# Centre for Regulatory Studies

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Public Infrastructure Inquiry

Productivity Commission

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Dear Sir,

 Productivity Commission Draft Report of Public Infrastructure

I write to comment on the draft Productivity Commission report on Public Infrastructure.

I found the draft Report refreshing in its balance and objectivity and wish to firstly convey my congratulations to those who drafted it. In my experience, the public policy domain around the provision of public infrastructure is these days filled with as much ideological and conflicted advice as sensible guidance. I wholeheartedly agree with your judgment that our ‘inadequate project selection’ methods need an overhaul, along with reforms encouraging better decision making. I also endorse your comment that private financing is ‘not a magic pudding’ and that neither government guarantees nor tax concessions are costless. And whilst I do not personally agree with your conclusion that ‘well designed user charges should be used to the fullest extent’ (unless of course governments are given a specific mandate at an election for this) or that ‘the market appears to be workably competitive’ (the basis of which is not clear to me), these are perhaps small issues in the bigger scheme of infrastructure matters with which this report deals well.

I would like to make several observations on the draft Report which may assist in your final considerations. These are shown below.

1. There is an inherent ambiguity in the PPP language. I have noted that *PPPs may refer to a project; a project delivery mechanism; a policy; or a governance tool*; Hodge and Greve (2013), which is attached to this submission for your information. You imply both of the first two meanings on page 92 for example, and touch on aspects of the last. What this ambiguity means is that PPP is as much a language game or policy brand as it is a technical concern, and our notions of when a specific PPP approach is ‘successful’ are as oriented to questions of politics and governance as they are utilitarian.
2. Your term PPP covers ‘procurement models involving some private capital’ (p5) and I believe this was well said. I suspect that the various Australian state governments, however, have different ideas as to just what their own ‘PPP model’ is, and I think it would enhance the PCs report if this ambiguity were made explicit. Whilst you say specifically (on p92) that PPPs generally include private financing… but that nonetheless ‘PPPs may be delivered through a variety of models such as DBFO, DBFM, BOO’ etc… there is clearly a wide range of possible combinations as to how the two sectors can work together, there are numerous options to choose from as well as hundreds of ways of structuring contracts to emphasize whatever dimension either party wishes to pursue. Fundamental dimensions pertain to the degree of finance from each sector, project specification and risk bearing, as well as incentives for performance, questions of performance measurements, issues of transparency, accountability and governance. Australian states such as Victoria appear to have a very specific versions of 'PPP' in mind. The point here is that, to me, *there is no such thing as ‘the PPP model’*. *PPP is a phenomenon*, and is in reality ‘hundreds of different models or public-private structures’. When proponents say that ‘the PPP model is successful’ or that ‘we have been using the PPP model for thousands of years’, there is considerable rhetorical slipperiness. And in some ways asking ‘whether PPP is successful’ is a nonsensical question[[1]](#footnote-1).
3. However, whilst this definition is consistent with jurisdictions such as Canada, leading academic commentators such as Boardman, Poschmann and Vining (2004)[[2]](#footnote-2) catalogued 76 major North American 'P3' projects a decade ago, and noted that 'less than half included a significant private financing role'. They also noted that 'in practice, there ha[d] been considerable variation in the degree to which financial risk has been shifted to the private sector... and in some cases … projects ha[d] ended up largely or completely financed by the public sector'. More recent analysts such as Siemiatycki (2013) likewise supported this stance saying *that there had been a range of 'PPP' approaches used to deliver infrastructure in Canada* and both the extent of the use of private finance and the extent of risk transfer had varied widely. He observed that whilst most Canadian PPPs have involved some amount of private capital, many also 'received substantial up-front public investment...' The example of the $2.1billion Canada Line Light rail project shows this with some two thirds of the funding in this case being public. As well, he argued that Canadian PPPs had also been structured conservatively and had incorporated construction risk transfers, with little demand risk transfer. Such contracts are seen as more conservative compared to the frequent contract renegotiations and even project bankruptcy noted elsewhere. Thus, in the face of considerable diversity in approaches across that country, Siemiatycki rightly questioned whether there was even such as thing as 'the Canadian PPP model' at all.
4. Using this logic, and looking at our varied empirical experience, *I would question whether there is in reality, ‘an Australian PPP model’*, as well. Amidst the complexity and range of options, there is at a minimum, considerable difficulty in defining either 'the Canadian PPP model' or 'the Australian PPP model' let alone a global ‘PPP model'. In one sense, PPPs cover such a wide range of governance types and such a multiplicity of contractual structures that this conclusion is perhaps not surprising at all. The surprise (and disappointment) is that it has taken so long for this language multiplicity and ambiguity to be formally acknowledged. A decade after Linder’s (1999) ‘multiple languages’ insight, and two decades after the British rebranding of private finance policy to the warmer partnership label and the completion of several hundred PFI projects, the UK’s National Audit Office (2009, p. 6) finally noted formally that the narrow view of PPP as a specific type of long-term privately financed infrastructure contract was not accurate. It stated that whilst its review had concentrated mainly ‘on the widely used PPP model called the Private Finance Initiative (PFI)... there are also hundreds of other types of PPPs, ranging from small joint ventures to the London Underground PPPs which have a capital value of £18 billion’. Better late than never, we might say. Today, though, Australia's governments today still largely view PPP as PFI type arrangements and we are yet to catch up to the UK and formally acknowledge the multiple languages and ambiguity of the phenomenon. Perhaps we are happy to reject the old adage 'its better late than never' and believe, amidst the politics of PPP, that 'its better never than late'.
5. The mixed outcomes you refer to (p7) and potential benefits (boxes 2 and 3, pp7, 10) as well as the mixed outcome for public infrastructure more generally (p61) were well said. The subsequent discussions on the relative performance of PPPs against other delivery strategies, however, to me could have been stronger in some ways.
	* 1. First, as Hare (2013) recently put it, *the available PPP evidence is ‘both weak and mixed’.* This follows a long line of arguments which have traced the international VfM arguments; (eg. Hodge 2010). The UK NAO (2009) found financial modelling which was ‘error-ridden and given undue influence as the basis for decisions’, and in which ‘too much weight [wa]s placed upon subjective judgments of risk, which can easily be adjusted to show private finance is cheaper’. It also explicitly noted the difficulty in properly evaluating the UK’s use of PPP, and stated '[so] government cannot satisfy itself that private finance represents the best VfM option’. The recent wider analysis of Boers et al (2013, 470) also reviewed 48 audit reports from 21 Audit offices around the world and concluded that 'there is still no hard evidence to show that DBFM(O) projects represent the most efficient form of government procurement', and that whilst there are potential benefits to be gained from using PPPs, 'there is no reason ... to assume that these benefits will automatically accrue'. These recent analyses follow earlier sobering independent assessments, including those of my own.
		2. Second, I regard much of the *on-time and on-budget delivery analyses* as *fraught and often closer to advertising than to science*. And whilst analyses purporting better on-time/on-budget delivery are oft repeated, rarely repeated are analyses such as Pollock *et al*. (2007) who criticised the UKs on-time and on-budget findings as having no solid evidence base, stating that ‘all claims based on [this] are misleading’.[[3]](#footnote-3) Importantly, analytical results independent from industry or government (ie proponent) funding are rare and peer open-ness of original data for careful analytical review is also almost non-existent.
		3. Thirdly, the results presented in Box 3.2 (p91), compare PPP with ‘traditional’ project delivery (which includes both ‘design and construct’ and ‘alliance’ delivery methods.) The conclusion from this box is that PPPs ‘outperform’ traditional delivery. However, figure 6.1 of DTF (2009, 49) compares how costs change from initial business cases to project out-turns for these three methods separately. It shows that Alliance contract costs increase the most after the business case at around ‘50%’), followed by ‘traditional’ (at ~20%) and then PPP (at ‘~ 5-10%’). *Including alliances in with traditional delivery would appear to have resulted in artificially overstating the difference between ‘traditional’ and ‘PPP’ delivery methods* (at least when ‘outperformance’ is defined in terms of cost projection reliability).
		4. Fourthly, and most importantly, *most of these studies either did not directly tackle or control for multiple confounding variables in order to answer the real question to my mind* ***-*** *the cost of infrastructure ‘per unit’*. That is, some projects may well come in better ‘on-time’ or ‘on-budget’, and private finance based prediction methods may be more reliable than ‘traditional’ projections (however these are defined). But that does not guarantee that projects have a lower unit price. Indeed, the only study in the literature that I have found which specifically tackles the project costs of LTIC private finance projects is the analysis of Blanc-Brude *et al*. (2006), which conducted careful regression analyses across EU countries and found PPPs were 24% more expensive than expectations from traditional procurement – ironically, at about the same magnitude of traditional project cost-over-runs.[[4]](#footnote-4) In other words, from a statistical perspective, we must control for the amount of work done, and in the absence of controlling for this, analyses of PPP vs ‘traditional’ construction methods risk simply continuing the old public bad versus private good debate with little statistical control, and hence little veracity.
6. *The Public Sector Comparator* (p117), after decades of criticism and as confirmed by the UK NAO, *is a tool highly capable of being manipulated*. Whilst you noted ‘concerns about transparency’ and implied the possibility ‘that the public sector comparator is not meeting the purpose for which it was intended’, I was surprised you did not make the issue of PSC manipulation explicit in your report. The inherent flexibility of the PSC is another advertisement for maximizing the transparency of calculations, base data and assumptions. The UK Public Accounts Committee of Parliament labelled the PSC process as clearly ‘manipulation’ early on in the PFI debate. A decade later, NAO (2009) continued this theme stating that PFI was ‘one of many routes of delivery’, and that while it ‘can work well’, it was ‘not suitable at any price or in every circumstance’. It found financial modelling which was ‘error-ridden and given undue influence as the basis for decisions’, and in which ‘too much weight [wa]s placed upon subjective judgments of risk, which can easily be adjusted to show private finance is cheaper’; (National Audit Office, 2009). It also explicitly noted the difficulty in properly evaluating the UK’s use of PPP, and clearly stated '[so] government cannot satisfy itself that private finance represents the best VfM option’.
7. Locally, Fitzgerald (2004) argued that the *size of costs savings claimed* in his Australian PPP assessment *was largely dependent on the discount rate used* (with a lower discount rate suggesting a cost increase of 6 percent rather than the 9 percent cost saving estimated using the higher discount rate). This aspect of the PSC calculus is also interestingly still subject to considerable academic debate. Indeed Zwalfe et al (2014) looked at discount rates being adopted in eight international jurisdictions and found that most relied on a variable project specific discount rate formula; and that a prescribed number was rare. Moreover, most jurisdictions departed from the major theoretical views in applying a rate; the inclusion of risk in the discount rate remained controversial as the literature suggests; and no two jurisdictions had the same approach. As well, although certain themes were common, most governments had developed a tailored, jurisdiction specific approach to setting discount rate policy[[5]](#footnote-5).
8. Perhaps just as importantly here, is the likelihood that *we will still be having the PPP VfM debate in 10 years time* (which is what I suspect). Assessing the extent to which superior VfM may be achieved under particular public-private structures is an admirable ideal. But I currently argue, contrary to popular mythology, that at this point in time we still know very little about PPP success even at the most basic levels such as value-for-money and cost efficiency. Real technical challenges continue to confront PPP evaluation, and it remains a politically loaded task from the beginning. The PPP brand promises political success on the basis of symbolizing innovation and forward thinking from both sectors, and there has been much political capital invested in advocating jurisdictions across the globe. The ideal of PPP has power in the public psyche as well. Exactly what we mean by PPP success (or VfM) deserves more sophisticated consideration to my mind. PPP contracts should not be conflated with the broader planning processes in which they exist, and I am glad the Commission’s draft report acknowledges that LTIC PPP contracts can be applied to projects which are most worthwhile, iconic and successful as well as being applied to projects which have been badly selected or badly conceived. Viewing PPP as simply a technical tool and VfM as a financial or economic matter, however, conflates political and technical rationality in my view. More than two decades after the initiation of private finance as a preference for public infrastructure, we still contest the value this provides for citizens compared to traditional infrastructure delivery methods. I for one have been explicit in my judgment in acknowledging that despite controversial legitimacy and VfM findings, ‘PPPs have usually been politically effective for reformist governments’; (Hodge, Greve and Boardman, 2010). But *there is huge linguistic slipperiness in the matter of PPP VfM and ‘success’*. Davies (2008, 200), for example, comments that in the face of Australian governments all providing ‘directions for managers to achieve value for money, but [being] silent on how value for money should be measured’, even our Parliamentary watchdogs, the Auditors General, have been frightened by the ‘nebulous ’ VfM concept; Davies (2008, 216, 242). The VfM debate will continue for a long time yet.
9. One reason for this ongoing VfM and ‘success’ debate is the nature of the *multiple goals set for PPPs*. I have documented two dozen explicit and implicit goals of PPPs covering both technical and non-technical arenas; Hodge and Greve (2013). And only one of these goals is ‘value-for-money’. Political judgments as to success are thus likely to cover many criteria (as well as economic matters). To my mind, more thought is needed as to how PPPs contribute politically, and how to develop stronger analytical frameworks to analyse PPP as a governing mechanism with political payoffs as well as considering success from narrower perspectives such as VfM. (The place of PPPs as a potent governing tool to promote visible economic development is an example: 'nation-building projects'[[6]](#footnote-6) and ‘cranes on the skyline’ carry much political weight as visible measures of prosperity and signs of success.) Perhaps the PPP (LTIC) approach has helped put the politician back in the driving seat of economic activity and infrastructure development[[7]](#footnote-7)?
10. Another aspect that I have been critical of to date has been the governance of PPP. In one sense, many of our concerns over governance matters are not surprising. Governance matters are important in that the public interest needs to be protected despite the delegation of authority to private concerns. But at the centre of the PPP governance challenge there is an inherent and continuing tension. As Skelcher (2010) said, tight governance is needed to protect the public interest, but weaker governance is also required to enable risk- taking and innovation, along with incentivized private actor participation. These mechanisms can together provide a fair basis for potential investors as well as a framework that should reduce risks of corruption and opportunism. But PPPs 'raise important issues of democratic governance’, and whilst ‘organizations in the public domain are required to account for their activities in the public arena of discourse’, ‘forms of third party government like PPPs muddy the waters of accountability’, and may lead to a ‘democratic deficit’; Skelcher (2010). PPPs are much like a form of quasi-governmental body, emerging in a multiplicity of forms through ad-hocprocesses, and frequently a function of executive rather than legislative decision. So to Skelcher, *creating effective* constitutional *oversight remains a priority challenge for PPP*. Having said this, observers such as Willems and Van Doren (2011; 2012) oppose these views from the perspective of accountability and argue that most PPP accountability concerns are overstated and fail to understand the breadth of today's multiple and complex avenues through which communities hold governments to account. Perhaps the historical counterfactual of traditional accountability and transparency mechanisms have also been overly optimistic as well.
11. On the matter of transparency, I am on record for criticizing some of Australia’s PPP arrangements for being too secretive. General accusations levelled here have included; ongoing analytical manipulation with public sector comparisons lacking legitimacy and favouring private finance delivery; decision-making arrangements lacking transparency; large complex commercial deals clearly being done with business partners rather than with citizens also as equal 'partners'; traditional methods of gaining access to information and review through Freedom of Information or Administrative Law not now available to citizens under private law contracts; and governments lacking accountability amidst multiple conflicting roles[[8]](#footnote-8). I specifically labelled Victoria’s PFI type PPPs 'the illegitimate child' of the PPP LTIC family a few years ago (Hodge 2006: 324). |To my mind, then, *there is a crucial need for governments to improve transparency if we wish to improve the legitimacy of private finance structures* in Australia.
12. If public assets are to be privately financed and decision making heavily influenced by the private sector, *what rate of return ought be expected as ‘legitimate’ for many ‘safe’ public assets* - both for their initial construction, and for their ongoing operation? Another important governance issue, this seems to be me to *inherently* be *a question for a professional independent economic regulator* such as the current Essential Services Commission rather than be subject to ad-hoc deal by deal arrangements at the whim of the government of the day. We are yet to have a serious debate about differences and similarities between our traditional expectations of independent regulators of say electricity or water assets, and the long term contractual arrangements inherent within an LTIC PPP. It is now needed.
13. This has not been the first time that major reforms to our infrastructure delivery mechanisms have been suggested. Years ago I argued that 'rather than initiatives being forced to fit the existing narrow private finance model, we need to expand our horizons'. Moreover, I said that it was time for a range of new options for 'partnership' to be put more clearly on the table for real debate, and time to ‘try some new policy experiments in public finance and capacity building through new strong institutional options’. Our current Australian PPP debates and discussions are in one sense therefore belated news (Hodge 2009), but they are nonetheless most welcome. And importantly, PPP approaches are flexible enough to adapt if governments wish. The PPP brand today still offers manifold possibilities.
14. On the matter of *road user charging* (eg p126-133), too, I welcome your comments and encourage further debate. I am also reminded, however, that this *is an old debate*. Interestingly, Pigou (1912, 1920) initiated the idea of read pricing to optimize congestion on public roads. Now, a century later, we still debate not only the technicalities of the market mathematics (or post-GFC - imperfect markets), but the reality of what we as a society wish to achieve through such a market mechanism, including just who wins and who loses when such policies are initiated. And rightly so, as this discourse itself part of contesting when markets may or may not serve the public interest.
15. Likewise, your *concerns around the capabilities of the public sector* (p230) *are also welcomed*. This was a matter noted briefly in my book Privatisation: An International Review of Performance (Hodge 2000, 152). Here, the research of Holcombe (1991) was quoted. He looked at contracts for a series of water treatment plants in the US, and then contrasted these against the operational experience of each. Holcombe’s work voiced two concerns. First he argued that contracts for municipalities might often be less than favourable due to the informational advantage of privatizing firms, since they already knew a great deal about the task and probably about other agreements. Also, the private firm has an incentive to strike a profitable bargain, irrespective of unforeseen costs or circumstances. Second, he found that privatizing firms were allowed to pass on most of their costs to the municipality, so that deals were not in the interests of citizens. So, although contracts should in theory have resulted in lower costs to the service recipients, they did not and the end customer paid for any cost inefficiencies. This old illustration has relevance to today’s considerations because it emphasizes the requirement to assess not only the theory of contracts but the practice of contracts, the capability of governments when signing deals and the need for independent economic intelligence when monitoring what citizens are getting out of such deals and achieving a fair balance for all involved.

Best Regards,

Graeme Hodge

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1. While it is true in a sense that there is no one such single thing as the PPP model, it is acknowledged that we will continue to use 'PPP’ as a common shorthand. [↑](#footnote-ref-1)
2. See also Boardman et al (2005) on this point. [↑](#footnote-ref-2)
3. Difficulties in extracting this research data from behind government claims of ‘commercial-in-confidence’ also amplified the concern that peer review scrutiny of the UK’s well publicised studies of on-time and on-budget performance was not welcomed because they lacked rigor. [↑](#footnote-ref-3)
4. This review rightly cautioned against making any further VfM conclusions, however, arguing that life-cycle costs over the longer term were still unknown. [↑](#footnote-ref-4)
5. Australia’s use of two discount rates in the analysis of social PPP proposals was noted as ‘novel’ amongst all jurisdictions reviewed. [↑](#footnote-ref-5)
6. See http://www.theage.com.au/victoria/channelling-his-mentor-treasurer-looks-the-goods-20130507-2j5ux.html#ixzz2gQxAHGJu [↑](#footnote-ref-6)
7. This 'cranes on the skyline' led approach has been criticized, however. Buxton (2013) for example comments on the most recent Metropolitan plan for Melbourne saying that 'this is not a plan…it is a hoax driven by money', where government has 'largely given away planning to private interests', and now does not link infrastructure investments to land use. [↑](#footnote-ref-7)
8. Governments face multiple conflicts of interest, simultaneously acting as policy advocate, economic developer, steward for public funds, elected representative for decision making, regulator over the contract life, commercial signatory to the contract, and planner; Hodge (2006). Having said this, from the perspective of governments, perhaps the multiple roles subsumed by government are an attraction of this project delivery type. [↑](#footnote-ref-8)