

Public Private Partnership Programme

The New Zealand PPP Model and Policy: Setting the Scene

A Guide for Public Sector Entities

September 2015



THE TREASURY
Kaitohutohu Kaupapa Rawa

New Zealand Government

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1 About this Guidance

How to use this guidance

- 1.1 This guidance has been written by the Treasury PPP Team. It must be read in conjunction with other Public Private Partnership (PPP) guidance and applied in consultation with the Treasury PPP Team. It assumes that the Treasury's Standard Form PPP Project Agreement will form the basis of the contract to be signed with the private sector partner.¹
- 1.2 This document should be read by public sector entities (referred to as procuring entities throughout this guidance document) that are considering or implementing PPP as a procurement option for a major infrastructure project; specifically, those staff involved in the development and internal approval of the project business case and procurement process.
- 1.3 A glossary of terms used throughout this document is available on the Treasury website.²

The New Zealand PPP model

- 1.4 In the New Zealand context, a PPP is a long-term contract for the delivery of a service, where provision of the service requires the construction of a new asset, or enhancement of an existing asset, that is financed from external (private) sources on a non-recourse basis, and full legal ownership of the asset is retained by the Crown.
- 1.5 PPP procurement has been implemented in New Zealand for the primary purpose of improving the focus on, and delivery of, required service outcomes from major infrastructure assets. Whole of life services are purchased under a single long-term contract with payments to the contractor based on availability and performance of the asset. The combination of assets and services required to be delivered by the private sector are referred to in this document as the 'project'.
- 1.6 The PPP model seeks to improve outcomes by capturing best practice and innovation from the private sector. Lessons learnt from PPP projects can be implemented across a broader portfolio of public assets to significantly leverage the benefits of single PPP transactions. The competitive procurement process, focus on outcomes (with minimal input specifications and constraints), appropriate risk allocation and performance based payment mechanisms that put private sector capital at risk optimise the incentives and flexibility for private sector participants to deliver innovative and effective solutions.
- 1.7 PPP procurement is only used where it offers value for money over the life of the project, relative to conventional procurement methods. This means achieving better outcomes from a project than if it were procured using conventional methods, for the same, or lower, net present cost.

Questions and further information

- 1.8 General enquiries about the information contained in this guidance can be sent to ppp@treasury.govt.nz. Other guidance documents and useful information can be found at www.treasury.govt.nz/ppp.

¹ <http://www.treasury.govt.nz/statesector/ppp/standard-form-ppp-project-agreement>

² <http://www.treasury.govt.nz/statesector/ppp/guidance/glossary>

2 Overview

Introduction

- 2.1 This document provides an overview of the New Zealand Public Private Partnership (PPP) model and policy and is intended to set the scene for procuring entities, potential bidders and the public, by outlining:
- what PPP procurement is and, in particular, the key policy and contractual features that shape the New Zealand PPP model
 - the rationale for choosing PPP procurement to deliver major infrastructure assets and their related service outcomes
 - when a procuring entity should select PPP procurement over other conventional methods of asset delivery, and the process for this assessment (including integration with the Better Business Cases framework)
 - the role of the Treasury PPP Team in assisting the procuring entity with PPP procurement, and
 - a brief overview of the procurement process.
- 2.2 This document incorporates developments in New Zealand PPP policy and valuable lessons learnt from the practical implementation of PPP procurement in New Zealand to date.
- 2.3 This document is intended to provide an overview of the New Zealand PPP programme only. It is not intended to provide detailed advice and procuring entities should consult with the Treasury PPP Team for assistance in relation to a specific project.

Background

- 2.4 Increasing productivity in the public sector, including through the implementation of improved procurement and management of major assets, is important for New Zealand's long-run fiscal and economic performance. Government agencies should consider using private sector expertise in asset procurement and management where it delivers better value for taxpayers, either through enhanced services or lower overall costs.
- 2.5 The Government has stated that it will consider PPP procurement where it offers superior value for money over conventional procurement approaches. The evaluation of PPP procurement for all significant infrastructure investments has subsequently been mandated through a Cabinet Office Circular and the Government's Rules of Sourcing.^{3 4}
- 2.6 The New Zealand PPP Programme was established in 2009 with the creation of a PPP Centre of Expertise within the Treasury. Since this time the Treasury PPP Team has published PPP guidance and developed a standardised set of 'model terms' for PPP procurement (the Standard Form PPP Project Agreement).⁵ Each clause has been developed on the basis of its international validity and its relevance to the New Zealand market.

³ <http://www.dPMC.govt.nz/cabinet/circulars/co15/5>

⁴ <http://www.business.govt.nz/procurement/for-agencies/key-guidance-for-agencies/the-new-government-rules-of-sourcing>

⁵ Refer note 1 above

3 What is PPP Procurement?

- 3.1 Internationally, the history of PPP procurement spans more than two decades with early Private Finance Initiative projects in the United Kingdom generally considered to be the genesis of the PPP model.
- 3.2 While PPP procurement has been adopted in a number of jurisdictions (in both developed and developing economies) no clear and consistent definition has emerged as to what constitutes a PPP. This is largely due to the varying policy drivers which influence the design and implementation of PPP procurement between jurisdictions.
- 3.3 A number of international government bodies and non-government organisations have sought to provide greater clarity through published definitions of PPP procurement. These share a number of common characteristics which have informed the development of the New Zealand PPP model and definition, such as:
- involvement by both Public and Private sector parties
 - a long-term contract
 - construction of new infrastructure assets that enable delivery of services to the public
 - provision of at least some of those services by the private sector
 - risk transfer, and
 - private finance.

The New Zealand PPP model

Key characteristics

- 3.4 The key policy characteristics of the New Zealand PPP model include:
- the specification of outcomes required to be delivered to the public (the service outcomes)
 - the construction of a new infrastructure asset, or substantial enhancement of an existing asset, (the asset) to facilitate the delivery of the service outcomes
 - the delivery of service outcomes by a private sector partner for a defined period (often between 20-30 years)
 - the efficient allocation of risk to the party best able to manage that risk
 - the separation of ownership (retained by the public sector) and financing (provided by the private sector partner) to provide meaningful risk transfer and management, and
 - the application of a payment for performance regime to incentivise the delivery of specified service outcomes and penalise non-performance.

- 3.5 PPP procurement places a greater focus on whole of life performance to optimise decisions and activities that may otherwise occur in isolation, or with other short-term drivers. For example, the trade-off between the choice of construction materials and ongoing maintenance requirements is optimised for the duration of the PPP (including any required hand back period), rather than being unduly influenced by the up-front capital cost.
- 3.6 The integration of service and asset design is equally important to ensure that the asset is fit for purpose and enables efficient and effective delivery of operational services.
- 3.7 The application of private finance is an important component of PPP procurement as placing significant capital 'at risk' ensures that the performance incentives and risk transfer within the model are meaningful.
- 3.8 The New Zealand PPP model adopts a 'more for the same' approach to value for money. This recognises that a project procured under more conventional forms of procurement will incur a certain level of expenditure and seeks to maximise the quantum and quality of outcomes that can be achieved for that cost. This can be contrasted with a 'same for less' approach adopted in some other jurisdictions. This reinforces that PPP procurement is intended to improve the delivery of asset and service outcomes and act as a catalyst for change in the public sector.

Definition

- 3.9 The definition adopted by the New Zealand PPP Programme and the Standard Form PPP Project Agreement is:

A long term contract for the delivery of a service, where the provision of the service requires the construction of a new asset, or the enhancement of an existing asset, that is financed from external (private) sources on a non-recourse basis, and where full legal ownership of the asset is retained by the Crown.

Standard Form PPP Project Agreement

- 3.10 Following the commencement of the New Zealand Government's PPP programme in 2009 the Treasury established the Standard Form PPP Project Agreement which is the basis for the project agreement for all PPP projects in New Zealand.⁶
- 3.11 The standardisation of commercial and contractual terms and their application provides clarity, consistency and certainty of the PPP model for both procuring entities and the wider PPP market. This creates confidence in the model and results in more efficient procurement processes.

⁶ Refer note 1 above

3.12 Key aspects covered by the Standard Form PPP Project Agreement include:

- A fixed price for the design, construction and ongoing maintenance (and operation) of the asset
- Legal ownership of the asset is retained by the procuring entity at all times
- A performance regime which ensures that payment is only made once the asset is complete and service delivery commences, and only in relation to those service outcomes actually delivered
- Contractual certainty on risk allocation
- A clear process for agreeing any changes to the required service outcomes, and
- Provision for control of the asset to be handed back to the procuring agency in a pre-defined condition at no cost at the conclusion of the operating period.

3.13 The Standard Form PPP Project Agreement must be used by all procuring entities undertaking PPP procurement and is only to be adapted in consultation with the Treasury PPP Team to the extent required to accommodate any unique characteristics of a specific project.

New Zealand PPP procurement models

3.14 The New Zealand PPP programme utilises two models (distinguished by the scope of services required) to allocate the roles and responsibilities for a PPP project based on its specific characteristics and requirements.

3.15 The Design, Build, Finance, Maintain and Operate (DBFMO) model transfers the responsibility for delivery of the design, build, financing, maintenance and operation (service provision) of an asset to the private sector partner.

3.16 In comparison, the Design, Build, Finance and Maintain (DBFM) model transfers similar responsibility except in relation to the operational services, for which the procuring entity retains responsibility for delivery.

3.17 The DBFMO model has the potential to deliver greater benefits to the public sector because it provides greater opportunity for innovation and risk transfer.

Design, Build, Finance, Maintain and Operate

3.18 The DBFMO model offers maximum scope for innovation in asset and service design as it incorporates service provision. The key benefit lies in the ability for the private operator's service methodology to inform and influence the design of the asset to ensure the asset and service mix is optimised.

3.19 The DBFMO model allows the procuring entity to focus primarily on the service outcomes sought and incentivise these through the performance regime (upon which payment is based). This aligns closely with the government's focus on achieving better public services rather than solely focusing on the procurement of 'bricks and mortar' assets.

- 3.20 This model has been adopted for the delivery of a new prison facility and custodial services where the Department of Corrections specified the service outcomes to be delivered by the private sector. The service outcomes include custodial services that provide a safe, secure and humane environment and rehabilitation services that reduce rates of reoffending. To drive innovation, the Department minimised constraints where possible to allow the private sector flexibility in the design and operation of the prison to achieve the desired service outcomes.

Design, Build, Finance and Maintain

- 3.21 The DBFM model incentivises the consideration of the whole of life cost of asset and service provision through the inclusion of facilities maintenance, asset management, fitout and lifecycle refurbishment within the procurement. This 'bundling' creates a focus on optimising the cost of the facility and its operations over its entire life.
- 3.22 In comparison with the DBFMO model, as responsibility for the provision of operational services is retained by the procuring entity, the DBFM model requires a greater level of integration between the procuring entity and the private sector partner through the procurement phase to ensure that opportunities for innovation in asset and service design are realised.
- 3.23 The procuring entity is also likely to be exposed to a greater level of interface risk where it retains responsibility for the provision of operational services, particularly where the asset is complex and directly impacts the operating model such as a prison or hospital. This method is therefore best suited to projects where there is a strong policy or operational rationale for not including service provision within the PPP contract.
- 3.24 This model has been successfully used to deliver new school property where the Ministry of Education retains responsibility for the provision of teaching services within the facilities that have been designed and constructed by a private sector partner. The Ministry benefits through the up-front agreement of long-term performance standards for the assets at a fixed price, while school management teams are not burdened by property maintenance responsibilities. This enables them to focus on educational outcomes.

PPP performance regime and payment mechanism

- 3.25 PPP procurement is predicated on the concept of payment for performance. Together, the performance regime and payment mechanism incentivise enhanced asset performance and service provision (to the extent included within the PPP contract) throughout the operating period.
- 3.26 The required level of asset performance and service delivery is prescribed in terms of service outcomes by the procuring entity at the outset of the procurement phase. The contractualisation of these performance standards then ensures that the specified outcomes remain central throughout the life of the project.
- 3.27 The level of analysis required to identify these outcomes and an indicative performance regime is typically more substantial than for conventional forms of procurement. This analysis is also completed earlier in the procurement process (with project outcomes and indicative performance standards often identified during the development of the Detailed Business Case (DBC)).

- 3.28 The performance regime is both availability and service driven, with payments made by the procuring entity on a periodic (typically quarterly) basis commencing only once the asset is operational and calculated based on the actual performance of the asset and required service outcomes.
- 3.29 In the event that the asset (and/or service) does not perform as agreed, payments made by the procuring entity will be reduced through abatement to the extent that they may not cover the private sector partner's operating cost or, ultimately, the full capital cost of the asset. The application of private finance provides a direct link between asset and service performance and payment for the asset, ensuring that investors have a strong incentive to manage the performance of their service providers.

How does PPP procurement differ from conventional procurement?

- 3.30 The key features that distinguish PPP procurement from more conventional public sector procurement include:
- Specification of the service outcomes required from an asset rather than prescriptive input specifications that relate to the asset itself
 - Bundling of 'whole of life' services, that are otherwise procured independently at different stages of an asset's lifecycle, under a single long-term contract
 - The transfer of risk to the private sector partner where they are best placed to manage that risk, and
 - A periodic (typically quarterly) payment profile which commences only once the asset is operational and is calculated based on the actual performance of the asset and required service outcomes.

Forms of procurement excluded from the New Zealand definition of PPP

- 3.31 A range of alternative, or non-traditional, procurement models have emerged which may be appropriate for procuring entities to consider when determining the appropriate procurement model for a specific project. While these models may be valid alternatives to consider alongside PPP procurement, they do not address, to the same extent, the underlying policy concerns that led to the development of the New Zealand PPP model and are therefore excluded from the New Zealand definition of a PPP (as set out at paragraph 3.9).
- 3.32 Examples of models and processes that do not constitute a PPP include:
- joint venture arrangements
 - long-term leases
 - alliance models
 - early contractor involvement, and
 - outsourced service contracts.

4 Why has PPP Procurement been introduced in New Zealand?

Adoption in New Zealand

- 4.1 It is important for participants in the New Zealand PPP programme to understand the rationale for the adoption of PPP procurement in New Zealand and, in particular, how this may differ from other jurisdictions.
- 4.2 PPP procurement has been implemented in New Zealand for the primary purpose of improving the focus on, and delivery of, service outcomes from major infrastructure assets. This focus is two-fold:
- improving capital asset management and procurement through the implementation of whole of life asset costing and management, and
 - facilitating the provision of better public services through recognition that infrastructure assets exist primarily to enable the effective and efficient provision of public services.
- 4.3 PPP procurement has not been adopted in New Zealand to address problems in the procurement process (such as failure to deliver to time or budget, which could be satisfactorily achieved through appropriate provisions within conventional procurement contracts) or a lack of public funding for major infrastructure projects.
- 4.4 The PPP model utilises a performance-based contract that incentivises high quality performance by placing private sector capital at risk for non-performance. Through its focus on service outcomes the PPP model provides flexibility for private sector participants to apply their expertise and experience to deliver innovative and effective solutions for the benefit of the procuring entity.

Key advantages of PPP procurement

- 4.5 The key advantages that distinguish PPP procurement from conventional procurement methods in New Zealand include:
- an increased focus on the specification and the performance of service outcomes
 - an integrated service and asset design solution
 - a 'whole of life' perspective that provides greater cost certainty and optimisation
 - payment for good performance and abatement for poor performance
 - active management and optimal allocation of risk
 - wider benefits to New Zealand's infrastructure sector as a result of private sector expertise and experience, and
 - enhanced procurement discipline.
- 4.6 These are discussed in detail below.

An increased focus on service outcomes

- 4.7 Conventional forms of procurement focus on asset input specifications, which traditionally dictate how the asset is constructed. This approach results in heavily prescribed tender documents focused on the infrastructure asset itself as an end result, rather than as an enabler of the desired service outcomes.
- 4.8 In contrast, PPP procurement requires the procuring entity's identification of specific performance outcomes relating to the desired service outcomes for the project, with detail of the design and construction of the asset used to deliver those services determined by the private sector partner. As payment to the private sector partner is linked to the performance of the services throughout the contract, PPP procurement incentivises the delivery of the highest quality service provision within the project budget.
- 4.9 Importantly, specification of the scope of the project on the basis of the quality of service provision allows the private sector partner to introduce and implement international best practice and innovation. It also enables the exploration of alternative asset and service models that may provide the same or higher quality service outcomes.
- 4.10 By attracting international service, construction, and equity providers to the New Zealand market PPP procurement offers procuring entities access to a wide variety of sources of best practice and innovation which may not otherwise be readily accessible. These parties compete on the basis of their experience and ability to deliver those outcomes sought by the procuring entity, resulting in focused and well developed proposals.

Integrated service and asset design solution

- 4.11 Projects using conventional procurement models are often limited to a 'design and construct' brief without expressing the functionality or operational delivery outcomes required from the asset. This often results in the asset being influenced by the cost and ease of construction rather than the outcomes required from the particular infrastructure.
- 4.12 A significant benefit of PPP procurement is the integrated consideration of the design and services with the asset's operational functionality. Ongoing operational, maintenance and refurbishment requirements become the private sector provider's responsibility for the length of the contract period.
- 4.13 This not only achieves a higher level of long-term service delivery but is also likely to improve the quality of the design and usability of the asset. This benefit is driven through the structure of the PPP payment mechanism whereby the private sector provider will only receive full payment if the asset is available and fit for purpose for the duration of the operating period.

A whole of life perspective

- 4.14 The PPP model focuses on whole of life performance of an asset through full integration of up-front design and construction costs with ongoing service delivery, operational, maintenance and refurbishment costs. This is intended to deliver improved efficiency, greater cost optimisation and improved cost certainty over the life of the asset.
- 4.15 Conventional methods fail to incentivise the consideration of the long-term operating and lifecycle costs of new capital assets at the time approval for new capital investment is sought. By establishing an investment period that incorporates a substantial operating period (usually 20-30 years post service commencement), PPP procurement ensures the whole of life cost of infrastructure is well understood and sufficient capital and operating appropriations are sought at the outset.
- 4.16 The requirement for a higher degree of pre-procurement analysis under PPP procurement results in better quality information for the procuring entity and more robust, and defensible, decision making. This is a win-win; the procuring entity enjoys a greater level of certainty that the whole of life cost of the project is affordable while the government gains assurance that the future cost of today's investment is well understood.
- 4.17 Further benefit is gained through the transfer of whole of life risk; that is, the risk that the asset performs as intended for the duration of the operating period (which includes the risk, and cost, associated with facilities maintenance, lifecycle, fit out and specified equipment). This ensures the private sector partner is highly incentivised to explore innovative opportunities to ensure reliable service while managing the long-term cost of both the asset and service delivery, rather than solely focusing on minimising the up-front capital appropriation.
- 4.18 To date, this has led to design concepts, operating models and approaches to capital investment that had not previously been considered by the respective procuring entity. This increased understanding and optimisation of the whole of life cost of the project is beneficial to the procuring entity's wider asset portfolio as well as the immediate project.

Payment for performance

- 4.19 Globally, fiscal constraints have increased governments' focus on the efficient and prioritised appropriation of taxpayer funds. This has resulted in greater emphasis on agencies to account for the ways in which they apply public funds.
- 4.20 PPP procurement creates a direct relationship between the performance of an investment and the reimbursement of the associated capital cost associated with the asset over an extended period. Having private sector capital at risk for non-performance provides a strong incentive for the private sector partner to ensure the asset is always available and fit for purpose.

- 4.21 The performance regime ensures that the procuring entity only pays for the asset and service provision where those outcomes are achieved. If the asset does not perform as required and the service outcomes specified by the procuring entity are not met to the required standard, payment is abated in proportion to the level of underperformance. This incentivises the private sector partner to lift its performance to ensure future payments are received.
- 4.22 Abatements for non-performance (or penalties) should be appropriately sized to ensure that the contractor is incentivised to avoid or remedy performance failures.

Optimal allocation and active management of risk

- 4.23 While conventional forms of procurement may address procurement specific risk (such as 'on time' or 'within budget' delivery) they can fail to address a number of project related risks (such as lifecycle or operating cost implications). If these risks are not well managed, then an otherwise apparently successful procurement can be greatly undermined during the operating phase of the project.
- 4.24 A unique aspect of PPP procurement is the more rigorous up-front identification of risk inherent throughout the life of the project and the cost of that risk to the procuring entity. Once these risks have been identified and valued, the procuring entity is able to test which risks a private sector partner may be prepared to bear and whether they can manage these risks more efficiently than the public sector.
- 4.25 The critical principle applied to New Zealand PPP procurement is that individually identified risks should be allocated to the party best able to manage and mitigate that risk (in the sense of either reducing the likelihood of it occurring or reducing the cost of rectification or reinstatement). It is only where the private sector partner is better placed to manage a particular risk that it should be transferred. This principle recognises that value is not achieved through indiscriminate transfer of project risks that the private sector cannot manage better than the public sector.
- 4.26 The structure of the private sector partner ensures that procurement decisions and risk transfer are thoroughly tested. This is achieved as each member of the respondent consortium will consider directly the risk that they are taking under the PPP project agreement. Specifically, the financiers' interests are well aligned with those of the procuring entity which ensures decisions are rigorously analysed, thereby improving the overall robustness of the final project.
- 4.27 Even where it may not be value for money to transfer a risk to the private sector partner, the risk identification and quantification process has tangible benefits for the procuring entity through a greater understanding of those risks it will retain and how these should be managed.

Wider benefits to New Zealand's infrastructure sector

- 4.28 Utilising the expertise and experience of the private sector through PPP procurement offers several benefits beyond those realised in a specific project, as follows:
- PPP procurement challenges the way in which the public sector considers service delivery and provides opportunity to learn first-hand from others who have demonstrated experience and competency in providing similar services internationally.

- The PPP model allows the procuring entity to adopt innovation, whether in asset design or service performance improvements, brought by the private sector partner. This provides real scope for a single PPP project to lift the performance of an entire portfolio, as innovation and efficiencies can be replicated across the entity's wider procurement and asset management programmes.
 - PPP procurement drives continuous improvement through the implementation of performance regimes that allow a procuring entity to expect more from its private sector partner as it improves its own performance across the rest of its portfolio.
 - PPP procurement can provide contestability in certain sectors for infrastructure and services that have previously been solely provided by a public sector entity, without losing public sector control over the standard to which those services are provided.
- 4.29 PPP procurement may also be considered in situations where the savings in relation to a single project may not be significant. Instead, there may be greater value to the procuring entity through utilising the PPP project to effect institutional change.

Enhanced procurement discipline

- 4.30 The Government is focused on ensuring taxpayers' funds are applied prudently including through the delivery of high quality procurement and management of capital assets.
- 4.31 The PPP procurement methodology encourages a disciplined approach to procurement through detailed consideration of project requirements, desired outcomes and the rigor of analysis in compiling a Public Sector Comparator (PSC), which establishes a comparative cost if the project were to be procured using a more conventional form of procurement. As such, PPP procurement is less prone to cost escalation.
- 4.32 The additional clarity gained through this process is beneficial to all procurement decisions, even where PPP procurement may ultimately not be implemented. In particular, greater cost certainty provides better quality information to support more robust decision making.

5 When and how to consider PPP

5.1 It is important to note that:

- As with all forms of procurement, PPP procurement does not alter the investment case or objectives of a project and should therefore only be considered once a clear service (and corresponding asset) need has been identified and agreed.
- PPP procurement should only be used where it offers value for money over the life of the project relative to conventional procurement methods. This means obtaining improved outcomes from a project for the same, or lower, net present cost as if it were procured using conventional methods.

Cabinet mandated consideration of PPP procurement

5.2 Procuring entities that are planning any 'significant investment' (including any arrangements with Local Government Authorities seeking Crown funding or support) must evaluate all procurement options, including PPP procurement.⁷

5.3 The Government Rules of Sourcing require agencies that are considering PPP procurement to:

- consult with the Treasury PPP Team early in the development of the project's business case
- follow relevant Treasury guidance and instructions
- involve the Treasury PPP Team in the economic and financial assessment and advice to Ministers
- invite the Treasury PPP Team to participate in relevant project steering and working groups, and in the selection panels for all key PPP advisor appointments, and
- use the Treasury's Standard Form PPP Project Agreement as the basis for any contract and consult with the Treasury PPP Team over any proposed modifications.⁸

Integration with the Better Business Case Framework

5.4 Procuring entities should engage with the Treasury PPP Team to consider the potential suitability of PPP procurement for proposed projects at an early stage. For procuring entities applying the Better Business Case framework, formal consideration of PPP procurement is required through the development of an IBC and has implications for the process of developing both the IBC and DBC.

⁷ In terms of financial or risk thresholds, 'significant' generally means investments that require Cabinet or Ministerial approval as per Cabinet Office Circular (15) 5, that is, high risk proposals, or proposals with whole of life costs in excess of \$15 million, however funded. For further information, refer <http://www.dpmc.govt.nz/cabinet/circulars/co15/5>

⁸ Refer note 1 above

Indicative Business Case

- 5.5 The first and most critical step in the lifecycle of any procurement project is the definition of the service need. The clearer the definition and understanding within the procuring entity, the lower the risk that problems will arise later in the procurement process.
- 5.6 The service need must be defined by the procuring entity in consultation with users and stakeholders and be expressed in terms of needs, functions and operational performance requirements. The service need should reflect the desired outcomes (and outputs where appropriate) and wherever possible avoid prescribing design features or input requirements. This is to maximise the opportunity for innovation in meeting the service need.
- 5.7 The consideration of procurement options is carried out at Action 7 of the IBC where evaluation of a wide range of realistic options for meeting the identified service needs is required. The suggested approach is to consider possible options against five dimensions: scale, service solution, service delivery, implementation and funding. The resulting options for implementing the preferred solution may range from the procuring agency self-performing the delivery of all required assets and services to the provision of all services by a private sector provider through assets developed and owned by that provider.
- 5.8 An initial qualitative assessment of PPP procurement is required. This should consider the characteristics of the project and assess whether PPP procurement is likely to be suitable and offer greater value for money. Further detail of those characteristics which should be considered at a minimum are set out below.
- 5.9 If PPP procurement is to be included as a short list option, additional consideration is required as part of the IBC before PPP procurement is presented to Cabinet. This additional consideration includes consultation with joint Ministers (being the Minister of Finance and Minister responsible for the procuring entity) and engagement with potential interested parties through market sounding.
- 5.10 Two additional components (Actions 8a and 8b) are required to be added to Action 8 to provide for this additional analysis.

Action 8a: Market Sounding

- 5.11 Engaging with a representative sample of potential private sector partners (the market) early in the planning process for a project can provide real value to a procuring entity as it can help inform the opportunity for all parties – both in terms of readying the market for the project as well as helping the procuring entity resolve the optimal scope and scale of the project.
- 5.12 While care must be taken to ensure that appropriate probity processes are observed, market sounding provides the procuring entity an opportunity to gain a better understanding of the appetite of the market for the project as well as any preferences or challenges the market may have with certain scope and scale permutations.

- 5.13 The procuring entity must ensure that it is well prepared for the market sounding process and that it presents a coherent and considered opportunity to the market. If the procuring entity is not well prepared and has not considered a range of options or attempts to use the market sounding process to 'crowdsource' innovation or intellectual property then it is likely to damage the market's appetite for the project.

Action 8b: Endorsement by joint Ministers

- 5.14 If, on the basis of the initial qualitative assessment and market sounding, PPP procurement is considered a short list option then joint Ministers should be consulted prior to submission of the IBC to Cabinet. This provides Ministers with full visibility of the analysis and assumptions which underpin the project and allow them to consider whether there are any programme or external factors which may also impact the likely success of PPP procurement. For example, if the timing of another project, for which a different agency is considering PPP procurement, may clash then Ministers may consider intervening.
- 5.15 If joint Ministers agree that PPP procurement is an appropriate option, then further analysis will be required as part of the preparation of the DBC. The IBC should short list two procurement options for further evaluation in the DBC which include PPP procurement and the preferred form of conventional procurement. This is important as the preferred form of conventional procurement will form the basis for the calculation of the PSC and will ensure a second option is available if further analysis as part of the DBC results in PPP procurement being discarded.

Detailed Business Case

- 5.16 Where PPP procurement is endorsed by Cabinet, the DBC will build on the analysis completed as part of the IBC and Cabinet directive. Further qualitative analysis will be required as well as quantitative analysis in the form of compiling a PSC. Ideally, the scope of service provision to be included within the PPP will be confirmed at this time together with finalisation of the project's key outcomes and an indicative performance regime and risk allocation.
- 5.17 A number of actions required to complete a DBC require additional analysis where PPP procurement is a short list option. These include:
- Action 12: Risk and Uncertainty – a detailed understanding of project risks is required to ensure that the PSC is accurate and risk allocation is appropriate
 - Action 14: The Procurement Strategy – consideration of the procurement process specific to PPP transactions is required together with a market sounding of the proposed solution
 - Action 15: Specify Requirements – further consideration of the project scope and bundling options (particularly in relation to service provision) is required
 - Action 16: Risk Allocation – a detailed risk allocation schedule will be required to be completed to ensure that those risks which will be transferred to the private sector partner are well understood and valued for the PSC

- Action 17: Payment Mechanism – the performance regime is central to the development of a PPP specific payment mechanism and this is discussed further below
- Action 18: Contractual and Other Issues – consideration is required in relation to the PPP project agreement and any project specific matters which may require amendment to the Standard Form PPP Project Agreement, and
- Action 19: The Financial Costing Model – the development of a PSC will be required to confirm that PPP procurement offers value for money over more conventional procurement approaches. This action is discussed further below.

5.18 While all of the above actions require a degree of additional analysis for PPP procurement, three (Actions 14, 17 and 19) specifically require additional components to consider PPP procurement.

Action 14a: A second market sounding

5.19 A second market sounding is required during the preparation of the DBC (often late in the process) and serves two key purposes:

- It provides the procuring entity a final opportunity to test its proposed solution with the market. This is important as private sector parties will not respond positively to a project which it considers is underdeveloped or likely to change, and
- It allows private sector parties to understand the objectives and outcomes sought by the procuring entity and form credible consortiums and teams to respond to a possible procurement process. It is important that procuring entities allow the market sufficient time prior to the release of an EOI to ensure complete and competitive responses.

Action 17a: Development of a performance regime

5.20 Additional analysis is required to consider the specific performance standards and penalties which may be applied in the PPP project agreement. This requires the procuring entity to determine how the asset and service will be funded (on either an availability or user charge model) as well as how payment will be linked to the specific performance of the service outcomes required.

5.21 The procuring entity will need to consider how the performance regime can incentivise the delivery of those outcomes through performance payments and abatements as well as penalties for incidents which are simply unacceptable to the procuring entity.

5.22 The procuring entity should consult with the Treasury PPP Team regarding the proposed performance regime.

Action 19a: Development of a public sector comparator

- 5.23 Additional quantitative, or value for money, analysis is required for PPP procurement. This analysis compares the cost of procuring a project as a PPP with a PSC that represents the cost if the procuring entity were to deliver the asset and services itself using conventional procurement. This assessment requires detailed consideration of costs associated with:
- the design and construction of the asset
 - the maintenance and management of the asset throughout a prescribed period of operations
 - the delivery of services from the asset (where these are to be included under a DBFMO model), and
 - those risks relating to the asset and service delivery that are proposed to be transferred to the private sector under PPP procurement.
- 5.24 The PSC must then be compared with a Proxy Bid Model (PBM), which in addition to those costs included within the PSC also seeks to replicate those additional costs associated with PPP procurement (such as additional procurement costs and private sector costs of financing the project). The DBC must satisfy decision makers that there is sufficient scope for the private sector to introduce innovation and whole of life cost savings (through asset design, maintenance and risk transfer) to offset any difference between the PSC and PBM.
- 5.25 This analysis is important as PPP procurement will only be approved for a project where it offers value for money over the life of the project; that is, a PPP must deliver the outcomes sought from the project for the same or lower cost than the procuring entity could have itself (as established by the PSC). This is safeguarded through the requirement for Cabinet approval of the value for money case before a PPP project agreement may be signed for any PPP project.
- 5.26 Further guidance on the development of a PSC and quantitative value for money analysis has been published by the Treasury PPP Team (*Public Sector Comparator and Quantitative Assessment*).⁹

Project characteristics and suitability of PPP procurement

- 5.27 PPP procurement is most likely to be appropriate for projects of large scale and long duration where:
- the nature of the asset required is specific and can only be applied to the purpose intended (such as a prison or hospital)
 - the service is durable and it is unlikely that the service requirements will vary unpredictably over the life of the contract
 - outcomes or outputs can be well-specified, enabling clear specification and monitoring of performance requirements and standards

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<http://www.treasury.govt.nz/statesector/ppp/guidance/public-sector-comparator>

- the project is sufficiently complex that innovative design and service approaches may be employed, and
- there is sufficient market appetite and depth to ensure a competitive procurement process.

Nature of the required asset

- 5.28 The nature and characteristics of the asset required to deliver the service outcomes of the project are an important driver in considering procurement options. Where the asset required is relatively generic and could have a range of applications, it is unlikely that there will be a strong imperative for the Crown to retain ownership of the asset. In such a case the best value for money option may be private provision such as through a lease arrangement.
- 5.29 Where the required asset is highly specific to the proposed use (such as a prison or hospital), it is more likely that public ownership will be favourable to private ownership. The limited application of such an asset to other uses will mean that a private owner will likely seek to recover the full cost of the asset over the duration of the lease which is unlikely to be value for money for the Crown.
- 5.30 Once the appropriate ownership structure has been identified, those procurement options relevant to the ownership structure can be identified and considered. PPP procurement is only considered appropriate for assets for which long-term Crown ownership is preferable.

Outcome specification

- 5.31 As a general rule, if the required asset or service can be well specified, then it is likely that it can be measured and delivered by a third party under a contractual relationship.
- 5.32 Additionally, where the service can be clearly specified, clear performance specifications can be formulated to ensure higher levels of service outcomes can be contractualised and enforced. The PPP project agreement can include incentives to deliver stronger performance, resulting in greater efficiency and higher quality service outcomes.
- 5.33 Service outcomes which cannot be well specified, however, risk undermining the performance regime and, ultimately, the procuring entity's control over the asset and its performance.

Durability of service specification

- 5.34 The durability of the service specification is also a crucial issue for a public sector practitioner to assess as it will dictate the potential tenure of the contract. If a contract is easily specified and the nature of that service is unlikely to change significantly over time then it may suit a procurement model with a long contract term such as PPP procurement.
- 5.35 A shorter duration may be preferred where the required scope of an outsourced service is unpredictable otherwise the procuring entity may face a risk of costly contract variations or a premium being charged by the service provider due to future uncertainty.

Project complexity

- 5.36 Complexity (both in terms of asset and service provision) is also an important consideration in determining the suitability of PPP procurement for a specific project. Greater opportunity exists for a private sector partner to introduce an innovative solution where the project has a higher level of complexity. Innovation may include approaches that provide improved service outcomes or reduce the overall cost of the project.
- 5.37 Conversely, care should be taken to ensure that a project's complexity and a private sector partner's response do not undermine the value of the overall project. This might arise through the creation of difficult or costly interface issues with other services provided by the procuring entity or increased contract management and enforcement costs.

Project scale

- 5.38 The size of the project (both in terms of asset and service provision) is an important criterion when considering procurement options and the suitability of PPP procurement.
- 5.39 The larger a project is the greater ability it will likely have to absorb the transaction costs associated with PPP procurement and attract market interest. A small project or service contract may not be able to sustain those transaction costs associated with the required market development, procurement and monitoring inherent in PPP procurement, reducing the value for money proposition.
- 5.40 The scale of the project should also be considered in light of the cost to private sector parties in responding to the EOI and RFP. Potential respondents are unlikely to participate in a procurement process where they do not consider that the cost of bidding is offset by the reward of winning the contract.

The procuring entity's contract management competency

- 5.41 Effective management of outsourced service contracts is critical regardless of the form of procurement. However, due to the level of complexity inherent within the performance regime, PPP procurement requires a higher level of active contract management than other forms of procurement. Effective contract management is most likely to occur where service performance can be readily measured and the procuring entity has the requisite contract management resource and expertise.
- 5.42 Where the adoption of PPP procurement for a specific project requires a procuring entity to establish a contract management function, consideration should be given to the likelihood of further PPP projects or other opportunities to utilise this capability. If such opportunities are not apparent, the additional cost of establishing and maintaining this contract management functionality may diminish the value for money of procuring the project as a PPP.
- 5.43 A procuring entity considering PPP procurement should consult the Treasury PPP Team in developing its contract management plan. The Treasury PPP Team are able to provide advice on best practice PPP contract management as well as the Treasury's ongoing contract monitoring framework.

Competitive tension

- 5.44 The nature of the asset and service outcomes required will determine whether there are sufficient suppliers in the New Zealand market to ensure a competitive process to deliver value for money. Factors both internal and external to the project may have an impact on the level of competition available and the procuring entity must ensure that the project and potential procurement methods are robustly tested with interested parties.
- 5.45 The number and nature of interested parties will play an important role in delivering value for money and innovation within the project. Early engagement with the market is required to ensure that interested parties have sufficient opportunity to consider the opportunity and form consortia. This is particularly important where the project is likely to attract interest from new or international parties.

6 The Role of the Treasury PPP Team

- 6.1 The Government has established a PPP Centre of Expertise within the Treasury. The location of this Centre of Expertise within a central government agency is consistent with international best practice and considered most efficient as individual agencies are likely to undertake PPP procurement on a relatively infrequent basis.
- 6.2 Locating the PPP team within the Treasury has the benefit of providing a direct relationship with the Minister of Finance (who also has responsibility for Infrastructure) as well as close proximity to the National Infrastructure Unit,¹⁰ the Investment Management and Asset Performance team¹¹ and Treasury vote teams. This enables the delivery of joint advice to Ministers on the procurement of significant capital projects.
- 6.3 As a Centre of Expertise, the Treasury PPP team is responsible for:
- developing PPP policy
 - advising agencies in respect of PPP procurement
 - developing and maintaining the PPP market in New Zealand, and
 - the PPP procurement model and Standard Form Project Agreement.
- 6.4 Since its inception in 2009, the Treasury PPP team has developed:
- the Standard Form PPP Project Agreement, which forms the basis of all PPP procurement
 - an efficient and well understood procurement process for PPP projects
 - a growing market of parties interested in investing in, and being a part of a strong New Zealand (and Australasian) PPP market
 - a wide range of lessons learnt both from projects which have achieved contractual and financial close as well as those which have not proceeded as a PPP
 - a growing body of guidance material to support procuring agencies and the PPP market generally, and
 - a deep understanding of international PPP procurement practice through the establishment of relationships and regular engagement with PPP Centres of Expertise in other jurisdictions.

¹⁰ <http://www.infrastructure.govt.nz>

¹¹ <http://www.treasury.govt.nz/statesector/investmentmanagement/team>

Engaging with the Treasury PPP team

- 6.5 The PPP team understands that the requirement to consider a new procurement model can be daunting and encourages early engagement to discuss the PPP model and its suitability for a specific project. Ownership of, and responsibility for, all PPP projects remains with the respective procuring entity and seeking early engagement with the Treasury PPP team on procurement options will provide opportunity to understand how PPP procurement may suit project and agency requirements.
- 6.6 Early engagement allows scope for full consideration of alternative procurement options on a best-for-project basis. It also provides maximum opportunity to leverage lessons learnt from other projects and international best practice in the development of procurement options for a project.
- 6.7 The Treasury PPP team is able to provide agencies valuable assistance through:
- providing an understanding of the New Zealand PPP model and policy
 - the development of the economic, financial and commercial cases component of a project's business case (in particular, consideration of procurement options, market sounding, risk analysis and the development of a PSC)
 - experience in planning the procurement process and engagement with potential private sector partners
 - established relationships with market participants including advisors, investors, contractors and service providers
 - providing insight from lessons learnt and experience from PPP projects in other sectors, and
 - representation within the project's governance group and project team to provide support and direction throughout the procurement and negotiation phases.
- 6.8 Departments or agencies considering a significant investment must discuss the potential for applying PPP procurement with their Treasury vote manager or contact the Treasury PPP team directly.

7 The PPP procurement process

An overview of the PPP procurement process

7.1 The PPP procurement process contains the following three core stages:

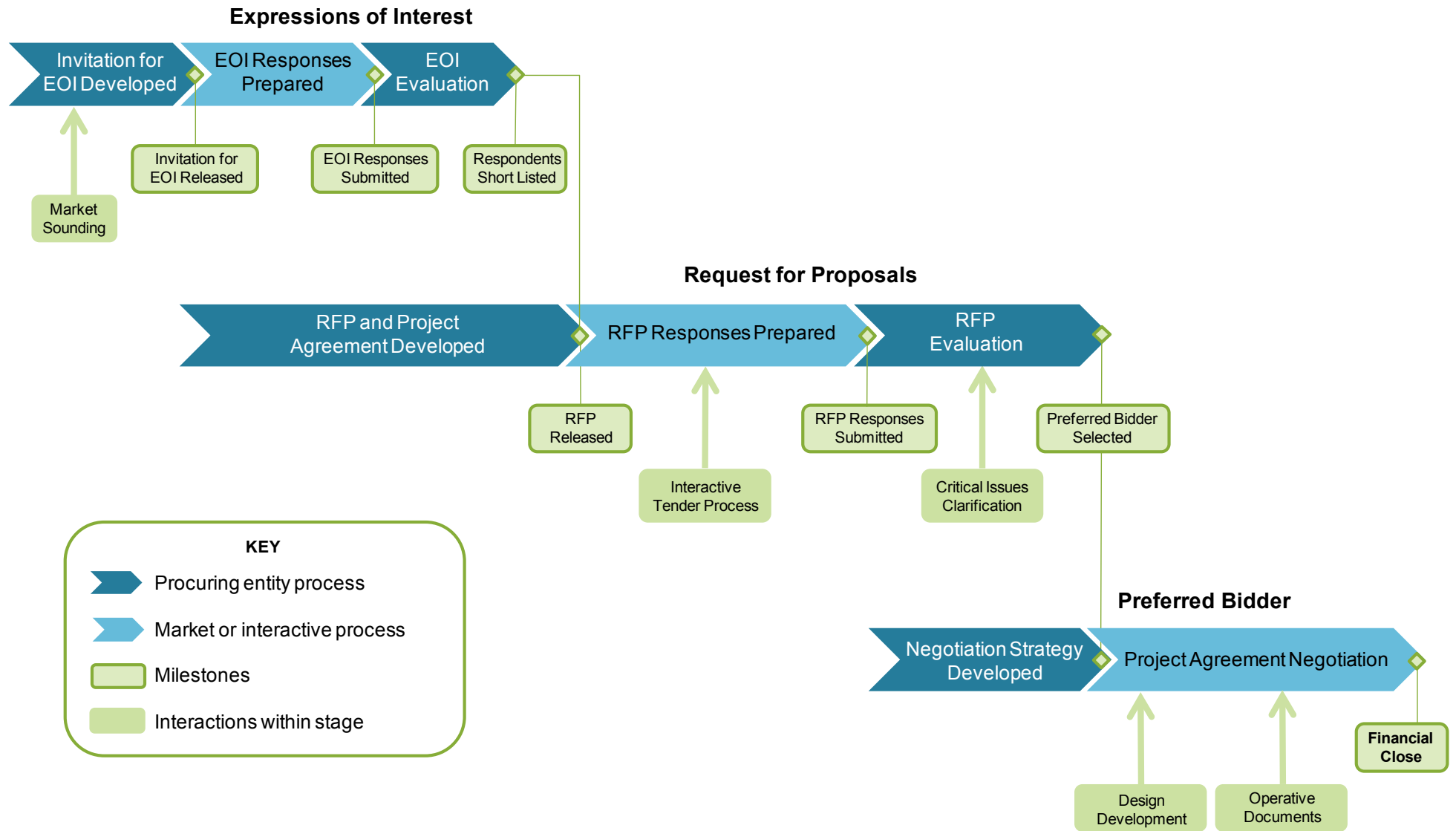
- the Expression of Interest (EOI) stage, during which the procuring entity conducts an open process to short list a set number of respondents to participate in the Request for Proposals (RFP) stage
- the RFP stage, during which the short listed respondents develop proposals for delivering the facilities and service outcomes required by the procuring entity, through an interactive tender process. The procuring entity then evaluates the proposals with the objective of selecting one respondent as the preferred bidder, and
- the Preferred Bidder stage, during which the procuring entity negotiates the Project Agreement with the preferred bidder and its debt providers, and resolves any critical issues identified in the proposal.

7.2 Detailed guidance on the PPP procurement process is provided in other Treasury guidance (including detailed information and timeframes for each of the stages set out above).¹²

7.3 An overview of the process is set out at Figure 1 below.

¹² <http://www.treasury.govt.nz/statesector/ppp/guidance/procurement-process>

Figure 1: Overview of the PPP procurement process



Who is involved in PPP Procurement?

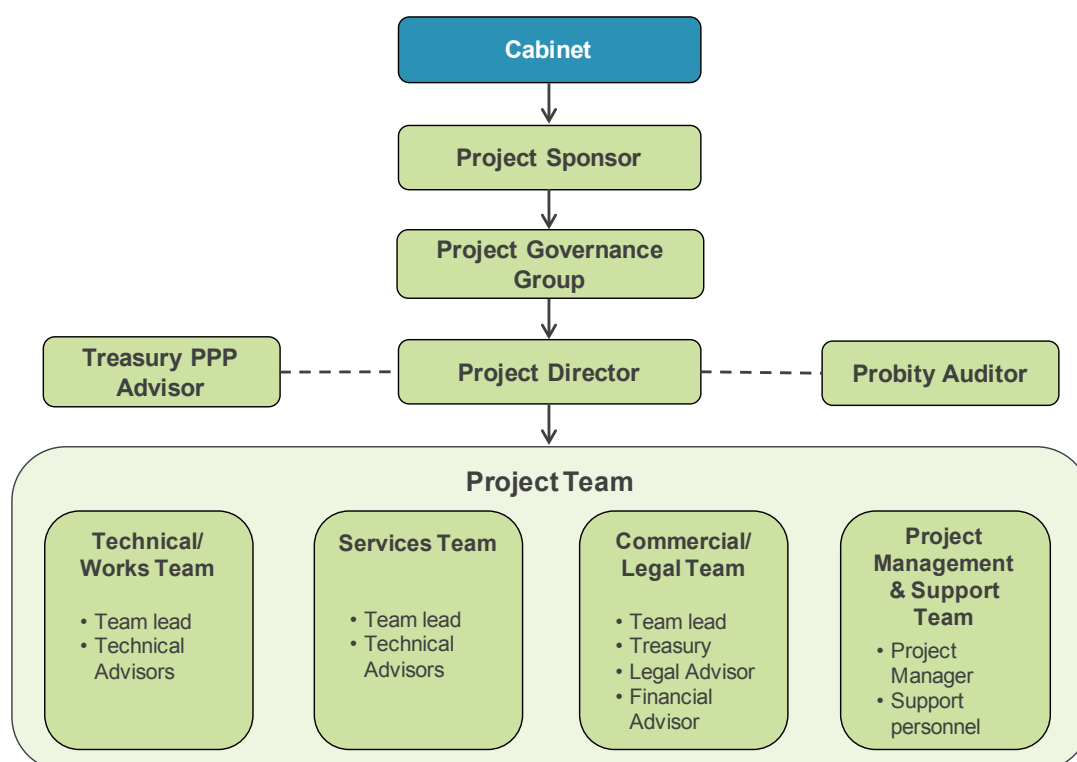
7.4 The whole of life approach to PPP procurement inherently results in a greater up-front investment of time and resources. It is therefore critical that procuring entities and private sector parties resource their respective project teams adequately.

The procuring entity

7.5 A procuring entity will need to establish a dedicated project team to manage the procurement led by a suitably qualified Project Director and governance group. This team should be established as early as possible and, at the latest, soon after PPP procurement is agreed by the respective agency and Cabinet.

7.6 An indicative organisational chart is set out below at Figure 2 below.

Figure 2: An indicative organisational chart for a PPP project



7.7 The procuring entity will need to supplement this project team with specific advisory assistance throughout the planning and implementation of the PPP procurement process. This would typically include:

- *Commercial and financial advisors* – including the provision of advice in relation to the commercial terms, the performance regime and performing a due diligence review of the financial model and financing proposal
- *Legal advisors* – including the provision of advice in relation to contractual, commercial, property, and resource management matters and performing a due diligence review of the legal and commercial structure proposal

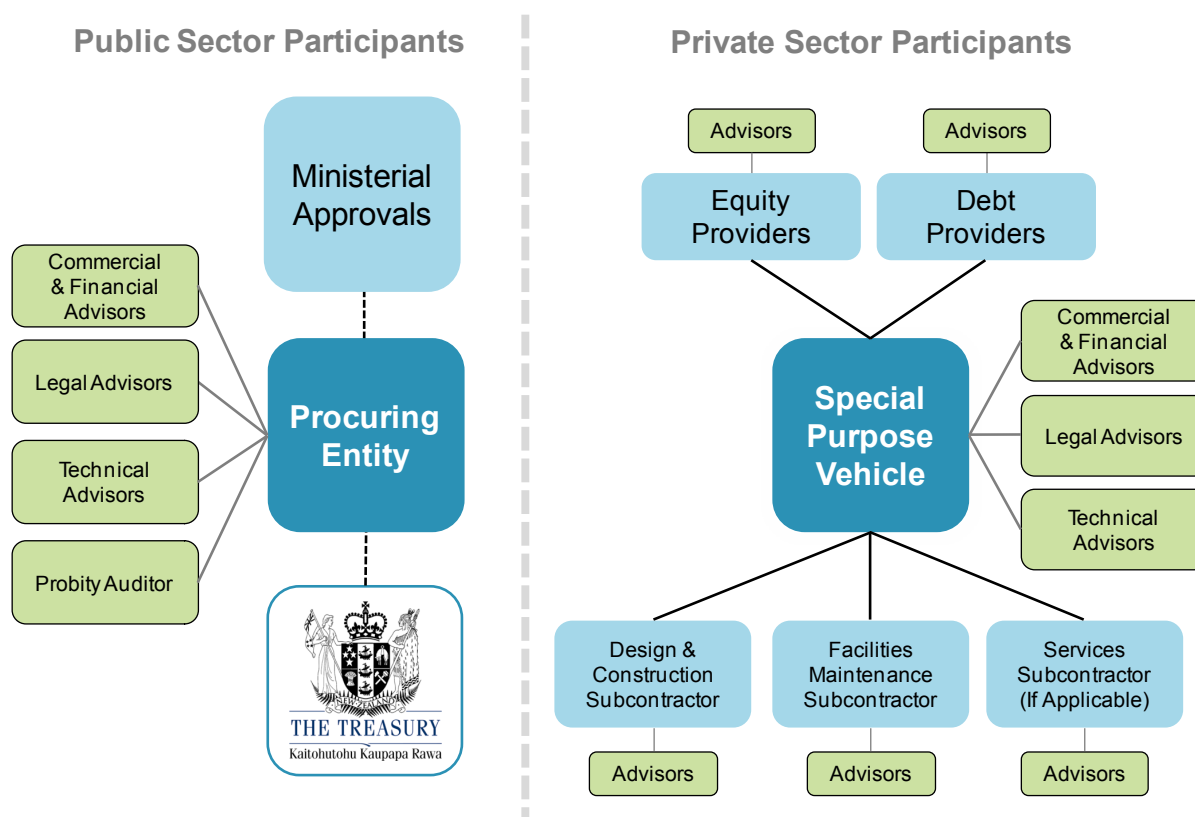
- *Technical advisors* – including the provision of advice in relation to the design and construction outcomes and requirements and performing a due diligence review of the design and construction programme, and
 - *Service provision advisors (where included)* – including the provision of advice in relation to the development of service outcomes, integration of service provision with the asset and performing a due diligence review of the service provision proposal.
- 7.8 The procuring entity may also require other specialist support such as property, insurance or stakeholder engagement assistance depending on the nature of the project and resourcing of the project team.
- 7.9 While advisors play an important role in PPP procurement, they do not replace appropriate resourcing by the procuring entity. The complexity and long term nature of PPP procurement means that the procurement process cannot be left to advisors exclusively. It is particularly important that the procuring entity retain, and be seen to retain, overall control of the process.
- 7.10 Equally it is important that procuring entities engage experienced and skilled advisors to ensure the successful delivery of the project and knowledge transfer. The typical relationship between the procuring entity and its advisors is set out at Figure 3 below.

The private sector partner

- 7.11 Given the breadth of capabilities required to participate in PPP procurement, the private sector partner will typically require cooperation between multiple entities through the formation of a consortium. This consortium will usually include:
- *Equity providers* – who provide capital to the project through a shareholding in the contracting entity (usually a special purpose vehicle)
 - *Debt providers* – who provide the balance of financing required through loan facilities (which can range from short term facilities to those that match the full duration of the operating period)
 - *Design contractors* – who develop the design for the required asset
 - *Construction contractors* – who provide input to the design and construction planning and carry out the physical construction works
 - *Asset management and facilities maintenance contractors* - who provide input to the design and construction planning and carry out the facilities maintenance works, and
 - *Service providers* – who, depending on the PPP method selected (being either DBFMO or DBFM), will provide input to the design and construction planning and carry out provision of core services throughout the operating period.
- 7.12 To participate in a procurement process, the private sector partner will also require a full range of specialist advisors including commercial and financial advisors, legal advisors and technical advisors.
- 7.13 The private sector partner will often require a greater number of advisors than the procuring entity as separate advisors are usually engaged by the consortium and each of the consortium members (for example, each debt and equity provider will likely have their own financial and legal advisor).

7.14 An indicative structure of a private sector partner, including its advisors is set out at Figure 3 below.

Figure 3: Participants in the PPP Procurement Process



Unsolicited proposals

7.15 In the normal course of events, PPP procurement is initiated by a procuring entity as a result of identifying a service need and deciding that a long term contract is appropriate following an evaluation of different procurement options. However, there are circumstances in which a private sector party may identify a suitable opportunity for the delivery of a service to a procuring entity by way of a long term contract.

7.16 The Ministry of Business, Innovation and Employment has published guidance on when unsolicited proposals should be given further consideration and how procuring entities should respond.¹³

7.17 Where a procuring entity receives an unsolicited proposal for a long term contract, further input should be sought from the Ministry of Business, Innovation and Employment and the Treasury PPP Team.

¹³ <http://www.business.govt.nz/procurement/pdf-library/agencies/guides-and-tools/Guide-to-Unsolicited-Unique-Proposals.pdf>