Concessions break state's sclerotic embrace

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Traditional government approaches to infrastructure are wasteful. There are better methods

New Zealand is suffering from acute arterial sclerosis of the infrastructure with major blockages in key areas of service delivery. Substantial new investment is critical if the blockages are to be addressed but if left entirely to the government progress will be slow.

Government finances are constrained as the economy slows and tax revenues drop. Increasing the government's indebtedness to finance new infrastructure will provide some relief but in tight fiscal conditions it would be prudent to explore other options.

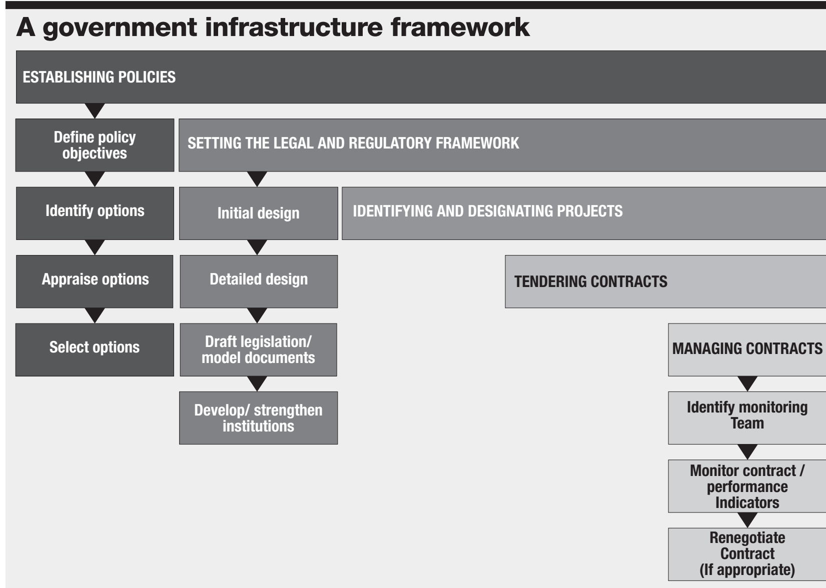
Currently, the vast majority of infrastructure contracted by the government follows a traditional model. These have the government contracting for the delivery of physical works and services rather than contracting for service outcomes.

There is little information on how well this approach is working but, by way of comparison, the UK Audit Office found that more than 70% of traditionally procured projects were completed late and over budget. This traditional approach does not incentivise contractors to use their knowledge to promote ways to reduce the projects operating costs nor indeed to complete under budget, early or to a higher specification.

An alternative is to consider all of a project's cashflows in making decisions about procurement. This approach is called life cycle contracting and has become a major theme internationally. It creates incentives to minimise the present value cost of a project, usually expressed as a long-run marginal cost, and it aligns suppliers' interests with those of the buyer and end users.

Life cycle contracting has its place as an infrastructure procurement option but also introduces the idea of infrastructure concessions or licences. For this approach to work, the government must ensure that the appropriate environment is created to enable private sector tensions to operate freely.

The creativeness of the private sector in finding solutions to complex financial and risk management issues is at the heart of the success of life cycle financing. The challenge is to offer a winning bid by finding the best balance between the offered price, bankability and return on equity.



These variables drive the finance plan where they are expressed in their component elements as capital structure, source and amount of finance, and the terms on which these elements are made available. It is the role of the financial adviser to structure the transaction by optimising these components. The graph highlights the pressure points and the importance attaching to the project's internal rate of return (IRR).

The financial adviser will massage the financial plan by leveraging or deleveraging the capital structure. This process is undertaken by substituting an array of different financial instruments within the capital structure until an optimum return on equity and debt ratios are achieved.

The chosen structure will typically benefit from the inherent advantages arising from the incidence of tax and its timing in project financing transactions. Developers will typically try to minimise their cost of capital by maximising the level of debt that the project can sensibly carry and minimize more expensive equity. To be competitive, the key point is to push the market to the outside limits of what it will accept, but not beyond the market boundary.

A further dimension of the structuring process is the laying off of risk. Project risks are a little like matter – in that matter can neither be created nor destroyed, just moved around. Risks can be assessed at various stages of a project's life cycle broadly defined in terms of development, construction and operating period risks.

These can be further divided between commercial, political and economic risks. Each needs to be measured for probability and impact, then fed back into the financial model or plan. Having identified the risks, the next step is to work through the risk allocation process with the various project parties. Assigning risk has a cost attached to it and this drives the oft told rule that risks should be allocated to the party best able to control them.

If the role of government is interposed into this process by way of a public private partnership (PPP) arrangement, then it is possible for government to specify the exact nature, level and type of risk it wishes to assume. The level of risk will obviously affect the pricing of a project and therefore the government is best to take on those risks that it can best manage and thus reduce the overall project costs.

Governments in general have shortcomings in managing development and construction activities (prisons and express roads are good examples) and in many instances running concessions by the private sector offers better value for money. This point raises the important and often pivotal issue in negotiations between parties, which is property ownership.

The transfer of ownership of the assets that underpin public services to the private sector are understandably unpopular. In retrospect, the privatisation programme in the 1980s and 1990s left much to be desired. The benefits of privatisation, without the downsides, can also be obtained through concessions (a type of PPP).

While these have many forms, at their heart they involve government licensing through competition for the rights to design, build, finance and/or operate infrastructure to a private group for a limited term. The role of government is to plan, procure and regulate outcomes from a private partner, which can be penalised or have its contract terminated for non-performance. Most importantly, assets remain publicly owned and the government can also retain the interface with the public if it wants.

Before proceeding to concessioning, the government should first establish an enabling environment for the legal setting and appropriate institutional support. This would involve moving toward the approach adopted by Australia, which has established Infrastructure Australia to set the rules of engagement, including the development of guidelines, documentation and processes for issuing concessions.

The infrastructure gap in New Zealand is worrisome and the longer action is postponed the less likely the country will achieve desirable economic objectives. Action is needed along with new ideas on how the gap can be closed.

Concessions can ensure all parties are winners if the process is managed well and the rules of engagement are transparent, predictable and fair to those involved. It is time to move forward by tapping into the learning curve of countries that have benefited from private sector involvement in public infrastructure financing.

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Richard MacGeorge is a principal of Ridgway Capital Projects and this article is based on a presentation to the NZ Council for Infrastructure Development's Building Nations Symposium in Auckland. Ridgway Capital Projects is an advisory firm providing financial and economic advice on infrastructure and utility projects

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