Productivity Commission Inquiry: Public Infrastructure

ISA RESPONSE TO DRAFT REPORT

07/04/2014

Industry Super Australia

About Industry Super Australia

Industry Super Australia (ISA) is an umbrella organisation for the industry super movement. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of five million industry super members. Please direct questions and comments to:

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1. Key themes

Our response to the Productivity Commission Inquiry: Public Infrastructure Draft Report is gathered around the following key themes and propositions:

1. The operation of the inverted bid model: section 2 addresses the detailed questions raised by the PC about the inverted bid model. This includes arrangements with the long-term equity partner including risk sharing arrangements; initially bidding project IRR in the funding competition which will be converted into an agreed revenue equivalent before the project commences; confirming that equity investors are not paid fees of any kind (their return comes from the efficient management of the asset over its lifetime); and preference for a "design to a cost" approach that allows innovation in construction design whilst delivering certainty in respect to cost as, by way of example, Transurban delivered with North Connex.

2. Industry Super Australia (ISA) supports the PC's draft finding that "governance arrangements are deficient and a major contributor to poor outcomes." We believe we have made the case in our three submissions to this inquiry that, as recommended by the PC, the proposed inverted bid model provides "a transparent and competitive process for the selection of private partners for the design, financing construction, maintenance and/or operation of public infrastructure". We set out the governance principles underpinning the inverted bid model which accord well with the principles put forward by the PC.

3. As the Commission notes "a key focus for the discussion is on the principles for efficiently allocating risks between the public and private sectors". We set out the risk allocation principles underpinning the inverted bid model and identify problems with the current approach. For example, long term equity investors do not currently contribute to project designs even though they will manage the project over its lifetime. Also under the current approach, bid sponsors are incentivised to make excessively optimistic forecasts to win bids, whereas long term equity is motivated to price risk accurately as they will be managing the asset until the end of its economic life.

4. ISA would urge the Commission to reconsider its recommendation that: "The early contractor involvement model should be trialled". It instead recommends early equity involvement. The rationale for early contractor involvement is that it improves project 'constructability', by the contractor bringing their knowledge to the design process through participation in an integrated design team. However, any advantage is more than offset by the lack of input by the long-term equity owner-operator in asset design, cost, service delivery and asset management, the cost premium applied due to as yet unidentified or unquantified risks, the lack of competitive tension driving design innovation and the cost and time implications of multiple tenders. Early engagement with potential construction partners is recommended but only after the long-term equity partner has been selected.

5. We suggest the Commission reconsider its position that: "The Commission advocates that clients should invest more in the initial design to reduce the design imposts imposed on tenderers." The US Construction Industry Institute considers that: "extensive equity involvement in the project is essential to clarifying the goals and maintaining them throughout the project". Equity owners focus on economic viability and asset management. From their perspective, the government's development of a comprehensive design and specification prior to tender neither adds value nor decreases risk. Contractors focus on construction and from a contractor's perspective, the development by the equity partner of a comprehensive design specification prior to tender reduces risk, costs and the tender schedule while leaving scope for innovation.

6. The inverted bid model is a viable alternative method to the traditional approach to the privatisation of brownfield assets. It delivers competitive sale proceeds to government but also aligns the interest of government with those of the long-term partner, that is the efficient management of the asset over its lifetime and reinvestment of capital to upgrade facilities and services to meet the government's evolving objectives. The model also potentially enables government to share gains above a certain threshold. Independent research from Newspoll shows equity investors such as superannuation funds can also be expected to overcome the public's resistance to privatisation.

7. The inverted bid model delivers value for money by the appointment of a long term equity partner who is motivated to accurately price risk and an open, competitive, transparent and interactive tendering for all aspects of the project along with several other key features. Value for money is not an assessment at a single point in time, but an ongoing process that extends over the project's life cycle. Value for money must also take into account the potential that, at some point in the future, government may wish to change features of the asset and the services it provides. In the absence of a long-term equity partner – whose interests are aligned with government and the long-term amenity of the projects – it would be very difficult to achieve change.

8. We recommend that the Commission consider the issue of fee leakage under the current procurement process, which adds to contract cost and is ultimately borne by taxpayers. We note that the only fee payable under the inverted bid model is the set fee paid to the proposed SPV Manager subject to achieving key performance indicators. In particular, we are referring to the advisory and transaction fees withdrawn by the project sponsor, which can extend to tens of millions of dollars.

9. We recommend the use of financial incentives on the following basis: all parties have an ongoing clear understanding of the objectives, all parties interests are aligned, in particular government and equity investors, all parties possess the appropriate competencies and capabilities, the rewards are appropriate and achievable, performance levels are initially set at achievable levels and progressively increased, incentives are set at levels that are commercially attractive, there is joint development of the performance measurement process, key performance indicators and target performance levels and there is timely and reliable feedback on project performance by using shared systems to measure and report on performance.

10. ISA suggests that the Commission not make any specific recommendations in respect to liquidity facilities in advance of the Financial System Inquiry. ISA notes that excessively cautious liquidity management by superannuation trustees will come at direct cost of member returns, and further work is warranted to assess the merits of liquidity facilities on commercial terms. ISA believes the Financial Systems Inquiry is best placed to assess the system wide implications of policies in this area.

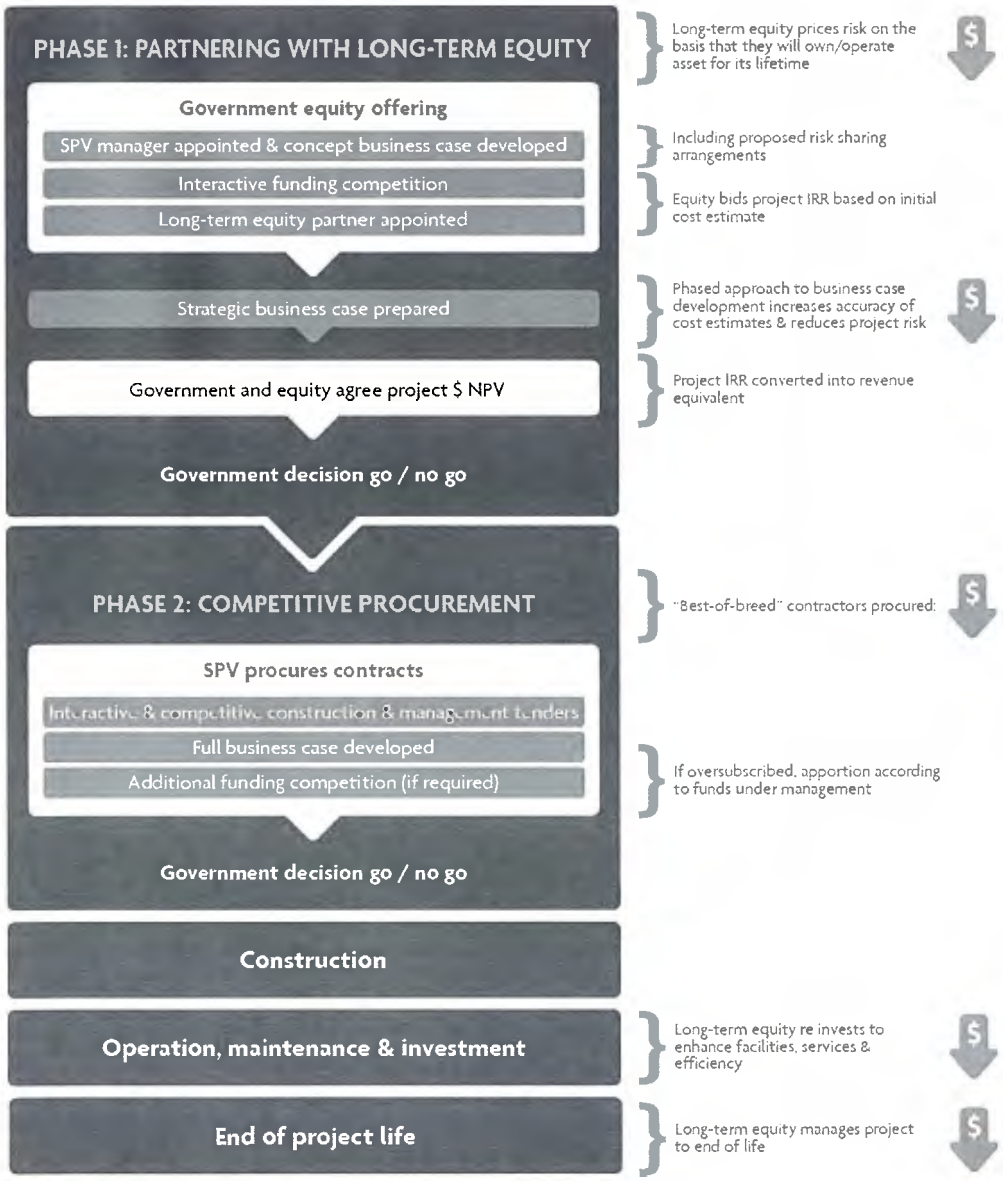
Recommendation: ISA recommends that the Commonwealth Government, in consultation with State Governments, develop guidelines for the inverted bid model and instigate a pilot project and report the results to COAG.

2. Inverted bid model

2.1 Recap on inverted bid model

Under the proposed inverted bid model ("IB Model", "IBM") the traditional bidding process is inverted by securing project financing through a funding competition prior to the construction and O&M tenders and raising of debt.[1] In other words, the government tenders initially for the long-term owner-operator followed by a separate bid for construction, O&M and debt finance. This effectively inverts the bid process relative to current PPP procurements that typically only see long-term equity after an initial sell down by project sponsors.

Figure 1: The inverted bid model



[1] If bids are on project IRR, the bidder will already have negotiated the terms of debt and there may be no need for a further tender for debt finance (refer to section 2.1)

2.2 Risk sharing

This section addresses the information request 6.3: "The Commission seeks feedback on the advantages and disadvantages of alternative procurement processes focused on long-term equity, such as an 'inverted bid' model. In particular, the Commission is interested in how an alternative procurement process should be designed to maximise efficiency gains and the likely benefits and costs of such an approach."[2]

It also responds to the question raised in section 6: "Financing mechanisms: A proposal to overcome the high costs of procurement – the inverted bid process."[3]

We agree with the Productivity Commission's view - expressed in section 6 - that "for the inverted process to be a viable procurement option the risk sharing arrangement, whereby at least some of the risks remain with the financier, needs to be prescribed before the project commences."

Under the inverted bid model, proposed risk sharing arrangements are set out in the "concept business case" prepared by the SPV Manager appointed to manage the project (refer section 6.2). Project risks are allocated on a case by case basis. Bidders are free to propose alternative risk sharing arrangements as part of the bid process to take on all transferable risks, select project risks or propose sharing some or all risks with Government.

Long-term equity owner operators are in the business of managing risk to achieve an optimal rate of return on their investment. The return to investors is commensurate with the quantum of risks they assume. However, there has been an increased investor appetite for risk sharing with governments where revenues can't be appropriately estimated during the bid process. One example is 'availability payments' made to the operator of a toll road, such as Peninsula link, irrespective of patronage.

The latter is akin to the PC's proposed "gain share/pain share".[4] Another variant of "gain share/pain share" could be on a whole of project basis: with minimum and a maximum IRRs/revenues set during the funding competition, above which returns are shared by the government. Minimum IRR/revenues can be justified for projects which do not generate sufficient revenues but their economic benefits far exceed the cost of developing the asset, including taxes generated by increased economic activity.[5] Financial support should not exceed the present value of future tax revenues.

2.3 Funding competition

We agree with the proposition put forward by the PC that "competitive tendering for the IRR is likely to lead to a more competitively priced rate of return."[6] As such, the IB Model uses funding competitions (FC) to deliver the best value for money.

The FC secures the preferred long term equity owner-operator. The objective of the FC is to efficiently test the appetite of long-term equity investors including but not limited to superannuation funds, establish the terms of equity finance and ensure that equity investors are selected in open competition with appropriate selection criteria.

Figure 2: Funding Competition

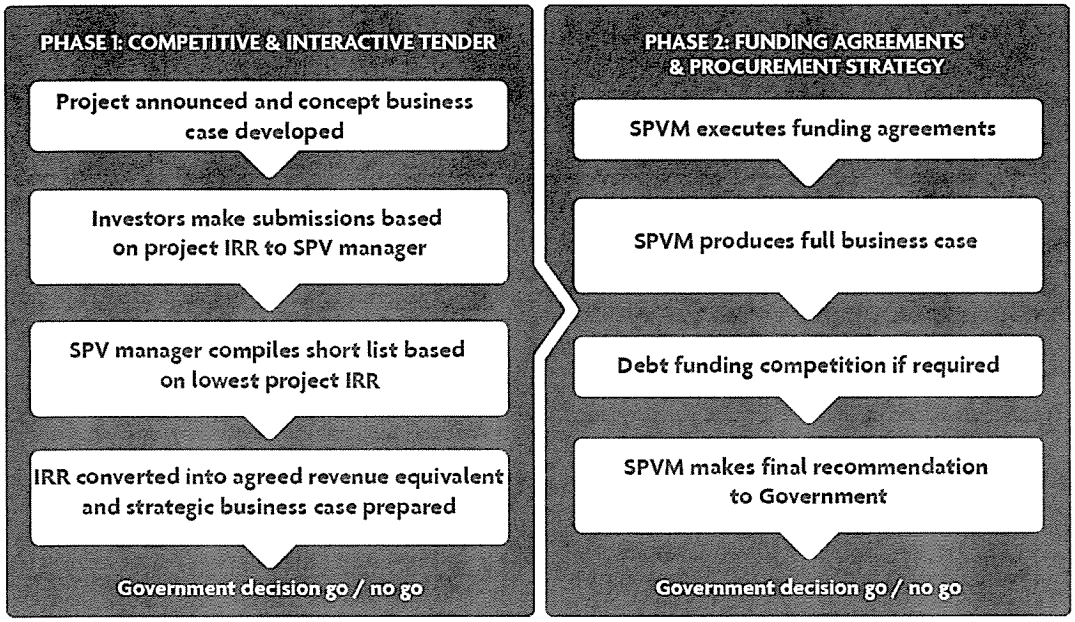
2 Page 34

3 Pages 213-216

4 Pages 213-214

5 AMP Capital (2014) Submission to Productivity Commission

6 Page 215



2.4 Revenue

As the PC noted, under the IBM, the project IRR would be converted into an agreed revenue equivalent before the project commences and government would guarantee the revenue payment rather than the rate of return, subject to the delivery of agreed outcomes.[7] However, initially under the IB Model, equity bids project IRR. This is because, unlike the current model where cost estimates are locked in upfront, the IB Model adopts a staged approach with increasingly detailed design/cost estimates in line with increasingly detailed business cases and government go/ no go decision points. We believe this maximises the scope for innovation and delivers more accurate project cost estimates. Long term equity is highly motivated to develop accurate cost estimates as, unlike current project sponsor, they are operating the asset over its lifetime.

2.5 Project IRR

It may be preferable for equity investors to bid project IRR (that is the weighted average of equity and debt IRR). As the PC suggests, if equity investors only bid equity IRR, the expected rate of return of the project is unknown.[8] It is feasible for equity to negotiate debt terms with unrelated parties prior to the funding competition, and so bid project IRR. However, there is a risk that if participants are required to bid project IRR, they are incentivised to take on "excessive" levels of debt in order to maximise the return on equity. This could easily be addressed in the terms of the funding by setting a maximum proportion of debt finance.

2.6 Equity and no fees

Under the IB Model, long-term equity investors, including superannuation funds are *not* paid any transaction, advisory or other fees of any kind – they earn their returns through the efficient management of a project over its lifetime. Potential investors must be principals acting on behalf of their own equity or manage long-term orientated investment funds. If developers, contractors and investment banks wish to bid, they must bring meaningful balance sheet equity to invest, for example 25% or more of the total equity required for the project, and be restricted in selling down

[7] Page 214
[8] Productivity Commission (2014)

that equity for a meaningful period of time after construction. The only fee paid under the IB Model is a fixed performance based fee paid to the proposed SPV project manager (refer section 3).

2.7 Cost changes

We acknowledge the PC's concern that "there is a risk of costing changing between the time the government and equity agree on compensation, and when the other consortium partners are involved in the project." Under the inverted bid model, this risk may be mitigated by the "design to a cost approach". Such arrangements were applied by Transurban in its role of long-term equity owner operator for the North Connex project in Sydney: *"The financial discipline shown by both Transurban – which has a vested stake in the financial success of NorthConnex and the government helped drive innovative bids with the construction cost strictly limited to $2.65 billion. 'We went to the market and said 'OK, we're going to procure this construction contract, and by the way guys, it's got to come in within $2.65 billion'."*[9] *(refer section 5.2: Early equity involvement).*

3. Governance

ISA supports draft finding 7.1[10]: "Institutional and governance arrangements for the provision and delivery of much of Australia's public infrastructure are deficient and are a major contributor to poor outcomes".

We believe that the inverted bid model set out in the submission and supplementary submission and in this response to the draft report meets the requirements of draft recommendation 7.1: *"Institutional arrangements for the provision and delivery of public infrastructure should incorporate good governance arrangements, including.... (the) use of transparent and competitive processes for the selection of private sector partners for the design, financing, construction, maintenance and/or operation of public infrastructure (and) "principles and processes for selecting efficient financing mechanisms and transparency of financing arrangements (and) performance reporting and independent evaluation of public infrastructure project performance."*

3.1 Governance principles

We also support the view that "the Australian Government should make eligibility for Commonwealth funding conditional on compliance with a set of good practice governance principles and policy processes."[11]

The inverted bid model has a set of principles that underpin its governance. They accord with the arrangements in Box 4[12] with some additional principles. The principles are:

- Accountability: Underpinning the partnership between government and their long-term equity partner and reporting to the project's SPV Board is the SPV Manager who is competitively selected with clearly defined key performance indicators (KPIs), and with profits directly linked to KPI performance
- Capability: The procurement and operation and management (O&M) teams require capabilities in complex procurement and whole-of-life infrastructure asset management. The government competitively engages a suitably qualified SPV to manage the procurement process and the asset over its lifetime

[9] AFR (2014) Pink bolts push up infrastructure (edited extract)

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- Clarity of roles: The IBM framework defines: SPV structure and governance; stakeholder roles and responsibilities (including whole-of-life infrastructure management); and procurement (including interactive tendering, and assessment criteria and processes)
- Clarity of scope: Prior to the financing tender, the government defines the project's scope, risk allocation, terms sheets, schedule, outputs and outcomes in a concept business case. During the procurement tender, scope is finalised in a full business case
- Service standards: Service standards are defined in the concept brief prepared by the SPV Manager ahead of the funding competition. Successful equity investors help to refine those standards and they then form part of the SPV Manager's KPIs
- Effective processes, procedures and policy guidelines: The IB model has standardised processes for the assessment of value for money throughout the project life-cycle. The same rigor should be applicable to the assessment, selection, and prioritisation of projects by governments. The IB Model process is transparent and open to review
- Shared risks: The business case articulates the level and type of risks (uncertainty, complexity and emergence), and proposed risk allocation/sharing arrangements, which are refined during the bid process. The governance framework through the Board and SPV manager facilitates the ongoing management of risk through the project's lifecycle
- Flexibility: The IB Model provides Government with the flexibility to steer and re-direct the project over its life cycle with the government's emergent policy and service delivery expectations in partnership with the projects long-term equity owner operator
- Standardisation: The IBM Model applies standardisation at every point in the project's lifecycle to simplify the procurement and ongoing management of the project and reducing costs, schedules, and risks
- Transparency: The IBM is an "open book" partnership between government and their long-term equity partner based on open competition and complete transparency. The operation of the SPV is also based on full "open book" transparency
- Value for money: The IBM governance framework, the appointment of an equity partner to manage the project over its lifetime, open and transparent and interactive tendering throughout the project and the competitive appointment and performance based contract of the SPV manager all work together to deliver value for money

4. Risk allocation

As the Productivity Commission states in section 3.4: 'Principles for efficient risk allocation': *"Effective risk management minimises the economic costs and maximises the potential economic opportunities associated with risks, thereby helping to ensure that public infrastructure is delivered in a way that provides the highest value to the community. Importantly, risk cannot be eliminated, just minimised through effective allocation and measurement."*[13]

It also notes that "a key focus of the discussion is on principles for efficiently allocating risks between the public and private sectors."[14]

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4.1 Risk allocation principles

The inverted bid model operates under the following key risk allocation principles:

- Risk allocation is only valid when the party with responsibility for the risk has the capacity to absorb the risk consequences
- Risk analysis should be life-cycle based. Many risks are emergent, and will not be visible at project initiation: there must be a process for managing these risks
- Risks are best mitigated by allocating their responsibility to the party that is best able to manage them
- Risks that cannot be clearly defined are best dealt with jointly by establishing a process for their ongoing management
- The governance process should provide full transparency, and promote / maintain flexibility and responsiveness in identifying and managing joint and emergent risks
- A transparent process should be built into the funding competition to negotiate proposed risk sharing arrangement in the concept business case before any tender
- There should be a transparent approach to develop shared risk allocation objectives, and shared processes and systems
- There should be a transparent risk escalation system that fast tracks risk identification, escalation and resolution with a 'no blame' approach

4.2 Problems with current approach

- Project designs are developed without input from long-term equity owner/operators
- There is often a high risk of doing business, by offsetting contractual risks onto parties that do not have the financial capacity to bear or effectively mitigate those risks
- Project sponsors dump risk on contractors - governments have frequently been asked to bear the consequences of risks that in theory had been held by the private sector
- There is an endemic short-term project focus, rather than on whole-of-lifecycle asset management, service standards, and community service obligations
- Sponsors are financially incentivised to produce overly optimistic forecasts in order to win bids and achieve financial close
- Construction contracts with equity investments often focus on windfall gains from secondary markets, rather than long-term asset management
- Governance and design processes are inflexible in addressing emergent changes to policy, technology, and community expectation
- Overly complex contracts and governance systems lack robustness to cope with the impacts of change
- Project sponsors often lack the capabilities to competently assess whole-of-lifecycle operations and asset management risks
- Project sponsors and contractors often use contract management systems that are win/lose based and focused more on litigation/claims support than project objectives
- The private sector generally has significantly higher capabilities in these adversarial contract management systems than government.

4.3 IB Model approach

The inverted IB Model uses a systemic approach to identify and manage project risks:

- The IBM aligns the incentives of the government and the long-term equity owners by using a transparent partnering model to facilitate both parties to work together with shared objectives
- The risk of doing business is decreased, since long term equity owners have the financial capacity to back-up project guarantees provided to the government
- Long term equity owner-operators have the skills and experience of long term asset ownership and management that short term financiers do not possess
- The process to select the SPV Managers ensures the appointee with have deep experience in all aspects of long term asset management
- This includes governance, strategy, finance, business planning and management, procurement, project management, construction and contract management, operations, maintenance, and asset management
- The SPV Manager's key performance indicators are aligned with and assess performance against the government's project goals and objectives
- The SPV Manager's planning process includes adjusting KPIs to reflect changed service standards, and changes in government objectives and community expectations
- Equity funders, SPV manager, and contractors are all separately and competitively tendered using an interactive tendering process
- The project brief, scope, business case, and services standard are initially developed by the SPV manager prior to the funding tender
- There is a strong incentive for equity investors to produce reliable forecasts since how they operate the asset over its lifetime will determine the return on investment

5. Early equity not contractor involvement

5.1 Early contractor involvement

ISA would urge the Commission to reconsider its draft recommendation 11.4 that states: *"The 'early contractor involvement model' should be trialled to test the costs and benefits of applying past contract performance by tenderers as a means of constructor selection, consistent with the practices of some private sector clients."* [15]

Instead we recommend early equity involvement.

The concept of early contractor involvement would undermine the benefits of the proposed IB Model under which the traditional bidding process is inverted by securing project financing through a funding competition prior to tendering for constructions. In other words, the government tenders initially for the long-term equity owner operator followed by a separate tender for construction, operation and maintenance and if required, debt.

The process deliberately delays contractor involvement until after the project's finance and strategic business case has been finalised and agreed.

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The rationale for early contractor involvement is that it improves project 'constructability', by contractors bringing their knowledge to the design process through participation in an integrated design team. However, any advantage is more than offset by the lack of input by the long-term equity owner-operator in asset design, cost, service delivery and asset management, the cost premium applied due to as yet unidentified and unquantified risks, the lack of competitive tension driving design innovation and the cost and time implications of multiple tenders. Early engagement with potential construction partners is recommended but only after the long-term equity partner has been selected.

Another concern about early contractor involvement is the risk of bias. Unless the contractor is retained as a consultant and is not permitted to tender on the project, their early involvement in the pre-tender design process will discourage other contractors from tendering as it is no longer a level playing field. The early incorporation of one contractor's design and construction approach limits their ability to bring their own design and construction innovations to the project. Assuming the early contractor is willing to forgo participation in the tender, their design and construction innovations would be intellectual property that could not be shared with other tender participants.

5.2 Early equity involvement

The objective of early equity involvement through the appointment of a long-term equity partner is to deliver value-for-money and fit-for-purpose infrastructure that is economically viable and sustainable over its lifecycle. Introducing equity early shifts the focus of procurement from construction to long-term economic viability, services delivery, and asset management - skills not generally held by contractors.

The IB Model enables long term equity owner-operators to have control over key early decisions. Benefits that flow from this approach include the capacity of government working with early equity to refine project scope prior the tender, reducing transaction costs and timeframes; ensuring certainty of funding before refining detailed design and conducting the construction tendering process; reduced costs by incorporating the "whole of life asset management" approach; and using a design to a cost approach unlike early contractor involvement who is more likely to adopt a "cost to a design" approach.

Box 1: Long term equity owner operator: Transurban and pink bolts[16]

The secret to a $3 billion deal struck between Transurban and the NSW government this week to build a new motorway on Sydney's outskirts is simple: no pink bolts. Specifying the colour of bolts used to build a new road sounds a little extreme, but it is finicky requirements of this kind that have pushed up the cost of building infrastructure in Australia.

So when Transurban approached the NSW government to build an underground tunnel linking two freeways, the M2 and F3, that would help commuters avoid the congested Pennant Hills road, it took a novel approach.

Typically, governments issue statements of "technical works" between 1000 and 2000 pages outlining in -precise detail how infrastructure should be built. Where, every entry and exit is [an explanation of] how to turn on a fan, how you turn off a fan.But in this case the government handed over responsibility for managing the tender process to Transurban. The result was a very different technical works document.

"We issued an eight-page document that basically said we need to start at this end, we need to finish at this end, we need to move this amount of vehicles the most efficiently we can using the least amount of energy, so you guys -figure out how best to design it."

The end result was that the government got a bigger bang for their buck than expected. "We had a requirement it be 4.6 metres high, two lanes minimum with a preference for three lanes and we started off with a 7.7 kilometre -tunnel. It's come back 'future proofed'. It's a 9 kilometre tunnel, it's wider, it's built for three lanes – marked for two lanes and a breakdown lane – and it's 5.3 metres high."

"You have to have on both sides a level of trust and understanding and transparency, and that can be hard between the government and the private sector."(But) both the NSW government and Transurban say they are delighted with the outcome of NorthConnex deal.

The financial -discipline shown by both Transurban – which has a vested stake in the financial success of NorthConnex – and the government helped drive innovative bids with the construction cost strictly - limited to $2.65 billion (engineering, consulting and financing costs are expected to be around $350 million).

"We went to the market and said 'OK, we're going to procure this construction contract, and by the way guys, it's got to come in within -$2.65 billion'." The winning -consortium, a joint venture between Lend Lease and France's Bouygues group that not only met financial and design expectations but addressed community concerns.

6. Design before tender

6.1 Early design proposal

We suggest the commission reconsider its position that: "clients should invest more in the initial design to reduce the design imposts imposed on tenderers."[17]

We note draft recommendation 11.1 *"Governments should invest more in the initial concept design specifications to help reduce bid costs, but in doing so, provide opportunities for tenderers to contest the specifications of the design."*[18]

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[16] AFR (2014) Pink bolts push up infrastructure (edited extract)

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We propose that recommendation 11.1 be changed to read: "*Governments should invest more in the pre-tender concept objectives setting, concept brief, and concept business case to help reduce bid costs, but in doing so, provide opportunities for tenderers to provide innovative options*".

The US Construction Industry Institute found: "Extensive owner involvement in a project is essential to initially clarifying the goals and then maintaining them throughout the project."

The IB Model recognises that:

- Equity owners focus on economic viability and asset management – from an equity owner's perspective, the government's development of a comprehensive concept design and specification prior to tender adds little real value or decrease in risk
- Contractors focus on construction – from a contractor's perspective, the development by the equity partner of a comprehensive design specification prior to tender reduces risk, costs and the tender schedule while leaving scope for innovation. The SPV manager would work with Government to develop the objectives, brief and business case

6.2 Objectives, brief and business case

Prior to appointing the long-term equity owner-operators, government can add value by working with the SPV Manager to develop project goals, brief and business case based on whole-of-life operations. The manger would then work with the successful equity partner to refine the objectives, brief and business case ahead of the construction tender.

- Concept objectives (outputs and outcome) will drive the project throughout its business case development, design, implementation and life-cycle operation in consultation with potential partners and other stakeholders
- Concept brief is a high-level project documents released prior to designs that includes: terms sheet; governance structure and processes; demand forecasts (including level of confidence); land ownership and availability; high-level area analysis; site survey and analysis; legislative and regulatory issues; schedule; and special conditions
- Concept business case that defines, estimated costs, funding and financing assumptions and the proposed risk distribution. Short-listed equity owners from the funding competition use the concept business case to determine their level of funding, proposed IRR, and construction and service delivery

6.3 Phased design development

The IB Model uses a multi-phase approach for concurrent development of the project's business case and design. Key drivers underpinning this approach are:

- The design should not progress in advance of the reliability and validity of the business case. The Inverted Bid Model uses a three-stage process to develop the business case (concept, strategic, and final), with each version reflecting the current level of certainty in design documentation
- The design process should be driven by the business case, that is the process should "design to a cost" rather than "cost to a design". A phased approach to design maximises the potential for contractors to add value though innovation and 'constructability'. Given its strategic importance the equity investor should select the design partner

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6.4 Building information modelling

We support draft recommendation 11.5: *"For complex infrastructure projects, government clients should provide concept designs using Building Information Modelling (BIM) to help lower bid costs, and require tender designs to be submitted using BIM to reduce overall costs. Governments should give serious consideration to where in their better practice guides they may specify the use of BIM."*

- Building information modelling can significantly reduce the number of documentation errors. It is estimated that 80 per cent of variations result from documentation error, and cause 20% of project cost increases

- BIM can improve design integration and reduce the risk of scope change for complicated and complex projects. It is estimated that 20 per cent of variations result from scope changes and cause 80 per cent of project cost increases

However, BIM should be used strategically to reflect the staged and concurrent development of the design and the business case - care needs to be taken that BIM is not used to progress the level of design detail in advance of the business case. Only after the project final business case is approved and the project SPV is funded, should significant resources be applied to fully document the design prior to commencing construction.

7. The inverted bid model and brownfield projects

7.1 Privatisation of brownfield assets

We strongly support the Australian Government's recent proposal to provide incentives to state governments to privatise state infrastructure assets where it is the public interest to do so and recycle the proceeds into new greenfield infrastructure projects.

This is in line with the Productivity Commission's draft recommendation 2.1: "There is no continuing case for retention of certain infrastructure in public hands. Accordingly, State and Territory Governments should privatise their government-owned electricity generation, network and retail businesses (and) major ports (and other assets) subject to appropriate processes to ensure value for money"[19] and " that existing infrastructure can be 'recycled' to provide a source of finance for new infrastructure, reducing the requirement to borrow."[20]

Independent research by Newspoll, commissioned by ISA, shows that superannuation funds have the potential to cut through community concerns about private sector ownership and potentially change the infrastructure game, unlocking billions of dollars for investment in new economic and social infrastructure.

Almost four in five said they would be more supportive of private investment if it involved super funds. Industry SuperFunds have proven themselves to be responsible investors: they seek stable, income generating assets capable of delivering sound returns with an investment time horizon measured in the decades. In short, it makes sense for Industry SuperFunds to manage assets as the public desires – a sensible long-term employer, service provider and corporate citizen.

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7.2 IB Model and brownfield assets

7.2.1 An alternative to traditional privatisation

The inverted bid model is a viable alternative method to the traditional approach to privatising of brownfield assets. The IB Model delivers competitive sale proceeds to government but also aligns the interest of government with those of the long term partner, that is the efficient management of the asset over its lifetime and reinvestment of capital to upgrade facilities and services to meet the government's evolving objectives. The model also potentially enables government to share gains above a certain threshold.

This model also provides a structure through which governments can better influence long term outcomes by:

- Ensuring that the focus remains on delivering community service obligations in contrast with private sector corporations where the primary responsibility of the Board is to the shareholders and regulation is required to ensure they meet service standards
- Overcoming the public's resistance to privatisation: in government hands the asset is owned by taxpayers. Under the inverted bid model they would continue to own the assets through their superannuation fund

7.2.2 Procurement and governance processes

The approach to brownfield assets is similar to greenfield:

- A competitive tender is held by the government to select a qualified SPV Manager[21]
- The SPV Manager develops the bid documents, including a due diligence report
- The SPV Manager develops a business case incorporating projected demand
- A funding competition is held with submissions including
    - bid price for existing brownfield infrastructure
    - asset refurbishment/expansion plan (if appropriate)
    - business case including long term investment plan
    - potentially a capital gains sharing arrangement
    - completion and service delivery guarantees
    - the proposed performance measures to assess service delivery
- The SPV Manager and equity owners jointly develop the strategic business case based on the tendered value and the proposed refurbishment/expansion
- If the strategic business case includes a significant capital program, the SPV conducts a competitive tender for the capital work
- Based on the outcome of the capital works tender, the final business case is jointly developed by the transaction manager and the proposed equity owners
- The SPV is formally established when the equity investors purchase the asset
    - The SPV is established under legislation/regulations that defines the governance, structure, and roles and responsibilities of the SPV

[21] The SPV Manager is a proposed construct however there may be alternative approached to project management and governance

- The SPV Board is required to focus on both service guarantees and shareholders
- The SPV is fully transparent to government and the equity partners

8. Value for money

This chapter address section 3.6: Addressing value for money under different delivery models.[22]

8.1 Assessing value for money

The following issues are key to ensuring the validity and reliability of a value for money:

- In the traditional process, value for money is generally tied to the projects delivery of specific operational/service outputs. However, these should be distinguished from outcomes that reflect the over-riding objectives of the policy program underpinning the project. While bid sponsors and contractors are focused on delivering project outputs, they often lack the necessary incentives to ensure the delivery of project outcomes. The IB Model expands the focus of procurement from project outputs to program outcomes.

- Value for money is not an assessment at a single point in time, but an ongoing process that extends over the project's life cycle. This is because what is judged as value for money will evolve over the medium to long term. For example, value for money must also take into account the potential that, at some point in the future, government many wish to change features of the asset and the services it provides. In the absence of a long-term equity partner – whose interests are aligned with government and the long-term amenity of the projects – it would be very difficult to achieve change.

8.2 Delivering value for money

The IB Model delivers value for money over the long term by:

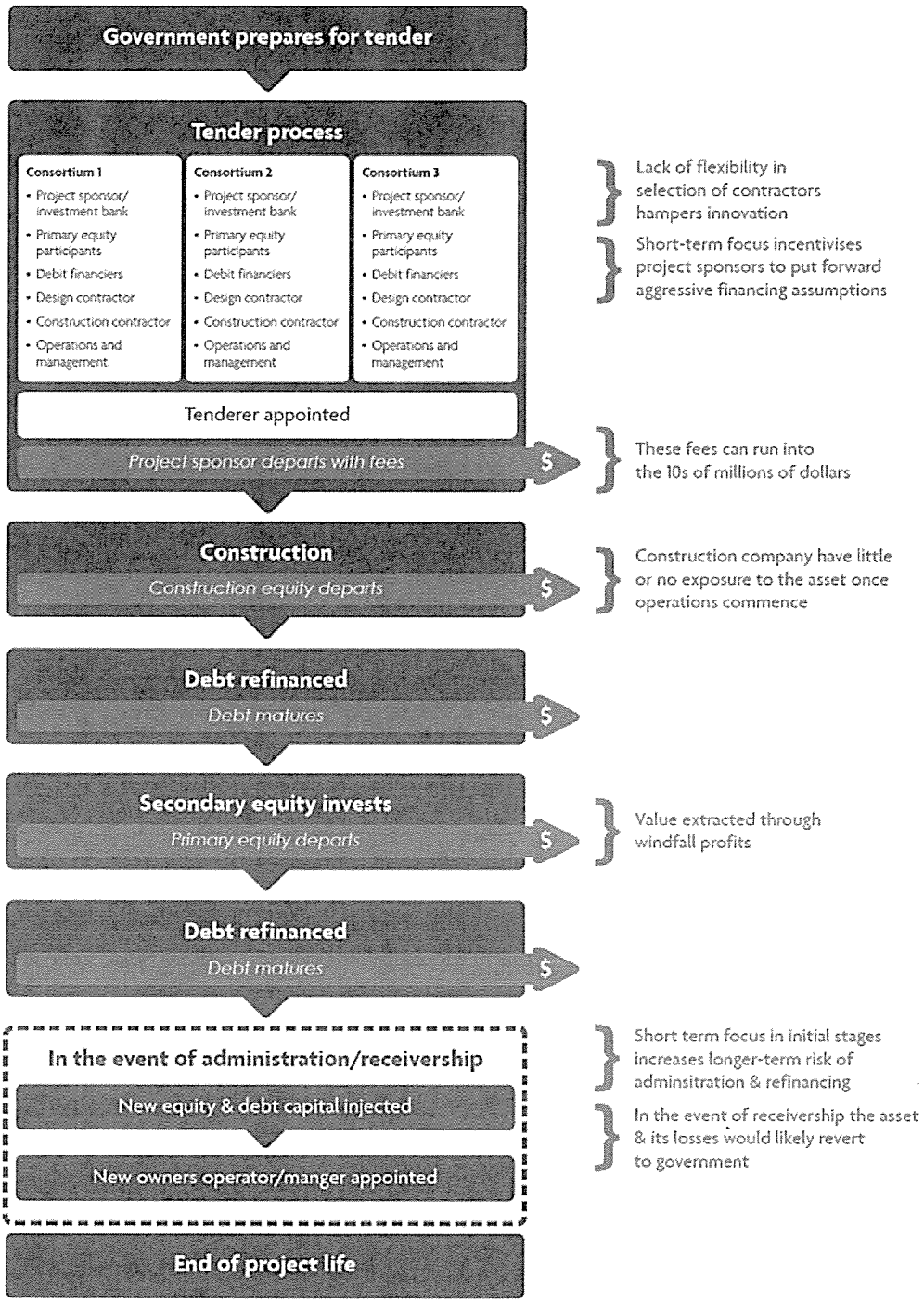
- The IBM governance framework, including the appointment of a long term equity partner to manage the project over its lifetime with no fee leakage (refer section 9)
- An open, competitive, transparent and interactive tendering for all aspects of the project
- Selecting an SPV manager through a competitive tender process under a performance based contract with set fees
- The development of 'fit for purpose' operational standards that underpin the design, construction, operation and management of the asset over its lifetime
- Separating finance from construction tender enables selection of 'best of breed' partners for each aspect of the project since none are tied to a consortium
- Using a standardised tender process, terms sheets, and contracts throughout the project to streamline activities and minimise time and costs
- Using a three-stage process to develop the design and business case enabling construction contractors to tender based on precise project specifications

[22] Page 117

9. Fee leakage

We recommend that the Commission consider the issue of fee leakage under the current procurement process, which adds to contracts costs and is ultimately borne by taxpayers. We note that the only fee payable under the IB Model is the set fee paid to the SPV Manager subject to achieving key performance indicators. In particular, we are referring to advisory and transaction fees withdrawn by the project sponsor, which can extend to tens of millions.

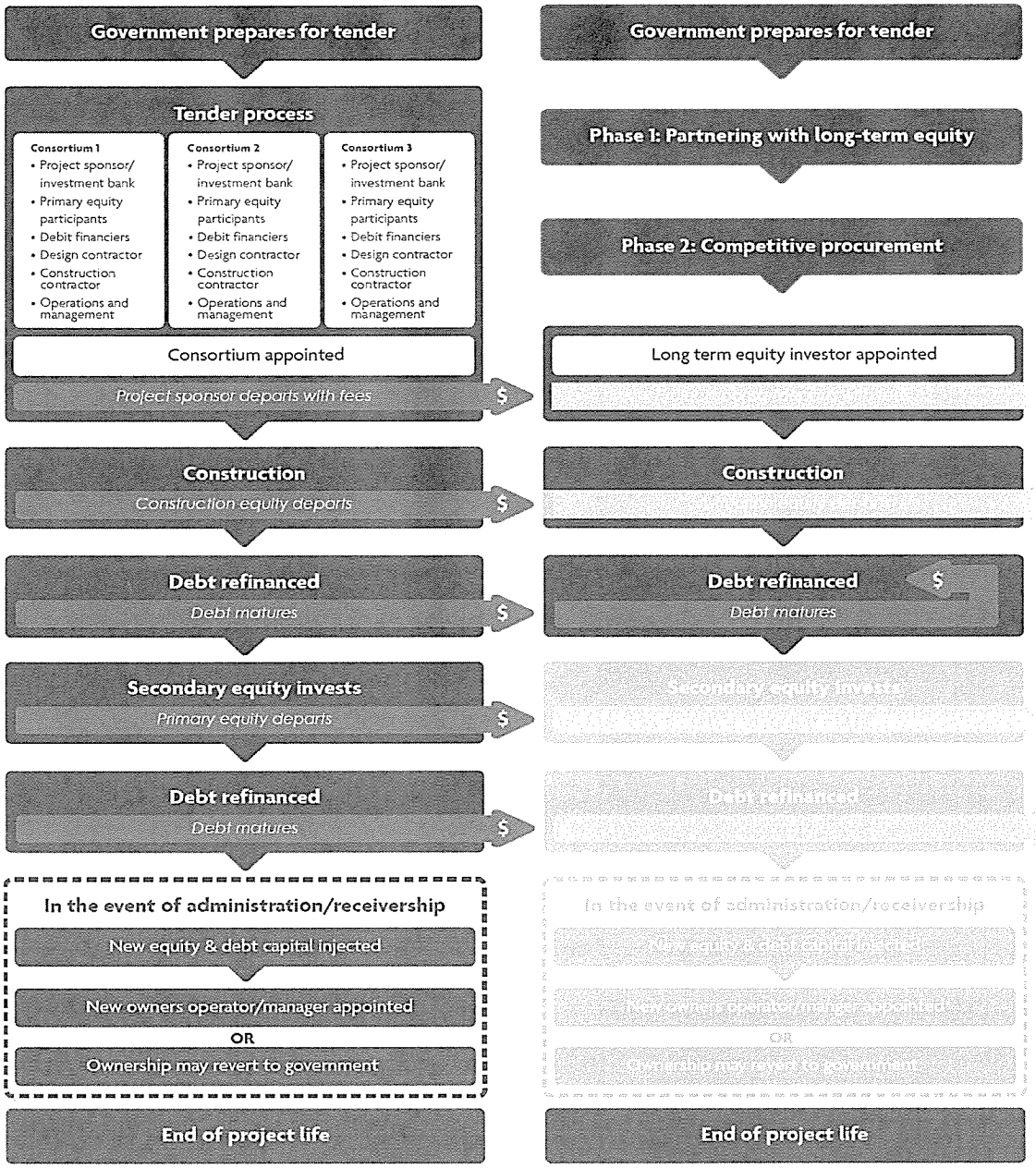
Figure 3: The current procurement model



The two critical differences between the current and inverted bid model are in the case of the latter:

- Finance is secured before construction, operation and maintenance etc.
- The successful bidder becomes long-term equity owner-operator of asset

Figure 4: Comparison between current and inverted bid model



10. Incentives

This section relates to information request 11.1: "The Commission seeks evidence on the appropriateness and effectiveness of the application of incentive payments within infrastructure contracts."[23]

We support the proposition that a reward system that uses focused incentive payments, will deliver improved whole-of- life-cycle infrastructure outcomes.

10.1 Counterproductive incentives

Current incentive strategies used in the traditional PFI models and many construction contracts are often counter-productive:

- Sponsors receive substantial success fees linked to financial close without responsibility for the project's medium/long-term viability - this strategy incentivises transaction managers to focus on achieving financial close, rather than the project's ongoing financial viability and achievement of government objectives
- Initial equity holders (such as contractors) are able to sell their equity share shortly after project completion, and in many cases receive substantial windfall commercial profits that are disproportionate to the risk taken. They are able to avoid responsibility for the project's ongoing financial viability and achievement of government objectives

10.2 Recommended incentives

The Inverted Bid Model uses a systemic approach to align the objectives of the government, equity owners, SPV manager, and contractors. Key aspects of the IBM incentives strategy are ensuring that:

- All parties have an ongoing clear understanding of the objectives
- All parties interests are aligned, in particular government and equity investors
- All parties possess the appropriate competencies and capabilities
- The rewards are appropriate and achievable
    - Performance levels are initially set at achievable levels, and progressively increased
    - Incentives are set at levels that are commercially attractive
- There is joint development of the performance measurement process, key performance indicators and target performance levels
- There is timely and reliable feedback on project performance by using shared systems to measure and report on performance

11. Liquidity Issues

ISA believes it is premature for the Productivity Commission to make conclusions or specific recommendations in respect to liquidity management facilities in advance of the deliberations of the Financial Systems Inquiry.

[23] Page 42

ISA has made detailed submissions to the Financial Systems Inquiry in relation to liquidity issues. (see Attachment 1)

ISA has submitted that the existing policy settings do not support the long term maturity transformation potential of superannuation, and the merits of liquidity facilities must be assessed in the context of the broader capacity of the financial system to support long term investment.

11.1 Productivity Commission Assessment

Whilst acknowledging the liquidity constraints facing superannuation funds the Productivity Commission suggests there are existing market based mechanisms (namely through listed infrastructure investment instruments) to ease liquidity constraints.

ISA does not agree that this mechanism supports good policy outcomes for two reasons.

Firstly investment through listed instruments is inherently more costly than unlisted vehicles with greater intermediation resulting in poorer returns for members and fee leakages to third parties. Such arrangements are inconsistent with sourcing the lowest equity funding for a project.

Investment through such vehicles is also unattractive for funds as the ultimate equity owners have little or no direct representation or rights in respect to the ongoing management of the asset.

ISA believes there is potential for funds to initiate inter-fund facilities to assist in liquidity management, however some regulatory amendments are necessary for this to occur.

Nevertheless further consideration must be given to the merits of a central facility. ISA recommends the PC give further consideration to a RBA repo facility, though it may be more appropriate to allow the Financial Systems Inquiry to assess the issue further in line with its broad terms of reference.

12. Attachment 1 – Excerpt from ISA submission to Financial System Inquiry - Liquidity

12.1.1.1 Liquidity facilities

In normal times, private participants typically transact in cash and liquid assets (such as government securities) in the financial system pursuing their own interests. In times of systemic stress, both the cost and availability of liquidity will depend crucially on official or public liquidity provided by the central bank. Liquidity is critical to the operation of an individual financial institution and more generally, the efficiency and stability of the financial system as a whole.

As it relates to super funds specifically, APRA has explained that liquidity risk refers to "the risk of not having enough cash inflows (after taking into account the available liquid assets) to meet cash outflows over any given time period, and in the case of superannuation funds, this means the potential inability to meet its payment obligations to beneficiaries in a timely and efficient manner."[24] Superannuation funds have developed and maintained liquidity management policy in accordance with APRA Superannuation Prudential Standards SPS220 and SPS530.

12.1.1.2 The nature of liquidity in superannuation

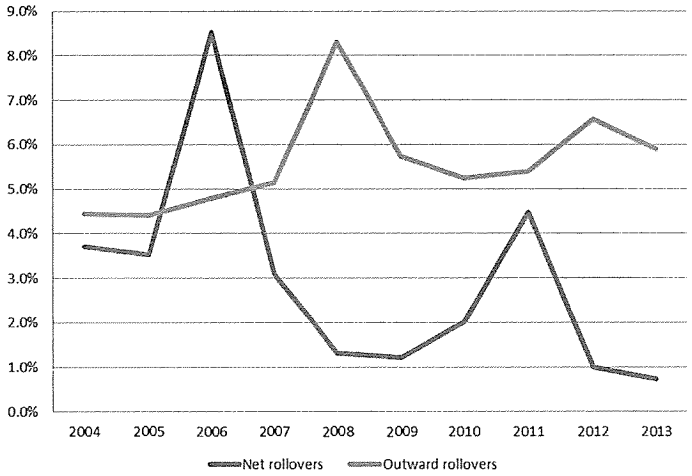
It is important to recognise that the nature of payment obligations to beneficiaries can affect the liquidity of a super fund. Broadly speaking, there are two categories of payment obligations of particular focus from APRA: (i) decumulation payments (both lump sums and pensions), in which cash is leaving the superannuation system, on the one hand, and (ii) rollover or transfer payments, in which member assets are moved within the superannuation system (either within a fund to different investment options, or between different funds), on the other hand. In addition, there are embedded or contingent payments obligations, such as margin calls and collateral requirements for derivatives positions.

The distinction between these forms of payment obligations is important. Payment obligations to beneficiaries in the form of pension payments must be in cash and reasonably on demand or as scheduled. This form of payment can be monitored and forecasted with a certain level of confidence based on a fund's demographics and other information.

Rollovers, however, involve transfers that come to rest somewhere else in the superannuation system. This behaviour is harder to predict. Figure 1 illustrates that for APRA-regulated funds, the net rollovers as a proportion of total fund assets peaked in 2006 (shortly after Choice of Fund legislation became effective) and 2011, and has trended downwards. The pattern shows the strong inflows due to compulsory superannuation. The more worrying trend is the proportion of outward rollovers, indicating outflows for funds on a system-wide basis is on the rise. The peak in 2008 coincided with the Global Financial Crisis, signalling that market events do have an effect on beneficiary behaviour, and these may influence liquidity.

[24] Venkatramani, R. S. G. (2008). Liquidity, Licensing and Super Funds: What's On Apra's Agenda

Figure 1 – Net rollovers and outward rollovers as proportion of total assets, %

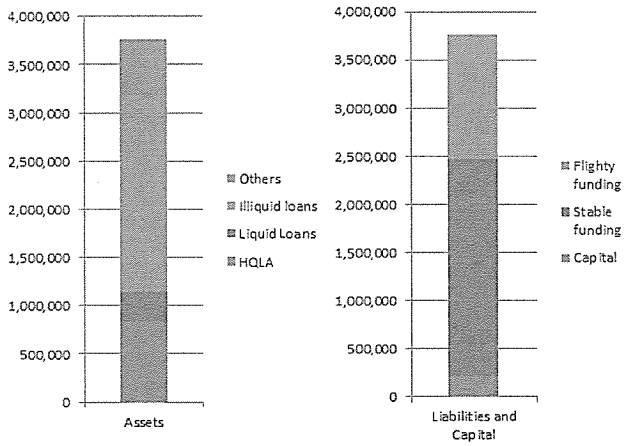


Source: ISA calculation based on APRA's Superannuation Fund Level Statistics.

Another environmental factor to understand in analysis of liquidity is the difference between the balance sheet structures of banks and super funds. Figure 2 shows the aggregate balance sheet of the banking system, where a large portion of illiquid assets (loans) are funded by the mix of stable funding (including capital) and "flighty funding" such as at call deposits. Banks also hold a sizeable portion of high quality liquid assets (HQLA) such as government bonds, which can be used to access the RBA's public liquidity facility via repo transactions.

The aggregate balance sheet of the super system and its structure is presented figure 3. Unlike banks, super funds invest heavily in marketable and liquid securities such as equity and fixed interest instruments (around 70% of their asset) despite having a relatively stable funding base. The real liquidity risk for individual super funds is where members change funds or investment options (represented by "flighty asset choice" and "flighty members/exit"). The liability-side of the balance sheet structure suggests that super funds should be the natural holder of long-term assets. However, as has been discussed and we discuss below, liquidity-related factors are a barrier to this.

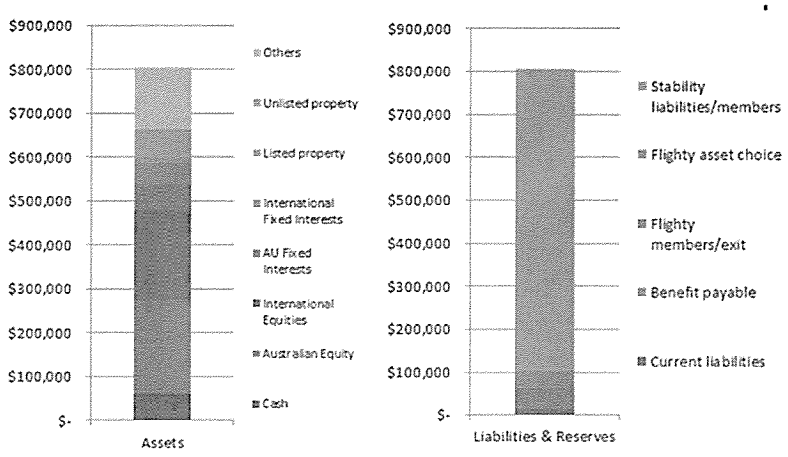
Figure 2 – Banks' balance sheet structure ($ millions), 2013



Source: Financial Institutions & Management Advisory (FIMA) & ISA estimates based on APRA Quarterly ADI Performance as at June 2013[25]

[25] "Flighty funding" includes call/on demand deposits and short-term borrowings etc. "Stable funding" includes term deposits, and long-term deposits among others.

Figure 3 – APRA-regulated funds' balance sheet structure ($ millions)



Source: FIMA & ISA estimates based on APRA Superannuation Statistics as at June 2013[26]

Factors affecting superfund liquidity management include:

- The demographics of the fund: as fund membership ages, net flows reasonably disconnected from market risk (contributions received less benefits paid) become neutral and eventually perhaps negative;[27]
- Fund portability and member switching, manifesting in two ways: firstly, members can switch from one fund to another; and secondly, an increasing number of investment options are offered by funds. In each case, assets may need to be liquidated to honour member choices.
- Switching or "short-termist" behaviour of an increasing portion of members, arising from demographics, marketing, and political narratives. Under current policy settings, engaged and individually-focussed members may contribute to procyclical pressure on asset prices and other members' balances in times of stress, even if rational, coordinated member patience would result in greater aggregate welfare (this is the internal challenge of liberalism, and has been solved in other contexts);
- Voluntary contributions, which are deemed to be an inflow of liquidity, may be becoming more volatile and sentiment-based;
- Prudential regulation of liquidity is on a fund-by-fund basis, even for systemic events. As a result individual fund levels of liquidity will be designed to enable a fund to withstand a shock on its own, even when a more systematic approach would result in superior allocative efficiency and comparable systemic resilience;
- To maximise members' returns, funds may want to increase investments in illiquid assets, which can result in tension between short-term liquidity prudential requirements and long-term performance objectives; and

[26] Flighty members/exit is based on the proportion of outward rollover in the total assets at end of period. We assume that the proportion of "flighty asset choice" is 5% of total assets based on a finding in Gerrans (2012) that 5-6.5% of members switched investment choice in the period from 2006 – 2009 (including the GFC).

[27] Amani Venkatramani, 'Liquidity, Licensing and Super Funds: What's on Apra's Agenda', Australian Prudential Regulation Authority, Conference of Major Superannuation Funds 2008, Monday 17 March 2008, stating that "The number of people aged 65 years and over will increase rapidly over the next 50 years, from 2.6 million in 2004 to between 7 and 9 million people in 2051. By then, slightly more than one in four Australians will be aged 65 years and over (around one in 8 at 2004)."

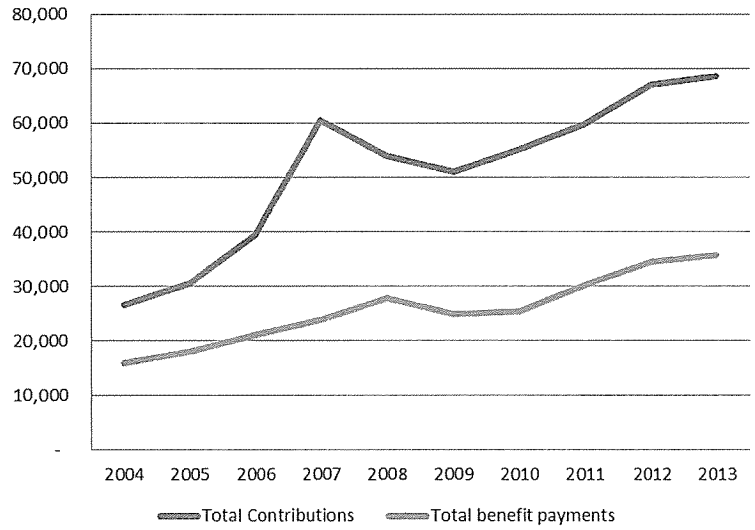
- Increased financial market volatility and the potential for systemic events, including exchange rate depreciation and the impact on hedging collateral requirements.

The above factors, together with the lack of support for super funds in a systemic liquidity event, are barriers to the super system's potential investments in long-term projects (such as infrastructure), which can deliver benefits for both members and the economy as a whole.

12.1.1.3 Super funds as an important part of the liquidity "plumbing" system

With the compulsory superannuation contribution, super funds are custodians of an important flow of funds from savings. This flow of funds has been increasing and will continue until the system matures. Figure 4 shows the total contribution and total benefit payments of APRA-regulated funds. Clearly, the inflow of funds is currently larger than the outflow of funds.[28]

Figure 4 – APRA-regulated funds' total contributions and benefit payments ($'000s)



Source: APRA Superannuation Statistics as at June 2013[29]

Flows of funds are allocated into different asset classes, with a significant amount into cash and liquid marketable securities such as equities.[30]

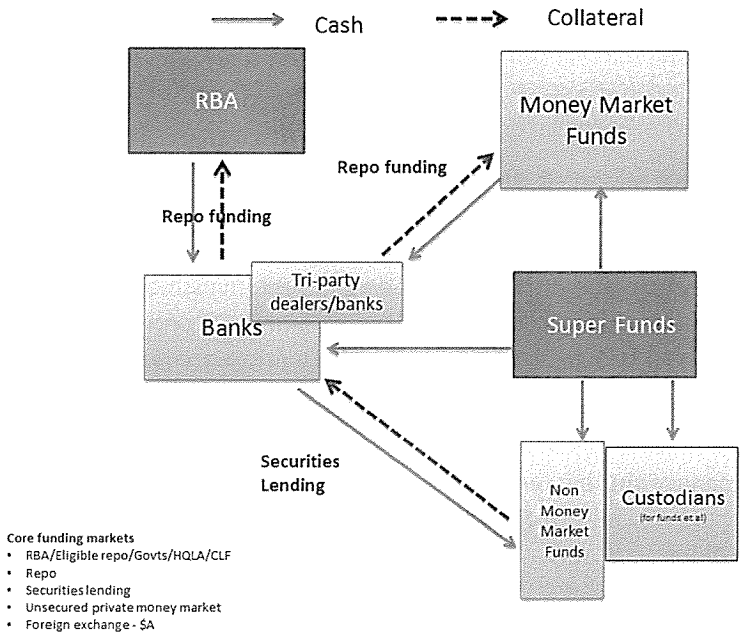
The strength of fund inflow has enabled super funds to support the capital markets. During the GFC, superannuation has helped to recapitalise the balance sheet of Australian companies, including banks. Super funds, as part of their cash management and fixed income asset investment, have also been part of short-term funding markets. Through these channels, super funds have become an important part of the liquidity system. The following diagram (figure 5) illustrates this point.

[28] There are rollovers in and out of a particular fund, but in these cases, the funds stay in the superannuation system. Benefit payments are the only sources of outflow for super system as a whole

[29] Flighty members/exit is based on the proportion of outward rollover in the total assets at end of period. We assume that the proportion of "flighty asset choice" is 5% of total assets based on a finding in Gerrans (2012) that 5-6.5% of members switched investment choice in the period from 2006 – 2009 (including the GFC)

[30] APRA-regulated funds allocate 7.53% of assets to cash in 2013, and around 50% to equities

Figure 5 – Collateral/liquidity "Plumbing" – system wide



Source: FIMA

12.1.1.4 Systemic liquidity

Industry SuperFunds have been strong and successful competitors in superannuation. As a result they enjoy very high levels of net contributions.

Net inflows for Industry SuperFunds as a whole are so strong that, in the case of some funds, the allocation to illiquids could more than double relative to current allocations while still being able to pay benefits.

However, Industry SuperFunds have always sought to promote the optimal policy settings for the superannuation system as a whole, and the future resilience of the system.

In a systemic liquidity event, banks have long accessed special, external, facilities as part of their liquidity management.[31]

In a systemic liquidity event, a number of financial institutions can face short-term funding pressures, such as an inability to roll short-term debt or obtain additional funding. Banks at risk of a bank run may need access to additional liquidity to pay off a sudden surge in withdrawals. There could also be pressures on the liability side, including rolling over short term wholesale funding.

Banks, however, have a number of tools at their disposal, including:

- Banks have access to the RBA repo facility through its open market operation. This is an important aspect of banks' liquidity management, enabling banks to manage short-term liquidity pressures. Since the GFC, the RBA expanded the range of securities eligible for repo transactions.[32] The scope

[31] ISA notes that the nature of banks and super funds are quite different. For example, banks are more leveraged, and take on risk instead of depositors and other individual liability holders.

[32] Guy Debelle, Assistant Governor (Financial Markets) Reserve Bank of Australia, 'Market Operations in the Past Year', 2008 FTA Congress, Melbourne, 31 October 2008

for longer duration repo transactions also has increased since the GFC. In addition, certain banks can access the Committed Liquidity Facility.

- Banks may receive Government support, such as in the GFC where the Commonwealth Government guaranteed bank debt issues, enabling banks to raise funding in the capital markets;
- Banks can also raise additional equity capital in the stock market. During the GFC, banks were able to recapitalize quickly through a number of private placements.

Super funds, on the other hand, currently must rely solely on the strength of their cash positions, such securities as are able to be liquidated in an orderly market (which may be limited), and inflows from contributions. In crisis time, funds may face liquidity problems as margin or collateral is due in respect of hedging positions, or if a number of members switch between different investment options or to another super fund. If payment obligations continue after cash and liquid securities become exhausted, funds must seek to sell their illiquid assets at a time where prices are likely to be far from fair value (or seek relief from APRA). Such sales would add pressures to an already disorderly market.

Industry SuperFunds are well-placed to manage these issues. But that does not mean that all segments of the superannuation industry are as well-placed or that improvements to public policy cannot result in better outcomes for the public.

Leading up to and during the GFC, the superannuation system was experiencing net cash flows that were strongly positive. Some retail funds raised gates on withdrawals, but for the most part the system was able to cover its commitments and ride through the liquidity pressures. Industry SuperFunds, and other funds with strong cash positions, were able to recapitalise the Australian sharemarket.

In ISA's discussion with a number of super funds and liquidity management experts, there is a consensus that while super funds did well in the GFC, future systemic events likely will be more challenging. As the system matures, net contribution flows are likely to be reduced. Furthermore, as indicated earlier, member behavior and sentiment will likely lead to more instability, which can make liquidity management harder in a crisis. These risks to the system should be considered carefully.

Furthermore, without predictable systemic liquidity support for a systemic event, super funds will hold larger amounts of liquid assets to manage their liquidity risk, moving away from the optimal portfolio structure and reducing the potential role of super funds as long-term investors in the economy. Asset allocation for institutional risk management purposes, rather to obtain optimal risk adjusted net returns, could reasonably be expected to result in a misallocation of resources in the economy. It also presents an opportunity lost to earn additional illiquidity premiums for those members who stay committed.

12.1.1.5 Liquidity facility for super funds – the framework and possible structures

A public liquidity facility for the super system warrants consideration as an option not only to shore up systemic stability, but also to enable more long-term investment during good times. Access to a public liquidity could form part of a good and approved liquidity management policy and practice. Because of the nature of superannuation liabilities, and the lack of contagion through channels other than distressed sales, it should not lead to problems such as "too big to fail."

Preliminarily, the framework for a liquidity facility for super funds should be based on repo transactions with the RBA (the RBA, as part of its public policy objectives, should determine the appropriate eligible securities for repo transactions).

Super fund participation in the RBA's public liquidity facility could be beneficial in a number of ways:

- Reduce systemic risks and mitigate the perceived risks by members of illiquidity and a resulting pressure on a fund during times of systemic stress;
- Provide an additional tool for super funds' liquidity management policy and practice;
- Allow super funds to optimise portfolio allocations, supporting further investments in illiquid assets, especially infrastructure, that otherwise would not occur; and
- Thereby achieve higher returns to members and reduce the public pension outlays.