14 May 2014

Public Infrastructure Inquiry
Productivity Commission
LB2 Collins Street East
Melbourne, VIC 8003

By email: peter.harris@pc.gov.au

Dear Mr Harris

Productivity Commission Draft Report – Public Infrastructure

We are following up on our submission dated 4 April and our presentation at the public hearing in Melbourne on 9 April, relating to the Commission's information request 6.3, on what is referred to in the draft report as the 'inverted bid' model.

We understand that the Commission is not convinced that the tender for the project return can be competitive if the bid return can vary depending on the outcome of risk allocation between the government and the equity investor. We further understand that the Commission is concerned that the equity investor could increase its project return once appointed as the preferred bidder, and the Commission wishes to investigate whether it is possible for the government to effectively 'lock in' the bid return.

We believe that it is possible to 'lock in' the bid return as follows:

1. The government finalises engineering and detailed design sufficient to allow a detailed risk allocation prior to inviting equity investors to bid on the project;
2. The government selects the investor with the most competitive IRR as its preferred equity partner;
3. The preferred investor puts out open-book tenders for construction, operations and debt in partnership with the government, however, the project IRR is not subject to change; and
4. All subsequent project risks identified between Stages 1 and 3 are borne in accordance with the agreed risk allocation. Any new risks would need to be dealt with using a pre-agreed mechanism.

At this point, it is worthwhile to step back and consider the broader issue. Throughout this Inquiry, we have observed some concerns that we believe are based on a misunderstanding of the inverted bid process or indeed seek to defend the status quo. The fundamental issue is that under the current PPP model, short-term bidders are building long-term infrastructure. If this persists, many of Australia's largest infrastructure investors, will continue to 'sit-out' of the PPP greenfield market and the value for money outcome will be less than optimal.

To avoid confusion, I wish to re-iterate some of the key attributes of the inverted bid model:

- **Greater innovation**: The inverted bid model allows the long-term investor the opportunity to explore the most innovative ways to design, deliver, operate and finance infrastructure projects. We believe long-term investors have most to lose and their participation stimulates greater innovation than current bid processes where innovation is promised by advisor-led consortiums.

- **Greater efficiency (time, cost and value)**: The inverted bid model allows long-term investors to leverage their buying power and relationships with greater certainty and, therefore, allows for enhanced competition in tendering out construction, operations and debt.

  The inverted bid model expects to avoid unnecessary bureaucracy and reduce the time between decision and action. Taking note of several large existing projects in the south eastern states of Australia, there are multiple departments, each with their own legal and financial advisors reviewing the same material and each others' work. We do not believe that such duplication represents good value to the taxpayer.

- **Addressing Australia's growing infrastructure backlog:** One of the submissions noted that the inverted bid model puts disproportional emphasis on the cost of equity when the biggest cost contributors are design and construction and operating costs. The submission notes that compared to reducing construction or operating costs, reducing the cost of private sector debt or equity will have a relatively minor impact on a project's overall net present value. What this observation implies is that the cost borne by equity investors for failed projects delivered by short term bidders is acceptable. This ambivalence towards equity investment is surprising at a time when governments across Australia actually want superannuation funds to deploy greater amounts of capital into infrastructure.

- **Transparency and fairness, for both taxpayers and working Australians**: Under the inverted bid model, those asked to take the greatest risk are also responsible for pricing that risk. The current system is imperfect in this regard and the lack of transparency of how large bids actually work will allow this imperfect pricing of risk to continue. At the heart of the issue is the fact that most decisions are currently made for pools of investor equity, often superannuation money, by advisors who rely on investor capital deployment to realise their own fee revenues. This misalignment of investor and advisor motives continuously leads to inappropriate pricing of risk – if governments are happy to be the beneficiaries of an inefficient system where there is fee leakage and that fails to safeguard the deployment of working Australian's retirement savings, then this is regrettable.

  The inverted bid model is not about reducing competition – it is about introducing real competition that takes place subject to the realisation that parties competing without alignment to the long-term investors are more likely to "win at all costs" and mask the cost borne by long-term equity investors.

We believe that the overarching benefit of introducing the inverted bid model or at least requiring bidders to be genuine, long term equity investors, is that it will reduce the risk of failed investments by correcting the misalignment between short term bidders and equity. More infrastructure equity investors will be encouraged to enter the greenfield PPP market, and governments will benefit from greater competition, much reduced fee leakage and a better value for money outcome.

We remain keen to work collaboratively with you in order to make improvements, flesh out details and address any real or perceived concerns. Please do not hesitate to contact Azhar Abidi if any further assistance is required.

Yours sincerely

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