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## Approaches to Risk Sharing and Risk Management for PPPs in Australia

- KDI / ADB/ ADBI Conference - Knowledge Sharing on Infrastructure Public-Private Partnerships in Asia
- 19-21 May 2009
- Richard Foster, Executive Manager, *Partnerships Victoria*



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## Agenda

- Risk allocation and risk management approaches
- Use of financial incentives as risk management tools
- Sharing of “difficult” risks



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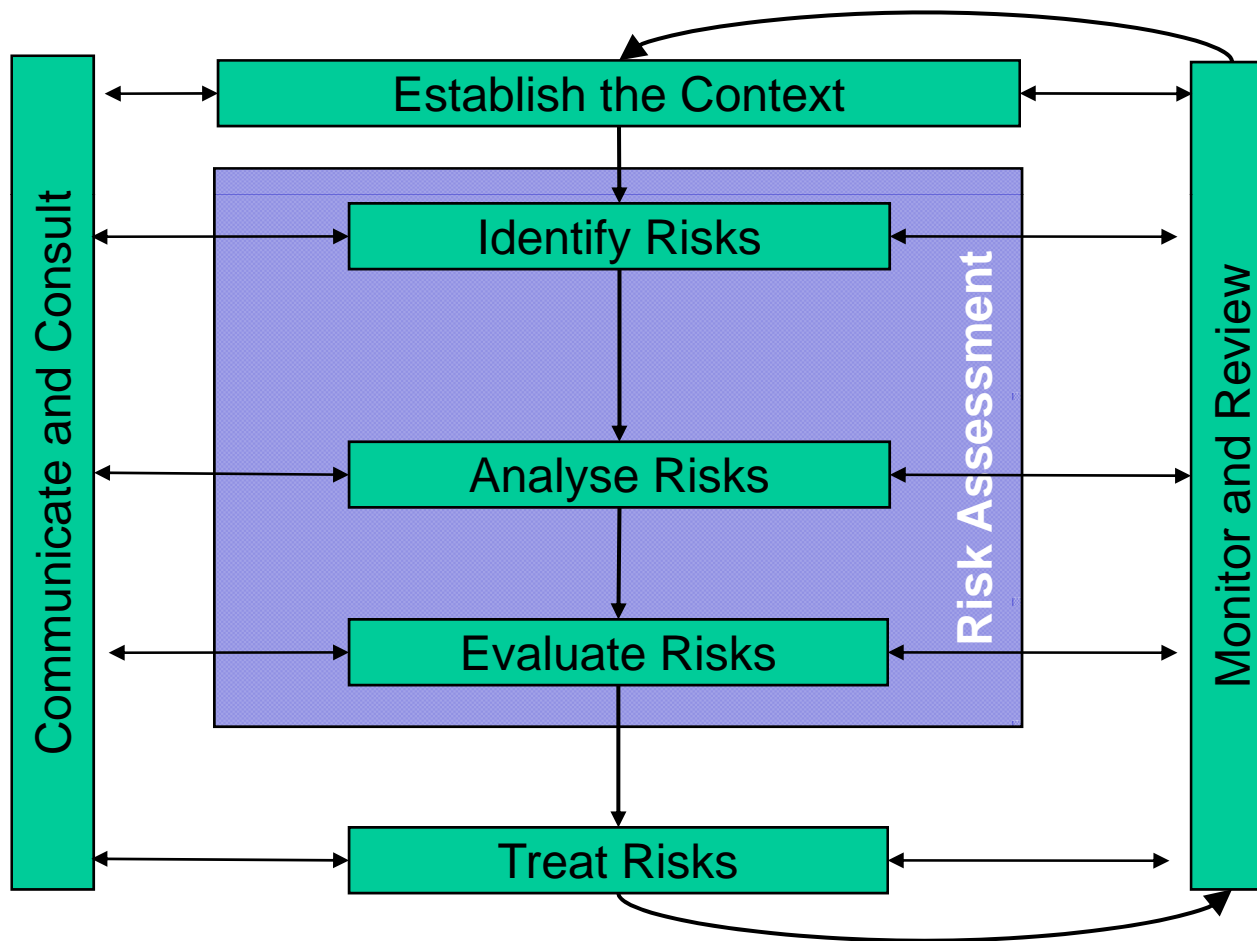


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## What is risk?

- **Risk is the chance of an event occurring which would cause actual project circumstances to differ from those assumed when forecasting project benefit and costs**

## Risk Management Overview (AS/NZS 4360:2004)





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## Risk Allocation

- Risk allocation is a means by which government treats risks in a PPP
- In Victoria, risk allocation has evolved from a focus on maximum risk transfer to the private sector in the 1990s, to optimal risk allocation from 1999 onwards

## Optimal Risk Allocation

- **Allocate risks to the party in the best position to control them**
- **The party in the greatest position of control with respect to a particular risk has the best opportunity to:**
  - Reduce the likelihood of the risk eventuating
  - Control the consequences of the risk if it materialises
- **Advantages:**
  - Creates an incentive for the controlling party to use its influence to prevent or mitigate the risk in the overall interests of the project
  - Thus seeks to drive best project cost and risk outcomes



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## **PPP Risk Allocation in Australia is now standardised**

- **National Standard Commercial Principles for Social Infrastructure projects and draft Standard Commercial Principles for Economic Infrastructure projects have been developed in consultation with the private sector**
- **Individual project circumstances require some departures at a detailed level**
  - Procuring agencies consult with central PPP units

## Risk Allocation through the Lifecycle

- **At business case (feasibility study) stage:**
  - Indicative “tick a box” allocation of key risk categories
  - Allocation of risk to government shouldn’t be used simply to make the project viable
- **At Expressions of Interest (pre-qualification) stage:**
  - Proposed “tick a box” allocation of key risk categories
- **At Request for Proposals (bid) stage:**
  - Comprehensive risk allocation in draft contract
- **At contract execution:**
  - Risk allocation is set in contract

## Contractual Risk Allocation

- **The contractual risk allocation position is governed by three things:**
  - specified service obligations;
  - payment/pricing structure; and
  - express contractual provisions adjusting the risk allocation implicit in the project structure.
- **As government pays (or users pay) the concessionaire for services, risks associated with service delivery are transferred to the concessionaire**
- **Government expressly “takes back” certain risks**



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## Contractual Risk Allocation

- **The contract allocates responsibility for the financial consequences of risks occurring, it does not absolve government of responsibility for service delivery**

## Optimal Risk Allocation May Evolve Over Time

- **A variety of factors relevant to risk allocation may change over time, including:**
  - The context
  - Our understanding of the risk, and hence our assessment of the risk
  - Options available to us to treat the risk
- **Consequently, the optimal allocation of a risk may change over time**

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## Evolution of Risk Allocation – Tolls Roads in Victoria

CityLink	EastLink
Contract signed 1995, IIPV policy	Contract signed 2004, <i>Partnerships Victoria</i> policy
Traffic reduction measures on associated roads	No reduction measures on associated roads, except where necessary during construction
Compensation payable for competing public transport or road improvement projects	No compensation for competing public transport or road improvement projects
No direct State share in refinancing benefits	State shares in specified refinancing benefits
Limited community consultation	Extensive community consultation
No discounts for weekend road usage	Discounts for weekend road usage



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## Impact of different PPP models

- **The financial incentives (“commercial levers”) available to government to manage PPP risks differ from one model to another**
- **For example, the financial incentives depend upon whether the project is reliant upon:**
  - User charges (e.g. toll roads)
  - Government availability payments (e.g. hospitals)

## For projects reliant upon user charges

- **The transfer of demand risk provides a strong driver for performance**
  - However, this depends on the level of competition (e.g. alternative routes to a toll road)
  - Sharing of demand risk (e.g. if government shares in revenue above specified levels) creates a need for additional government monitoring
- **In past Australian toll road projects, government has only shared downside demand risk where demand is affected by a limited range of external or government-controlled events (no minimum revenue guarantees)**



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## For projects reliant upon user charges

- **The concessionaire's interest in maximising revenue will not necessarily drive the best outcomes for the community**
- **Australian toll road contracts now include key performance indicators (KPIs) relating to availability and customer service**
  - The concessionaire can be required to make payments to government or reimburse road users if KPIs are not met



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## For projects reliant upon government payments

- **A well calibrated payment mechanism, linked to the output specification, is important to drive the desired outcomes:**
  - Abatement of payments can, and does, occur
  - Calibration of the payment mechanism ensures that it provides an appropriate incentive for performance – it is not too harsh and not too weak
- **Our experience includes projects with:**
  - No abatements to date
  - Abatements up to approximately 5% of an individual monthly or quarterly service payment



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## Applying abatements

- **The payment mechanism should not be applied arbitrarily, without considering:**
  - The impact upon facility users or the public
  - The response of the concessionaire
  - The potential impact of abatement on the relationship
- **Any waiver / relaxation should be documented in accordance with legal advice to avoid creating a precedent**



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## Abatement – An example

### NOTES TO THE FINANCIAL STATEMENTS FOR THE FINANCIAL YEAR ENDED 30 JUNE 2008

	2008	2007
	\$'000	\$'000
<b>(d) Finance Lease Core Services (refer to Note 13)</b>		
Interest on the Capital Component	31,288	30,936
Contingent Rent	353	58
Operating Component	9,590	8,542
Abatement	(938)	(39)
Insurance Component	1,330	1,192
	41,623	40,689



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## Sharing of “difficult” risks

- **Some risks are difficult for either party to manage alone, making allocation difficult**
- **Australian approaches to dealing with these risks generally reflect:**
  - The principle of optimal risk allocation, to the extent it can be applied in these circumstances
  - Value for money considerations – bidders may be asked to price departures from government’s preferred allocations of these risks
  - “Bankability” is a subset of these principles
- **Government’s exposure to these risks can be very difficult to quantify**

## Some “difficult” risks are best shared – 1

- **Risks for which government can best manage the likelihood of occurrence but the private party can significantly influence the consequences**
  - For example: government initiated modifications, change in law
  - May be best managed by “sharing” the risk on the basis each party bears a specified proportion of the cost (government often takes the largest share)
  - Alternative, the parties can agree cost thresholds that determine how the cost is split between them – the private party takes all risk up to the lowest threshold, government takes all risk above the highest threshold

## Some “difficult” risks are best shared – 2

- **Risks for which neither party can effectively manage the likelihood of occurrence or the consequences**
  - For example: changes in insurance premiums
  - Even if the consequences will not threaten the project’s bankability, government sharing some of the risk may offer better value for money than transferring the risk in full
  - Shared using similar mechanisms to those on the previous slide

## Some “difficult” risks are best shared – 3

- **Risks which have low likelihood but severe consequences and threaten the bankability of the project**
  - For example: uninsurable force majeure, financial market disruption preventing refinancing
  - While government may not be able to mitigate the likelihood or consequences of these risks, it may have to take the risk above certain thresholds to ensure the project is bankable
  - Such sharing can offer value for money where it assists government meet its service delivery objectives and termination rights ensure government's liability is not open ended



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## Summary

- **Australia has reached a significant degree of standardization in PPP risk management and allocation**
  - But some evolution continues and all projects have their specific issues
- **Having contractual mechanisms that impose the right financial incentives on the contractor are a key risk management tool**
- **Some “difficult” risks require sharing mechanisms, but optimal risk allocation and value for money remain government’s objectives**



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