout the public sector to ensure that the public's interest is effectively represented, monitored, and, ultimately, satisfied.

3.4 The latest PPP model includes more private sector involvement, risk transfer and interdependence. Assuming that this trend continues and PPPs remain important deliverers of public sector services, then:

- how these partnerships perform will become more evident and important; and
- each sector will be more exposed to the other's challenges and opportunities.

3.5 Successfully managing a programme of PPPs will require an equal focus on choosing the best projects or programmes and sustaining the appropriate sector environments to allow the projects and partnerships to work as effectively and efficiently as possible.

3.6 For this to happen, the public and private sectors need a high level of:

- knowledge and expertise;
- participation;
- resources and supporting structures;
- transparent information flows; and
- trust and accountability in the process.

3.7 Setting up and sustaining these components will allow all participants to make the most informed decisions based on the best possible information from the most sources at an affordable cost. For all PPPs, this is essential to encourage creativity and innovation and to correctly allocate and price risk. These components will encourage transparency and accountability in the projects and programmes.

3.8 In a similar way to how the sharemarket provides an organised, supporting environment for the efficient pricing and contractual exchange of shares for money, so in a PPP context, the public and private sector environments provide the market platform for the efficient pricing and (longer-term) contractual exchange of public services for money.

Lessons from international experience

3.9 Most international observations and analyses of PPPs have focused on the structures, mechanics, and economic evaluation of individual projects or programmes. However, as PPP markets have matured, there has been more focus on improving and sustaining the wider environment.

3.10 Because the more mature markets have large and diversified commercial, industrial, and financial sectors, the main focus was on the public sector environment and its PPP policies, governance, and structures. However, in 2008, as the effects of the financial crisis unfolded, it became clear that sustaining the private sector environment was just as important and a combined responsibility of both sectors.

3.11 In addition to those risks referred to in our 2006 report, international experience suggests that as the range of partnerships in New Zealand expands, other issues will need to be considered. These are summarised in Figure 4.

Figure 4
Risks when public private partnership markets expand

Public sector risks	Private sector/stakeholder risks
Reduced overall governance from shortages of, and inability to retain, public sector skills to interact with the private sector and to manage and monitor PPP projects or programmes Lack of dissemination of good practice through all layers of government Low accountability and a lack of transparency because of more complexity, information asymmetry, and commercial confidentiality Little focus or support for local government Difficulties in managing change and uncertainty within the project, programme, and organisation	Greater potential for conflicts of interest between advisors and professional experts Communities disempowered by increasing complexity and lack of knowledge A lack of appropriate local capacity and capability Failure to keep communicating with government and stakeholders

3.12 We spoke with several public sector agencies involved in PPPs and confirmed similar issues. One particular point was the public sector's difficulty understanding and appreciating the private sector's approach to uncertainty, innovation, change, and doing business.

3.13 An important part of any partnering process is to recognise and manage each partner's motivations and incentives. This will require most public sector agencies to think differently and is one of the reasons why, in 2009, Britain's National Audit Office published a report on better commercial skills for complex government projects.

3.14 Reflecting on two decades of PPPs in Australia, the *International Handbook on Public-Private Partnerships* noted that "both sides have come closer together in what they know, and both have learned from each other."[13]

13 Hodge, G, Greve, C, and Boardman, A (eds) (2010), *International Handbook on Public-Private Partnerships*, Edward Elgar, Cheltenham UK, page 420.

Part 4
A comparative analysis and review: 2006-2011

4.1 In this Part, we summarise the findings and observations from an analysis of the market for PPPs.

The maturity analysis

4.2 In 2006, Deloitte published *Closing the Infrastructure Gap: The Role of Public-Private Partnerships*. This paper included a worldwide "maturity" analysis of PPP programmes. It compared the maturity of countries' PPP markets using typical success factors based on levels of sophistication and activity.

4.3 We asked Deloitte to review and update its maturity analysis. This was done through discussions with PPP market participants in New Zealand and other selected countries.

4.4 The maturity analysis groups PPP markets into three stages:

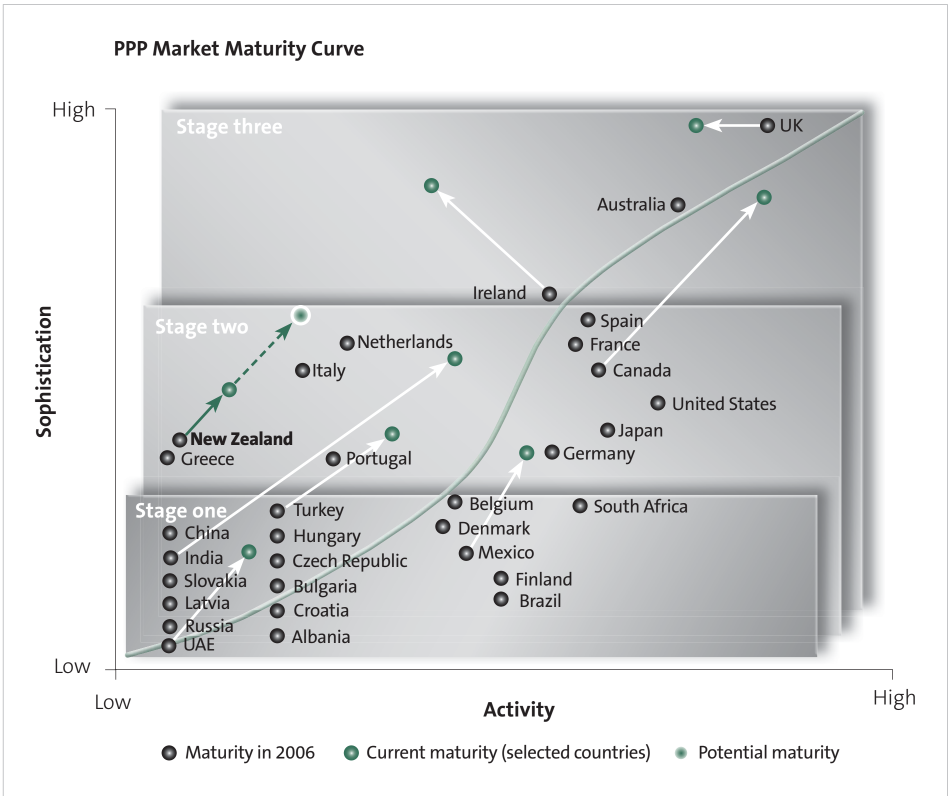
- Stage One: the developing PPP market;
- Stage Two: the active PPP market; and
- Stage Three: the well-functioning and mature PPP market.

4.5 The market's maturity was assessed using nine success factor themes:

- awareness of risk transfer principles;
- public sector PPP experience;
- private sector PPP experience;
- community and stakeholder support;
- market size;
- stable and supportive public sector environment;
- available funding;
- recognising and achieving outcomes and innovation; and
- legal framework and commercial structures.

4.6 Figure 5 shows Deloitte's current assessment of New Zealand's PPP market maturity and its potential movement compared with other countries with similar partnership programmes.

Figure 5
Comparing the market maturity of public private partnerships in different countries



4.7 In 2006, New Zealand's PPP market was assessed as "developing", with pockets of Stage 1 and early Stage 2 activity in, for example, the transport sector.

4.8 Deloitte considers that New Zealand has moved firmly into Stage 2 of the maturity framework. The NIU, set up as a dedicated central agency, has published a draft standard form contract and draft guidelines to support public agencies with transactions. Two pilot projects are testing innovative approaches, such as contracting for outcomes, and are helping to improve structuring arrangements more suited to this country. However, there remains relatively little PPP activity.

4.9 The international landscape has changed because the global financial crisis has affected the investment potential of PPPs and the ability of the public sector to afford them.

4.10 Britain's PPP market is the most mature, with sector-specific agencies and contracts. The market has a well-diversified capital base with financial instruments to fund projects for their entire term and to price specialised risks.

4.11 Canada's PPP market has moved into Stage 3, with high market activity and sophistication. Canadian innovations include the use of federal grants to subsidise project financing, obtaining Cabinet pre-approval for projects up to an agreed level, and engagement with the resource consent approving agency during the bid process.

4.12 Ireland, which has many parallels with New Zealand in terms of population and being near a much larger market, has a well-established PPP market. Around 2000, Ireland's National Development Finance Agency helped set up the programme by running the procurement process on behalf of government agencies. There have been about two to three projects each year. This has been enough to support the market, although activity has slowed because of Ireland's economic crisis.

Observations and findings

4.13 New Zealand is pioneering two innovations that, if successful, will further raise the country's position on the PPP maturity curve.

4.14 The Wiri prison PPP includes providing custodial services in its performance specification. The contract transfers risk and responsibility to the private sector, not just for design and building, but for delivering services with performance-specified outcomes. The project's most innovative feature is to partly link the output specifications and associated payment mechanisms to social outcomes such as reduced reoffending.

4.15 The current standard contract includes generic "front end" contract provisions designed to be applied consistently in PPPs, with more detailed and specific "back end" schedules as appendices. Deloitte considers that if this approach can be streamlined (into, for instance, a smaller-scale, or "PPP lite", variant) requiring a fraction of the bid costs and time frames of traditional PPP transactions, its use could extend the benefits of PPP procurement into projects that have been considered too small to procure using the PPP approach.

4.16 Deloitte believes that achieving this streamlining will be challenging but, if successful, will demonstrate world-class innovation. In particular, achieving a working outcomes-based payment mechanism is ambitious for a first PPP project. Further, adopting a procuring approach supported by a more streamlined contract requires a change in mindset from a traditional "contract-focused" approach to a "partnership approach".

4.17 Paragraphs 4.18 to 4.59 provide a summary of Deloitte's commentary and observations about each of the success factors grouped under the nine themes. At the end of each section, a table summarises Deloitte's assessment of New Zealand's maturity using the success factors that contribute to the stage of maturity.

Awareness of risk transfer principles

4.18 There is a broad understanding of risk-sharing principles in the context of value for money, and, in particular, the principle that the party best placed to manage a specific risk should be allocated that risk. Because of the country's lack of experience with PPPs, participants have found it challenging to identify which risks should be transferred. Work on modelling these risks continues.

4.19 Many participants are small and lack the financial capacity to absorb losses and penalties linked to exposure to inappropriate levels of risk. Although larger private sector participants have invested resources to understand and price risk transfer in PPP opportunities, many smaller participants lack the same understanding. Therefore, smaller participants must rely on advisors or co-bidders to gain this understanding.

4.20 There is a general consensus that the private sector would generally manage well the design, building, and labour risks. However, transferring to the private sector those risks linked with demand for services, insurance, refinancing or resource consents was seen as unlikely to be good value for money.

4.21 Government entities, such as the New Zealand Transport Agency, have built up knowledge of PPPs independently of the NIU, but knowledge remains patchy throughout the public sector.

Figure 6
Awareness of risk transfer principles

Stage 1 Maturity	Expectations of risk transfer are appropriate and ensure that only risks that can be better managed in the private sector are transferred.	achieved
	Risks that may not represent good value for money to transfer because of the immaturity of the PPP environment have been identified.	partly achieved
Stage 3 Maturity	Advanced approaches to understanding and modelling project risks are employed.	partly achieved
	There are standardised sector-specific risk allocation processes as a starting point for negotiations.	not achieved

The public sector's experience of partnering with the private sector

4.22 The NIU has a central role in expanding public sector agencies' knowledge of PPP principles and practice. It helps government agencies prepare for, evaluate, and carry out PPP transactions by providing access to knowledgeable and experienced professionals.

4.23 How much public sector agencies know about PPP principles and practices varies. Agencies preparing for or participating in PPPs know the most and have appointed teams to manage the process.

4.24 Public sector participants and their advisors play an important role in developing parts of the private sector market. Participants interviewed appreciated the NIU's efforts to consult widely to understand issues relevant to setting up a PPP market and to regularly engage with the market.

4.25 Much of the focus of the public sector procurement teams has had to be on negotiating successful transactions. When these transactions close, monitoring outcomes and benefit realisation will become a priority. Maintaining a continuity of knowledge during the transition from negotiation to monitoring will become more important.

Figure 7
Public sector experience of public private partnerships

Stage 1 Maturity	Public sector agencies have the necessary knowledge of PPP commercial principles.	achieved
	A Public Sector Comparator model has been established.	achieved
	A central agency has been established to support government departments responsible for procuring projects.	achieved
	A central agency has been established to support local authorities responsible for procuring projects.	not achieved
Stage 2 Maturity	Processes are in place to monitor the project outcomes and realisation of expected benefits.	partly achieved
	Public sector agencies have experience in PPP transactions.	partly achieved
	Dedicated PPP units have been established in public sector agencies.	partly achieved
Stage 3 Maturity	Public sector agencies understand the skill sets that are needed to execute PPPs and have access to an appropriately experienced team (including advisors).	partly achieved
	Processes are in place to ensure knowledge transfer from advisors to government agencies.	not achieved

The private sector's experience of partnering with the public sector

4.26 Private sector participants do not all have the same knowledge and experience of PPP concepts. Some participants, especially the larger ones, have invested heavily in capability and have used international networks to participate effectively. However, some smaller organisations lack the resources to access PPP knowledge or experience.

4.27 Although the domestic market capabilities may increase, in the short term, most PPPs will need foreign participants, especially to obtain equity funding or to deliver specialised operational services. Participants reported a lack of depth in the market for facility managers.

4.28 Some foreign participants do not fully understand New Zealand's commercial environment and unique aspects of its PPP programme. They must invest time and resources to compete effectively.

4.29 There are enough accounting and technical advisors in the market. Many have drawn on their international networks and recruited resources with experience in overseas PPP markets. However, relatively few firms can provide full financial advisory services and support, such as taxation and audit advice, which international market participants are used to.

4.30 The legal services market does not have enough experienced PPP advisors to support multiple bidders and the procuring agency without overlap.

Figure 8
Private sector experience of public private partnerships

Stage 1 Maturity	Private sector participants know PPP commercial principles.	achieved
	Private sector participants have experience in PPP transactions.	partly achieved
Stage 2 Maturity	There are enough market participants with the appetite, financial capacity, knowledge, and experience to take part in and sustain a competitive PPP market.	partly achieved
Stage 3 Maturity	The PPP environment has innovative features.	partly achieved

Support from the community and stakeholders

4.31 Many people, the media, communities, and stakeholder organisations do not understand PPPs. This situation is slowly improving. For instance, the Social Policy Unit of the Salvation Army recently published a well-informed policy perspective on PPPs, using Australian social housing PPPs as examples.

4.32 Some larger Māori organisations are well informed and have shown clear interest in participating in PPPs. However, they are aware of the high costs of participating effectively and, therefore, are taking time to better assess the opportunities and risks of investments.

4.33 Māori organisations could play a potentially important role in the PPP market as:

- potential equity sponsors, given their long-term investment horizon, experience in managing land and infrastructure-based assets, and intergenerational view of asset stewardship;
- potential service delivery providers, given existing iwi-led involvement in delivering some public services (such as education, social accommodation, and healthcare), especially where such services can potentially improve social outcomes for Māori and the wider community; and
- participants in meaningful public consultation.

4.34 Foreign participants can find it hard to understand Māori perspectives and issues.

Figure 9
Community and stakeholder support for public private partnerships

Stage 1 Maturity	The community and stakeholders understand and support the PPP programme.	partly achieved
Stage 2 Maturity	Māori understand the PPP environment and how they might become involved in the project.	partly achieved
	The role of Māori organisations in developing the PPP environment is understood.	partly achieved

The size of the market

4.35 Maintaining an adequate number of projects or programmes is seen as an essential prerequisite to encouraging investment in bid teams that have the skills required to participate in PPPs.

4.36 It is important that the size and number of projects is balanced against market depth. The current balance is reasonable, but any reduction could result in a loss of private sector interest.

4.37 The international PPP community sees New Zealand as part of the Australasian market. The New Zealand PPP market appears to be developing unique characteristics. The further it diverges from Australian market norms, the more difficult it will be to attract market participants from overseas.

4.38 Within the main private sector participant groups of equity sponsors, contractors, facilities management operators, service providers, debt funders, and advisors, there are at least two to four leading players, providing a theoretical minimum base for a competitive PPP market. However, the lack of depth creates the risk that competition could be weakened if some participants leave the market.

4.39 PPPs vary greatly in size. Participants expressed concern that medium-sized projects might not generate enough interest from larger investors and contractors, while the relatively high costs and project complexity of such projects could be beyond the capabilities of smaller contractors.

Figure 10
The scale of the market for public private partnerships

Stage 1 Maturity	There are enough market participants to form a robust, competitive environment.	achieved
	The number of PPP projects is enough to sustain the market.	partly achieved
	The market has the scale to support multiple simultaneous projects.	partly achieved
Stage 2 Maturity	There is enough opportunity to keep the private sector interested.	partly achieved
	The market is deep enough for each of the main market participant roles: contractors, operators, facilities managers, equity sponsors, debt funders, and advisors.	partly achieved
Stage 3 Maturity	There are innovative hybrid delivery models.	partly achieved

A stable and supportive public sector environment

4.40 New Zealand's high standards of public sector governance and procurement are a good base for a successful PPP programme, and the country's credit quality is seen as high.

4.41 Since 2008, the Government has strongly supported PPPs. The two pilot projects signal its support for the wider use of PPPs. The Government has indicated that PPPs should be considered for projects or programmes with whole-of-life costs exceeding $25 million.

4.42 The NIU's evaluation criteria are transparent. Participants in the market clearly understood the need to demonstrate value for money. Some participants with international experience have concerns about the contracting-for-outcomes model.

4.43 Probity standards in this country are high. It is important that they remain high to maintain a fair, transparent market. Imposing excessive compliance costs or restrictive rules could discourage participation.

4.44 Market participants are confident in the Government's commitment to seeing current PPPs through to financial close, and in its financial capacity to afford contracted payments.

Figure 11
A stable and supportive public sector environment

Stage 1 Maturity	Government support for the use of PPPs as a procurement option.	partly achieved
	Departmental level support exists for PPPs.	achieved
	Evaluation and award criteria are transparent.	achieved
	The standards of probity applied by procuring agencies are appropriate.	partly achieved
	There is confidence in the Government's commitment to projects.	achieved
Stage 2 Maturity	There is confidence in the Government's long-term financial capacity.	achieved
	The credit quality of the procuring agency is enough to support long-term financial commitments.	achieved

The availability of funding

4.45 The lack of sophistication and financial instruments in the domestic capital markets constrains the growth of PPPs. In particular, there are:

- limited lending indicators and poor liquidity in the long-term debt market, which makes it difficult to price the risk of refinancing debt;
- few lending institutions with a local deposit base to help support the risk of long-term lending in domestic currency; and
- no established financial instruments that could act as alternatives to bank debt.

4.46 Few specialised domestic equity sponsors are in the market. New Zealand has no secondary market for PPP funds.

4.47 However, the four leading commercial banks – ANZ, ASB, BNZ, and Westpac – and international banks active in the PPP market have enough debt funding capability and lending appetite to support most transactions.

4.48 Australian banks' high share of the domestic banking market and the limited availability of long-term funding instruments to support local currency lending are seen as a possible constraint on the number of bidders that can take part in large transactions.

Figure 12
The availability of funding for public private partnerships

Stage 1 Maturity	There are enough equity providers with the appropriate financial capacity and sophistication available.	not achieved
	There are enough debt providers with the appropriate financial capacity and sophistication available.	partly achieved
Stage 2 Maturity	Capital markets have the features needed to support the environment for PPPs.	partly achieved
	Market participants have access to the relevant financial instruments to allow hedging of relevant risks.	partly achieved
Stage 3 Maturity	Innovative debt funding instruments support the market.	not achieved

Recognising and achieving outcomes and innovation

4.49 Public sector agencies have embraced a focus on whole-of-life project outcomes.

4.50 Output and service specifications and associated payment mechanisms have been drafted to reward innovation and encourage behaviour to improve outcomes. The extent of these innovative outcomes-based payments mechanisms could potentially push New Zealand up the PPP maturity curve. However, it is not yet possible to assess how effective these innovations are and whether they can be extended to the wider public sector.

4.51 Market participants suggested that more innovation and more efficient outcomes could be achieved by giving more feedback to bidders to ensure that they understand project requirements well. Continuing to clearly signal potential future PPP opportunities would help private sector organisations to prepare adequately.

Figure 13
Recognising and achieving outcomes and innovation for public private partnerships

Stage 2 Maturity	Clear public sector expectations of project objectives and outcomes, including clearly defined output specifications and service specifications.	achieved
	The main benefits of a successful PPP programme are well understood.	achieved
Stage 3 Maturity	The approach to procurement focuses on the entire life of projects.	partly achieved
	Processes are in place to use private sector innovation in the wider public sector.	partly achieved
	Delivering PPP projects has changed how organisations behave.	partly achieved

Legal framework and commercial structures

4.52 This country's established common law tradition, based on respect for contracts, reputation for transparency, and good standards of governance, gives the international market confidence.

4.53 The NIU has drawn up a standard draft contract from first principles. It incorporates precedent from other countries with established PPP markets.

4.54 The NIU has issued preliminary guidance to help government agencies, to be applied at the agencies' discretion. The unit is drawing up more comprehensive guidance, incorporating experiences from pilot projects.

4.55 The market sees a standard contract as being essential for delivering PPPs efficiently. However, some private sector participants say that provisions for risk transfer are weighted in favour of the Government and differ from provisions in other markets.

4.56 The standard contract, designed specifically for New Zealand, is unique. This requires prospective bidders to invest time understanding the approach used. Some participants were concerned that the standard contract might require major project-specific amendments to meet the needs of more (and less) complex transactions and could threaten value for money, particularly on smaller projects or programmes.

4.57 Sector-specific standard contracts, which are common overseas, do not yet exist in New Zealand, given the market's size and lack of projects in specific sectors.

Figure 14
The legal framework and commercial structures for public private partnerships

Stage 1 Maturity	Standard contracts have been developed.	achieved
	Enabling legislation is in place.	achieved
	Required legislative and regulatory framework is in place to support the PPP programme.	partly achieved
Stage 2 Maturity	Legal precedents show that commercial structures and contracts are enforceable.	partly achieved
	There are agreed standard provisions within contracts.	partly achieved
	Standard contracts have a proven history of being fundable.	not achieved
Stage 3 Maturity	There is sector-by-sector developing of standard contracts.	not achieved
	Standard contracts have proven durable during operations.	not achieved

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