Partnerships Victoria

Guidance Material – June 2001

Risk Allocation and Contractual Issues

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Partnerships Victoria Guidance Material

Risk Allocation and Contractual Issues

a guide

June 2001

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Part One: *Partnerships Victoria* risk allocation principles

1 Overview

1.1 Purpose of this guide

This guide is one of three documents to assist in implementing the *Partnerships Victoria* policy framework for partnerships between government and private parties to provide public infrastructure and related ancillary services.[1]

The objectives of the guide are:

- to increase understanding of risk allocation and the objectives of public and private parties when negotiating risk allocation;
- to identify all major risks relevant to *Partnerships Victoria* projects, outline the legal and commercial issues associated with them, and indicate the preferred government position on allocating the risks;
- to indicate government's preferred position on major risks and offer guidance to government practitioners on how each of these risks may be best addressed in their particular project, recognising that each project has unique features; and
- to lower transaction costs by providing, where appropriate, examples of suitable clauses to give effect to government's preferred position on some of the more standard risks, again acknowledging the need to assess their application in any given project.

This document focuses on risk and its management in *Partnerships Victoria* projects. The term 'risk' in this context is 'the chance of an event occurring which would cause actual project circumstances to differ from those assumed when forecasting project benefit and costs'.[2]

Part One sets the scene and establishes the guiding principles.

Part Two identifies the major risks in *Partnerships Victoria* projects and discusses in detail, with the aid of generic examples, the related commercial and legal issues. The generic examples used throughout this guide attempt to cover a variety of *Partnerships Victoria* projects, including accommodation-based projects such as projects for hospital, education and courtroom accommodation services. References to hospital, education, courtroom or other accommodation services projects are intended to be interchangeable, even where the generic example focuses on only one of them for the purpose of illustration.

A government-preferred position on allocating each identified risk is also outlined in Part Two. In some cases, more than one satisfactory approach to risk allocation may be outlined. Examples of suitable clauses are included where appropriate.

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[1] Other guides in the *Partnerships Victoria* suite of documents include an *Overview*, the *Practitioners' Guide* and a technical note, *Public Sector Comparator*.

[2] Chris Furnell, Risk identification and risk allocation in project finance transactions, paper presented at the Faculty of Law, The University of Melbourne, May 2000, p. 1.

Part Three covers the key contractual issues in effecting risk allocation and provides examples of suitable clauses where appropriate.

1.2 Government-preferred position

Even though government's preferred position (as outlined in this guide) represents the risk allocation position generally acceptable to government in a *Partnerships Victoria* project, it is not intended to be an inflexible position that claims to define the boundaries of acceptance of risk by government in every *Partnerships Victoria* project.

First, as noted, it should be kept in mind that each project is different (even projects of the same nature). The final risk allocation position in a particular project (which may not necessarily reflect government's preferred position) depends on the characteristics of the project in question. A rigorous analysis of the factors affecting risk should be conducted for every project.

Second, the positions adopted in this guide are seen as providing the best value for money for government at this stage of the development of the public-private partnership market in Victoria. However, as financial markets develop further, industry sectors mature and perhaps become subject to more formal economic regulatory regimes, and experience with public-private partnerships broadens, government may obtain a better value for money outcome by changing the risk allocation positions outlined.

1.3 *Partnerships Victoria*

The *Partnerships Victoria* policy builds on and improves the policies of previous Victorian governments and draws on experiences in other countries, including those of the Blair Government in the United Kingdom, involving private provision of public infrastructure and associated ancillary services. Government is open to a variety of forms of productive partnerships. Under the policy, government approval processes are designed to minimise delays and expense for private participants. With improved understanding between government and private parties and greater transaction efficiencies, there is scope to increase contestability in the provision of public infrastructure services, to improve outcomes for both government and private participants, and to maintain Victoria's attractiveness as a place in which to invest.

Partnerships Victoria seeks to reap the financial and efficiency benefits of partnerships with the private sector without compromising important community values including the right to know, the right to participate and the right of equal access to public infrastructure. Value for money criteria are therefore linked with public interest criteria to determine whether and how a public-private partnership may be appropriate for a particular project.

The key features of *Partnerships Victoria* include:

- government to retain responsibility for delivery of core services;
- value for money and optimal risk allocation;
- focus on public interest considerations; and
- a greater range of partnership models than in previous Victorian policies.

1.4 Practical application of the policy

In practice, the decision as to whether or not a service should be delivered as a *Partnerships Victoria* project depends on three core questions:

(i) which (if any) part or parts of the proposed service is a service which government itself should deliver to its citizens? (the core services question);

(ii) for all other aspects of the service and supporting physical infrastructure, what is the project model that delivers the best value for money? (the value for money question); and

(iii) do the outcomes of the value for money question satisfy the public interest criteria articulated in the policy? If not, can the public interest criteria be satisfied by either building safeguards into the contract or through regulatory measures (and at what cost), or should the project be reconceived to 'reserve' further areas of service for provision directly by government? (the public interest question).

1.5 The core services question

Decisions as to which services constitute core services which should not be delivered by the private sector are made by government on a case by case basis. If the whole service is considered to be a core service, there will be no scope for a *Partnerships Victoria* arrangement with the private sector. Ultimately it is a decision for government to determine the point at which the core ends and ancillary services begin. Not all public services provided to the community are necessarily core in the sense that government needs to provide these services itself.

In practice, core services are delivered in a context which generally does not preclude participation by private parties. The services performed by doctors and nurses within public hospitals, teachers within government educational facilities and judges within courts are widely regarded as core services which it is a function of government to provide. However, there is no reason, in principle, why supporting infrastructure and ancillary services within those service areas cannot be delivered by the private sector.

1.6 The value for money question

Partnerships Victoria requires a full cost-benefit analysis of a proposed project before government determines whether the project should be undertaken. Where government approves the project, and where it seeks to involve the private sector through the undertaking of a public-private partnership, private sector bids are assessed against public sector benchmarks to determine value for money. The quantitative benchmarking tool is the Public Sector Comparator (PSC).

Value for money is maximised by allocating risk optimally. In very general terms, this means allocating each risk to the party best able to manage that risk. In theory, this reduces individual risk premiums and the overall cost of the project, because the party in the best position to manage a particular risk should be able to do so at the lowest price. (Optimal risk allocation and its application in public-private partnerships are explored in detail in Chapter 4.)

The PSC is used to estimate the hypothetical risk-adjusted cost to government of delivering the proposed project using the most efficient form of government delivery. The PSC is then compared against private bids. Care should be taken, however, to ensure that the comparison is between genuinely comparable items. There is a strong possibility that bids will not be identical to the proposed service specifications and risk allocation outlined in the bid documentation on which the PSC is based. To compare such a bid with the PSC without appropriate adjustments would therefore be misleading.

If the bids are more expensive than the PSC, and the level of service delivery and the risk allocation in the bids is similar, in the absence of other significant offsetting qualitative benefits, the project would be best delivered as a public project.

The concept of value for money is dealt with in more detail in Chapter 15 of the *Practitioners' Guide*, and the role of the PSC is discussed further in Chapter 2 of the *Public Sector Comparator* technical note.

1.7 The public interest question

The public interest question is addressed rigorously during the pre-tender stage of the project. For each potential *Partnerships Victoria* project, a public interest test needs to be undertaken to ascertain whether the public interest can be protected satisfactorily. The framework for conducting a public interest test is set out in Section 18.2 of the *Practitioners' Guide*.

The public interest has various aspects:

- protection of *community rights* (including legal rights through planning and appeals processes);

- protection of *public rights* (of access to the facility, health and safety, and access to information); and

- protection of *users' rights* (including privacy, access for disadvantaged groups and consumer rights).

These are elaborated in a series of public interest elements articulated in the policy.[3]

- **Effectiveness**. Is the project effective in meeting government objectives?

- **Accountability and transparency**. Do the partnership arrangements ensure that the community can be well informed about the obligations of government and the private sector partner, and that these obligations can be oversighted by the Auditor-General?

- **Affected individuals and communities**. Have those affected been able to contribute effectively at the planning stages, and are their rights protected through fair appeals processes and other conflict resolution mechanisms?

- **Equity**. Are there adequate arrangements to ensure that disadvantaged groups can effectively use the infrastructure?

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[3] Department of Treasury and Finance, *Partnerships Victoria*, The Department, Melbourne, 2000, p. 8.

- **Public access**. Are there safeguards that ensure ongoing public access to essential infrastructure?
- **Consumer rights**. Does the project provide sufficient safeguards for consumers, particularly those for whom government has a high level of duty of care, and/or those who are most vulnerable?
- **Security**. Does the project provide assurance that community health and safety will be secured?
- **Privacy**. Does the project provide adequate protection of users' rights to privacy?

1.8 Variety of partnership models

The combined response to the three core questions — core services, value for money and public interest — determines the underlying model for the project.

In a hierarchy from maximum to minimum retention of service delivery by government, the various models may be expressed broadly as follows:

(i) public sector delivery of services (considered to be core services) with private parties providing infrastructure-related services only;

(ii) public sector delivery of services (considered to be core services) with private parties providing infrastructure-related services and related ancillary services (for example, a prison accommodation services project);

(iii) public sector delivery of services (considered to be core services) with private parties providing infrastructure and related ancillary services, together with some services to the community (for example, a sporting facility linked with a government educational facility); and

(iv) private sector delivery of a full range of services to the community including infrastructure (for example, particular road and rail projects).

Related ancillary services, in this context, may cover a number of operational services including information technology services, accommodation services resulting from the infrastructure, building-related services such as maintenance and some support services. In some cases, such as certain transport projects, the privately provided services may extend to the delivery of services to end-users.

Table 1.1 illustrates the range of service delivery models available under *Partnerships Victoria*.

Table 1.1 Range of *Partnerships Victoria* models

	Increasing role of the private sector			
Private party role	Infrastructure services only	Infrastructure and ancillary services	Infrastructure and partial private-to-public service delivery	Infrastructure and service delivery to users
Government role	All public-to-public services	Delivery of core public services	Delivery of core public services	No operational role
Example	Public buildings	Non-core hospital services, non-judicial court services	Community facilities linked to educational facilities (e.g. after-hours usage)	Roads, rail, port facilities, car parks

1.9 Structure of *Partnerships Victoria* contracts

The emphasis of *Partnerships Victoria* is on *services* received by government, not government procurement of infrastructure. Government pays for services provided by the private party, which are delivered through privately owned infrastructure as part of the service package.

The philosophy of risk allocation underlying this emphasis on service purchase and delivery is that government frees itself from asset-based risk (including design, construction, operating and residual value risk), and becomes a service recipient. Government does not pay if the service is not delivered and payments are reduced if services do not meet the specified standards.

In practice, the risk allocation in *Partnerships Victoria* projects is made somewhat more complex by the requirement of value for money. This means that government may agree to assume some risks which the private party is less well placed to manage (and consequently would charge a higher price to assume).

The conceptual framework used throughout this guide is that, because government is a service recipient providing full payment only on satisfactory delivery of these services, all project risk is *initially* allocated to the private party. It is then a matter for government to determine, on a value for money basis and having regard to the cooperative framework of the partnership, what risks it should 'take back' to achieve an optimal risk position. The outcome of this analysis is indicated in the document calling for Expressions of Interest and reflected more comprehensively in the contract released with the Project Brief.

In this context, taking back means a deliberate decision by government to assume or share a risk that would otherwise lie at the door of the private party. This is to be distinguished from government unconsciously taking back risk through behaviour which compromises an agreed risk allocation.

1.10 Contracting with government under *Partnerships Victoria*

This section addresses the implications for optimal risk allocation arising from contracting with government under *Partnerships Victoria*.

At a minimum, government needs to ensure that, in a *Partnerships Victoria* arrangement:

- the infrastructure adequately allows for the delivery of any core services; and
- the private party provides the contracted services to the contracted specifications.

Depending on the nature of the particular service, government accountability means there are special issues concerning termination for default, step-in powers and reinstatement obligations. This may also dictate the project structure by, for example, requiring the land on which the infrastructure is sited to remain in public ownership — and leased to the private party on terms which allow government to resume both the lease and the asset on termination of the project contract. (These and related issues are dealt with in greater detail throughout Parts One and Two.)

Regardless of the project structure or the terms of the contract, government cannot transfer to the private party its responsibility and accountability to the public for the delivery of services that it is legally obliged to deliver or which it is has undertaken to provide to the public.

Government can manage this responsibility in a number of ways. It can provide services directly to the public, contracting only for the provision of intermediate services (e.g. water treatment services) necessary for the delivery of the services to the public (e.g. clean water) by government. Alternatively, government can contract with a private party to provide services directly to the public on government's behalf and monitor the performance of service delivery.

The nature of the payment mechanism by which government or other parties pay for these services is critical in allocating the financial liability for service delivery to the private party. (See Section 5.3 for a fuller discussion of this issue.) The payment mechanism should provide that if service delivery is sub-standard, government can seek financial redress and other remedies to maintain performance incentives for the private party.

Non-delegable duties of government

As noted, government cannot transfer to the private party its accountability and responsibility to the public for the delivery of all services. Government may have a continuing, non-delegable duty of care to recipients of certain services provided by the private party — particularly those recipients in a position of vulnerability, whom government owes a duty of care. This non-delegable duty of care may arise at common law or under legislation.

The existence of non-delegable duties limits the extent to which government can transfer legal responsibility for the provision of services to the private party. This is the case even where the financial consequences of a breach of the duty can be transferred (e.g. by indemnification from the private party, adequately supported by insurance carried by the private party). This is notwithstanding that the private party carries the primary liability under the commercial arrangements.

Where government has a non-delegable duty in delivering a service, it may remain liable for any negligence on the part of the private party engaged to provide the services on government's behalf. In this way, a non-delegable duty imposes a similar liability on government for the acts of the private party as for the acts of its own employees.

While government's duty to third parties cannot be transferred to the private party, as discussed previously the financial consequences of the duty may be allocated to the private party by way of indemnity and other contractual provisions. In this way, *Partnerships Victoria* allows government to allocate to the private party the financial consequences of risks associated with a duty that would also exist if the services were delivered under a public service delivery model. As the private party delivering the services is in the best position to manage the risk of a breach of duty in the delivery of services, *Partnerships Victoria* facilitates optimal risk allocation in relation to the financial consequences of risks associated with non-delegable duties.

Examples of non-delegable duties relevant to government include a hospital's non-delegable duty to its patients, and a school's non-delegable duty to its pupils. Other examples may arise in the fields of education, human services and justice.

2 The private sector perspective

2.1 Introduction

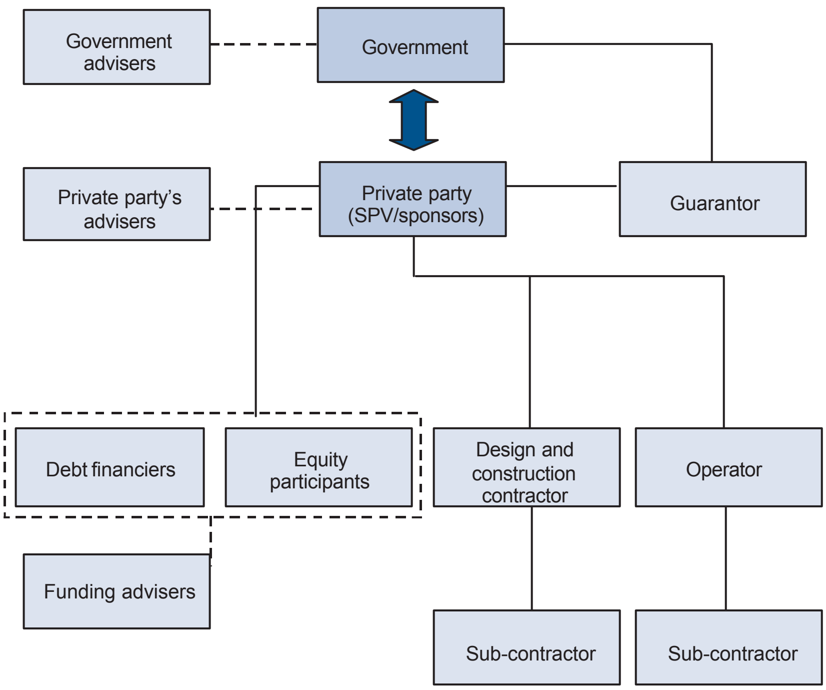
When considering risks and negotiating a risk allocation position, it is imperative for government to understand the drivers behind the private party's risk position. This section is an attempt to identify these drivers by describing the private party's general approach to risk, in particular highlighting the effect financing has on the private party's risk position and issues of particular concern to the private party when contracting with government. Chapters 3 to 6, which deal with risk identification, allocation and mitigation, should be considered in light of this discussion.

2.2 Who is the private party?

Throughout this document, the term ‘private party' is used to describe the private sector entity with which government contracts. Traditionally this has been a 'special purpose vehicle' (SPV), created specifically for the purposes of the project. The private party is not limited to this form however, and can be set up under a number of structures including as a subsidiary of an existing company, a joint venture and a trust structure. Behind the private party, however, there may be a number of private sector interests seeking to be represented through the private party. Government needs to appreciate each of these interests when negotiating its position.

A consortium of private sector parties is likely to include debt financiers (often in a syndicate arranged through a bank), equity investors/sponsors (who invest in the fortunes of the project and are therefore exposed to both the 'upside' and 'downside' risks), a design and/or construction contractor, and the operators. The following is a configuration of a typical consortium and its relationship with government and government's advisers.

Figure 2.1 Typical private sector consortium



There is a strong preference under *Partnerships Victoria* for government to contract with a single party which is fully accountable to government for all contracted services. From a government point of view, risk allocation is most effective if there is a 'whole of cycle' contract with a single private party, to give that party the strongest possible incentive to ensure that the design and construction phase converts into a highly effective operation. However, Figure 2.1 illustrates the possible complexity of the private party and the differing interests that may underlie its objectives in negotiation.

This configuration does not apply to all consortia, however. For some smaller projects, a much simpler consortium structure may apply. In such cases, it is common for the sponsor to be a large company which finances the project on its balance sheet. In some cases, the sponsor may refinance the project on successful commissioning and an SPV may be established at that stage.

2.3 The private party's approach to risk

Generally speaking, private parties take on risks if they can be appropriately priced, managed and mitigated. As discussed in Chapter 6 (Risk mitigation), this often involves transferring the risk to a third party, by way of sub-contract or insurance. For example, although there is a risk that an innovative design for a project may not be suitable for the designated purpose, that risk may be partly mitigated by appointing an experienced (and insured) designer. The private party then accepts the financial consequences of the risk, provided it can earn a commensurate return for accepting them.

Sometimes the level of competition among bidders and the bidders' strategic aims may affect the size of their expected return. For example, if a bidder is keen to develop expertise or a presence in an industry sector (e.g. the water industry), it may reduce its desired risk-adjusted return on water projects in the short term in order to have an opportunity to develop that expertise or presence.

Conversely, a sponsor or certain financiers may see risk itself as a profit area and seek to accept risks at high premiums. However, if the risk is one which carries a significant probability of interrupting or diminishing the payment stream that will service debt, the private party demands a significant premium to accept that risk. This in turn significantly increases the cost of financing the project. The private party's uneasiness in taking these types of risks becomes more acute when the risk is not within its control. In such cases, it may be possible to change the nature of the risk or the scope of the project so that the private party can better take the risk on. Alternatively, if this cannot be done, it may well be more cost-effective for government to take back the risk and reduce the costs of financing the project.

Generally, the private sector (including financiers) considers a project as a whole and may be willing to accept higher risks in certain areas if they are balanced out by lesser risks in others.

2.4 The impact of project financing on risk assumptions

Project financing is most often divided between debt financiers and equity participants. Debt financiers provide a significant part of the financing for the project (typically up to 80 per cent) at pre-agreed interest rates, and as discussed below, accept limited risk. Equity participants finance the balance of the project by, in effect, purchasing shares in the project. These equity shares vary in value according to project profitability. Equity participants accept a greater level of risk than debt financiers as their potential returns are higher (i.e. 'blue sky' as opposed to a maximum of interest and principal repayments).

Because debt financiers' returns are confined to interest payments, their dominant concern is that the cash flow from the project is sufficient to meet the debt repayment schedule (including interest). They therefore exert pressure on the private party not to take on risks which may jeopardise the project cash flow dedicated to amortisation of debt. This is particularly so if the project is funded on a non-recourse basis, which prevents the debt financier from being able to call on the private party or its parent companies to meet the debt obligations. However, if repayments are made from sources other than the project cash flows, or recourse to the parent companies is available, the financiers may be more relaxed about a wider assumption of risk. Nevertheless, limited recourse finance is the norm for *Partnerships Victoria* projects, except perhaps for smaller projects.

Government should not limit consideration of financing options to the forms of finance discussed above. Other financing options which may be realistically used to finance the project and facilitate optimal risk allocation should also be considered.

2.5 Special risk issues when contracting with government

Risk of government activities and determinations

In contracting to provide public infrastructure and related ancillary services, a private party may believe that the usual commercial risks are magnified because it is contracting with government. This is because government is seen as having special powers which unbalance the commercial relationship between the two contracting parties. In particular, government's role in law-making is perceived as giving it the opportunity to 'change the rules'. As the survey conducted by the University of Melbourne and the Victorian Department of Treasury and Finance found, there is 'a general perception that a private sector provider is ‘contracting with the umpire’ which creates a general unease about changes to all areas of legislation and policy'.[4]

Government activities and determinations can affect all projects, regardless of whether government is directly involved as a contracting party. The private party's perceived exposure to the risks of government activities and determinations is greater, however, under *Partnerships Victoria* projects, because of the direct contractual interest that government has in the project.

Contracts cannot, and should never attempt to, constrain the ability of governments to change policy or make new legislation. Governments need the discretion to make new policy, as necessary, to carry out their broader responsibilities. However, it may be appropriate for contracts to provide for redress to the private party should there be policy or legislative changes which discriminate against a *Partnerships Victoria* project. Establishing a stable regulatory environment, the details of which are conveyed at bid stage, can also assist in minimising the perceived threat in this area.

Over and above these risks of unequal commercial partnership is the capacity of government to do the project harm, should relations sour. This embraces the eventuality of a change in

[4] Department of Treasury and Finance, Victoria, and the Department of Civil and Environmental Engineering, The University of Melbourne, *Private Provision of Public Infrastructure, Risk Identification and Allocation Project: Survey Report*, Melbourne, 1999, p. 40. (The report of this collaborative project is referred to as the *Survey Report* in this Guide.)

government or political circumstances where a project is tarred by association with a previous government or an unpopular policy. In such circumstances, the private party may require protection, contractually and/or (in very limited circumstances) legislatively, from unfair treatment.

Termination and step-in

According to the *Survey Report*, termination and default risk is a major area of private sector concern. Survey respondents wanted step-in (presumably termination) limited to major breaches or defaults and sought reasonable 'cure periods' in which to rectify a default. There was an underlying concern about 'the ability of government with an 'anti-privatisation' ideology [to use] step-in provisions for political purposes'.[5]

There was also concern that, under many contracts, government is able to take control of the asset with no consideration awarded to the private party. This was seen as creating an incentive for government to behave opportunistically and to terminate contracts even in situations of minor default. However, a requirement that government pay fair market value for an assumed asset was seen as a protection. (These issues are addressed in Chapter 17, where appropriate bases for compensating the private party are set out.)

Summary

The risks discussed here are sometimes called legislative and government policy risks. These are special risks that the private party will want addressed to reassure it that it is not in a position of unusual disadvantage. The underlying principle in such an approach should generally be to place the private party in a position where it is neither advantaged nor disadvantaged by the fact that it has contracted with government. (For a fuller discussion of legislative and government policy risk, see the discussion on scoping and defining change in law risk in Section 15.6.)

2.6 Risks of particular concern to the private party

In some past projects the allocation of particular risks has been the subject of protracted negotiations between government and the private party. These risks include legislative and government policy risk, site-specific risk and force majeure risk. These risks are just as relevant to private-private contracts as they are to public-private contracts.

The private sector is also concerned with tender process risks. These are not risks in the sense generally used in this guide. Process risks include transparency and probity issues, certainty of government following through with the project and delays that may increase bid costs. These are significant issues and are addressed in the *Practitioners' Guide*. They may also be dealt with in a project development agreement (discussed in Section 4.2).

Site-specific risks such as native title, pre-contamination of the site and imperfections in existing (government-owned) structures which are handed over to the private party pose many concerns to bidders. A common difficulty is that there is generally no time during the bidding phase to undertake all the necessary studies to quantify these risks. It is also inefficient for many bidders

[5] Department of Treasury and Finance and the Department of Civil and Environmental Engineering, The University of Melbourne, op. cit., p. 39.

to undertake separate investigations of the same matters, especially when their bids may not succeed. (These issues are discussed in Chapter 8, Site risk.)

In the case of force majeure risk, debt providers may pressure the private party to apply any insurance pay-out to meet debt repayments rather than using it to reinstate the project. This is most often contrary to government's interests in receiving the contracted services over the full project term and, where applicable, receiving the asset at the end of the contract term. Accordingly, the contract should require that insurance pay-outs be used to reinstate the facility. (These issues are discussed in further detail in Chapters 16 and 24.)

3 The 'science' of risk management: identification and assessment

3.1 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.' [6] It is at the core of project profitability (for the private party) and efficiency (in delivering public sector objectives). Because management of risks holds the key to project success or failure, ‘projects are about risks, about their evaluation and their subsequent acceptance or avoidance’.[7]

The first task in project planning is to identify all the risks and how to manage them to minimise threats to the project. Both the private party and government have an interest in minimising overall project risks and should contribute to that outcome, regardless of which party formally bears a particular risk. It is important to clearly provide in the contract which party is to bear the financial liability for risks if they eventuate.

3.2 The risk management cycle

The ‘science’ of risk management seeks to identify, prevent, contain and mitigate risks in the interests of the project. Risk management is an ongoing process which continues throughout the life of a project and occurs in five stages:

(i) **Risk identification**. The process of identifying all the risks relevant to the project;

(ii) **Risk assessment**. Determining the likelihood of identified risks materialising and the magnitude of their consequences if they do materialise;

(iii) **Risk allocation**. Allocating responsibility for dealing with the consequences of each risk to one of the parties to the contract, or agreeing to deal with the risk through a specified mechanism which may involve sharing the risk;

(iv) **Risk mitigation**. Attempting to reduce the likelihood of the risk occurring and the degree of its consequences for the risk-taker; and

(v) **Monitoring and review**. Monitoring and reviewing identified risks and new risks as the project develops and its environment changes, with new risks to be assessed, allocated, mitigated and monitored. This process continues during the life of the contract.

In practice, many of these stages do not occur in isolation. For example, risk allocation does not simply take place on a 'risk by risk' basis detached from the output specifications, payment structure, government policies and the contract itself.

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[6] Chris Furnell, Risk identification and risk allocation in project finance transactions, paper presented at the Faculty of Law, The University of Melbourne, May 2000, p. 1.

[7] Allen & Overy, from Furnell, ibid., p. 3.

Nevertheless, this cycle can act as a useful framework for determining which risks government should take back. The framework is also useful for managing risks throughout the life of the project.

The following sections deal with risk identification and risk assessment. (Risk allocation is dealt with in Chapters 4 and 5, risk mitigation is addressed in Chapter 6, and monitoring and review is discussed in Chapter 7.)

3.3 Risk identification

Risks are usually identified by reference to generic risk categories and/or risks based on different phases of the project. Care must be taken when using generic categories as many of them overlap and, if used in the abstract or in isolation, they could be misleading and even skilled practitioners may fail to comprehensively and accurately identify all relevant risks. A change in policy risk, for example, may equally be a network risk or an operational risk.

A useful starting point may be to use a checklist of the risks which typically apply to infrastructure service projects delivered through public-private partnerships. The use of generic risk categories or a general checklist should not, however, take the place of detailed consideration of the risks of a particular project by experienced personnel. A brainstorming session which includes these personnel is strongly advised for identifying project risks. The session may use the standard categories or phases to give an underlying structure to the risk profile for the particular project.

Typical project phases are:

- bid phase;
- negotiation with preferred bidders;
- construction phase;
- operational phase; and
- transfer of asset.

The first two phases are not documented in the contract, but they contain various process risks that government must consider.

Typical risk categories for infrastructure service delivery projects (in general) and in joint public-private projects (in particular) are:

- site risk;
- design, construction and commissioning risk;
- sponsor and financial risk;
- operating risk;
- market risk;
- network and interface risk;

- industrial relations risk;
- legislative and government policy risk;
- force majeure risk; and
- asset ownership risk.

Each of these categories is discussed in detail in Part Two.

3.4 Risk assessment

The key factors in assessing a risk are:

- the likelihood of its occurrence; and
- the size of its consequences if it materialises.

A risk which is extremely unlikely to occur and would have only minor consequences if it did occur is unlikely to be of great concern to anyone. A risk which is likely to eventuate and would have significant consequences is of major concern, especially if it is outside either party's control and not within their power to mitigate. In such a case, the premium charged for assuming the risk is high. Indeed, in some circumstances a party may prefer to walk away from the project rather than assume such a risk.

Likelihood of the risk occurring

For many risks, the likelihood of their occurrence both affects and is affected by how they are allocated. Allocating a risk optimally — that is, to the party best able to control its occurrence and consequences — reduces the likelihood of the risk eventuating by giving the party best able to control it an incentive to prevent its occurrence. That party is also likely to be in the best position to access information about the likelihood of the risk materialising and can therefore establish a realistic premium.

Consequences of the risk materialising

The party with the greater knowledge of the project's technical characteristics and/or structure and financing arrangements is also generally in the best position to manage the consequences if the risk materialises.

In estimating consequences, attention should be paid not only to the potential costs of restoring the project to expectation but to the cost of any mitigation options, including reallocation to an insurer.

4 The risk allocation framework

4.1 Risk allocation under *Partnerships Victoria*: a shift in mind-set

As with the Private Finance Initiative in the United Kingdom, *Partnerships Victoria* 'requires a total shift in mind-set to see [public-private partnership] as an opportunity to procure services, leaving the risks of ownership and operation of the asset with the private sector'.[8]

As part of this shift in mind-set, government must focus on:

- articulating the policy objectives it wishes to achieve through the partnership;
- identifying the service it is seeking from the private party and specifying the outcomes and outputs of that service;
- identifying the core services (if any) that government will deliver from the facility; and
- structuring the most suitable payment mechanism for the provision of the private party's service/output specifications, as identified above, in accordance with government objectives for the project.

Policy objectives and outcomes

Whatever the proposed method of project delivery, government should fully articulate the policy objectives it wishes to achieve in developing the infrastructure and delivering or procuring a service. For the project to succeed, the specification of outputs and the structuring of the project and payment mechanisms must all reflect these objectives.

Service/output specification and payment mechanism: the structure

Under *Partnerships Victoria*, government contracts the private party to deliver a *service* to prescribed standards, and bases its payment schedules on service delivery. Government is not obliged to make any payment until the service is delivered. Through this structural framework, the risks of service and associated infrastructure provision are implicitly allocated to the private party. Put another way, by purchasing *outputs*, government avoids all the risks of the process that produces them, from construction/commissioning risk to the longer-term risks of asset depreciation and technological obsolescence. In effect, capital expenditure on a risk-laden asset is replaced by recurrent expenditure on a service for which the private party bears the bulk of the risks. If this can be achieved at a cost to government that is less than the cost of delivering the service itself (allowing for risks and competitive neutrality considerations), the outcome is value for money.

[8] Private Finance Panel, *Risk and Reward in PFI Contracts: Practical Guidance on the Sharing of Risk and Structuring of PFI Contracts*, UK, May 1996.

The structure implicitly creates an *initial* risk allocation in which all risks associated with delivering the outputs to the specified service standards are allocated to the private party. The following sections build on this initial position in demonstrating how, in the period prior to release of the Project Brief and contract, government determines which risks can or should be taken back by it to achieve an optimal risk allocation under a *Partnerships Victoria* model.

4.2 Optimal risk allocation

There are various reasons why *Partnerships Victoria* should be considered for delivery of major infrastructure-related services. These include:

- innovation;
- expertise;
- whole-of-life approach to costing;
- more timely delivery of services; and
- risk allocation to the private party.

While each reason is important and allows for a better level of service to be delivered to the public, they are all but contributors to the broader value for money objective.

Optimal risk allocation seeks to minimise both project costs and the risks to the project by allocating particular risks to the party in the best position to control them. This is based on the theory that 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 *and* to control the consequences of the risk if it materialises. Allocating the risk in line with those opportunities creates an incentive for the controlling party to use its influence to prevent or mitigate the risk and to use its capacity to do so in the overall interests of the project.

The optimal risk allocation objective is not inconsistent with the structural framework outlined in Section 4.1. Rather, the objective of optimal risk allocation helps government to determine which of the risks implicitly allocated to the private party it should take back (or share in a defined way) in order to achieve better value for money. Generally, government takes back a risk only where to do so would improve value for money or is in the public interest. Chapter 5 deals in detail with how government can use the contract to adjust the initial risk allocation implicit in the structure by taking back certain risks.

Government is liable only for those risks it expressly takes back under the contract. Where risks in particular categories may be difficult to identify in advance or their consequences difficult to measure, they may be dealt with using a risk-sharing mechanism such as a material adverse effect regime.[9] However, in all projects there may be unforeseen risks outside these categories which, by virtue of the *Partnerships Victoria* structure, the private party bears.

Mechanisms such as the material adverse effect regime may also be used to share identified risks which neither party is in a position to control. These mechanisms generally provide redress

[9] Material adverse effect is defined and explained in detail in Chapter 18.

to the private party if risks in the categories specified in the regime materialise and materially affect project viability. However, they defer the decision on the precise manner in which the risk will be shared until the risk materialises. (These procedures are mentioned throughout the risk discussions in Part Two and are discussed in Chapter 18.)

In certain circumstances, timing and other issues dictate that activities which involve risk and cost must be undertaken before financial close. This may include commencement of approval processes required for the project and purchase of financial instruments to lock in finance costs. Government accepts as a general principle that risk and cost sharing may be appropriate for these liabilities. One way of providing both parties with certainty in dealing with these issues is to use a project development agreement which contains an agreed risk profile for risks at the pre-contractual stage.

4.3 Risks over which no party has control

As indicated, there are some risks over which neither party has control, such as force majeure risk.

Unless these risks are specifically taken back by government, they fall to the private party. From one perspective, this may be appropriate because many of these changes, such as changes to corporate tax rates, affect the business environment generally. However, rather than incur a high premium for allocating all of these risks to the private party (and thereby diminish the value for money outcome), government may wish to adopt a shared approach to specific risks by using a mechanism like the material adverse effect regime described above, where the parties act together to mitigate and share the consequences of the specified materialised risk. An example might be the cost of future capacity upgrades, which are dependent on future usage patterns which neither party can predict at the time of contract.

Where payment for the service is not made by government but by the end-consumer, the private party may be able to mitigate a materialised risk by passing through any additional costs to the end-users. Any passing through is, however, subject to appropriate contractual restrictions and may be subject to a regulatory regime which ensures that the level of pass-through is justified.

Where a risk beyond the control of either party is likely to eventuate — like movements in general price levels (i.e. inflation) or exchange rates — it is appropriate for it to be dealt with in an express provision in the contract. Such changes may be significant, but they are unlikely to be momentous unless the financial projections are deficient. The long term of the contract should not prejudice the private party's ability to adjust its prices from time to time to reflect changes in general price levels on pre-agreed input costs.

At the opposite end of the spectrum, where a risk is highly speculative, it may also be best dealt with through an agreement to negotiate, or a material adverse effect regime, to avoid government paying a very high premium to cover remote eventualities. Uninsurable force majeure events may be in this category.

4.4 Risk premiums

In theory, government can allocate most risks to the private sector if the price it pays to allocate them is sufficiently high and the private party is able to diversify its portfolio to dilute the consequences of particular materialised risks. There is in fact a profitable market in risks, with private parties keen to assume risks for which government pays a high price relative to the likelihood or consequence of these risks materialising.

The question for government is whether the risk premium it is paying for allocating the risk is value for money or whether, in some cases, assuming the risk — taking into account the mitigants available to government — might cost government less than the risk premium.

In line with the theory of optimal risk allocation, allocating a risk that is predominantly within the control of one party to another party is unwise, because it is only accepted by a non-controlling party at a costly premium, thereby diminishing the value for money. If a risk is within government control and can be managed and mitigated, it does not make sense to pay a high premium for its allocation to the private party. Similarly, if a risk is within the private party's control and can be appropriately managed and mitigated, it should not attract a high risk premium.

The Public Sector Comparator (described in more detail in Section 1.6) establishes mechanisms for pricing risk to ensure that government is not charged an excessive risk premium. It is designed to assist in optimising value for money in risk allocation and, in particular, determining when a risk should be taken back by government.

4.5 Unintentional take-back

To achieve value for money, government must also ensure that the risk allocation for which it is paying is effective. There is little point in government paying a premium to the private party to accept design risk, for example, if government approvals at critical design stages effectively result in government taking back some of the risk.

4.6 Mitigation and optimal risk allocation

When considering adjustments to the risk allocation implicit in the *Partnerships Victoria* structure, it is important to bear mitigation options in mind. The most obvious of these is to pass the risk through to an insurer, which has the effect of capping the consequences of the risk at the level of the insurance premium.

There are two types of mitigation options:

(i) early options, designed to limit the likelihood of the risk eventuating or to reduce its consequences for the project if it does materialise; and

(ii) later options, generally involving cooperation between the parties to minimise direct financial impacts of a materialised risk. In many cases this may involve use of a material adverse effect regime or other similar regime, as discussed in Chapter 18.

Awareness not only of government's own capacity to mitigate, but also of the other party's mitigation options, assists in considering whether the risk allocation is in fact optimal. (Mitigation options are discussed in further detail in Chapter 6.)

4.7 Symmetrical risk allocation

Changes during the life of the project may not always have negative impacts. They may result in 'upside benefits' which increase the profitability of the project in unforeseen ways. When determining a risk allocation, thought should be given to 'symmetrical' provisions which create entitlements to upside benefits as well as any liability arising from a materialised risk. This gives the parties an incentive to achieve efficiencies to benefit the project and allow benefits to neutralise losses from risk events.

It may not always prove possible to achieve a symmetrical risk allocation at reasonable cost, as bidders are likely to increase the cost of their bids in the absence of the opportunity of upside benefits. The opportunity to share in upside benefits may not be worth the opportunity cost reflected in the additional bid price. This is a matter for case by case identification. However, it is government's preferred position that where government agrees to share in the downside of a risk, it should be entitled to share in any upsides if that risk materialises.

Care should be taken to ascertain any taxation or balance-sheet implications arising from symmetrical risk allocation.

Symmetrical risk allocation and the issue of sharing in super profits are more fully discussed in Chapter 19.

4.8 The risk matrix as a tool

A standardised risk matrix framework has been included in this guide as Appendix A. Its purpose is to illustrate how a risk matrix is constructed to show the range of risks that may apply to each project phase and, broadly, to set out government's preferred position on allocation.

When prepared and used wisely, a risk matrix can be a useful tool to both government practitioners and the private sector. During the pre-tender and tender phases, it can assist government practitioners in listing all the relevant project risks and their proposed allocation (whether allocated implicitly through the structure or by way of a take-back by government). During negotiations, it can act as a checklist to ensure all risks are addressed, and after signing of the contract it can be a useful summary of the risk allocation effected by the contract. The more exhaustive its treatment of the risks, the more useful and valuable is the matrix.

Risk matrices are widely used in the market-place. However, it is important to recognise their limitations. For example, if they are used in a simplified form, they can misrepresent the actual allocation of risk accomplished by both the structure and detail of the contract. A good example is where the risk matrix contains ticks for a particular risk in both the 'government' and 'private party' columns. This says little about the detail of the allocation. The contract and the project structure, not the matrix, are the tools by which risk allocation is achieved. (This is explained in Chapter 5.)

A risk allocation matrix which is presented to the private party as part of the Project Brief need not be (and in most instances should not be) as detailed as the risk matrix developed for internal purposes. It should be made clear to the private party that the allocation is offered for acceptance, not as an ambit claim as part of a hard-line negotiation that wastes everyone's time. Risk allocation negotiations can then focus on transaction-specific issues and the more important risks. Departures from the matrix included with the Project Brief should be minimised. Ideally, they should be shown as drafted amendments to the contract provided with the Project Brief. At a minimum, however, departures must always be shown in sufficient detail to allow government to fully understand them, and (where agreed to by government) to enable them to be drafted into the contract without the need for further negotiation.

5 Reflecting the risk allocation in a *Partnerships Victoria* contract

5.1 Primary mechanisms

Essentially, the risk allocation position between government and the private party in a *Partnerships Victoria* project is governed by three things:

(i) specified service obligations;

(ii) payment/pricing structure; and

(iii) express contractual provisions adjusting the risk allocation implicit in the *Partnerships Victoria* structure.

These elements, which are documented in the contract, together allocate risk between the parties. This allocation includes detail of how risk mitigation strategies may be applied in some circumstances to share or reallocate a materialised risk.

5.2 Service obligations

The government aim under a *Partnerships Victoria* arrangement is not to procure assets, but to receive services (e.g. hospital and courtroom accommodation services). Accordingly, a clear services/output specification (reflecting government policy objectives) is critical to the successful realisation of government aims for a partnership project, including achieving a desired risk allocation.

In clearly defining the required services, the following should be borne in mind (especially for the purpose of the payment structure):

- service delivery itself must be measurable; and
- both the quantity and quality of the service must be capable of measurement and comparison with key performance indicators.

In the call for Expressions of Interest and more particularly in the Project Brief and finally in the contract itself, the service delivery specifications should be drafted in a manner that accurately and clearly communicates government's output requirements, while minimising any prescription as to how the service is to be delivered or the asset maintained. This encourages innovation among the bids concerning the range of service delivery options and pricing proposals, which should in turn provide government with value for money. The actual technical/engineering method of service delivery and estimate of costs required to construct and maintain the asset and deliver the service, should be matters entirely for the private party — at its risk. Government's only concerns in this regard are, first, to be satisfied that the engineering solution is sufficiently robust to sustainably deliver the required services/outputs; and second, if the asset is to return to government with a useful life beyond the contract term, that it is suitably maintained during the contract term. If government attempts to define how the services are to be delivered (as opposed to simply specifying output specifications), it may inadvertently take back risk that would otherwise have been borne by the private party.

There may be limited circumstances where a minimal prescription of input specification by government is necessary in the public interest. An example may be input into how security requirements for an accommodation facility will be met, where the government considers it is necessary for protection of the public for security guards to be present on site round the clock, in addition to any security considered appropriate by the private party to meet the security output specification. Where input is specified, careful consideration should be given as to how the government intends to allocate risk and contractually enforce those inputs.

Given that the term of the contract is likely to be long, the contract should provide expressly that government will fund government-initiated changes to service specifications, either directly or through an increased service charge. However, mechanisms need to be established to ensure that the cost impact of such changes is minimised. (These issues are further discussed in Chapter 21.)

If the service is not delivered to the required standards, the payment of the service charge may be suspended or abated according to the agreed payment and pricing schedules. Where there is continued failure to meet the standards, termination clauses can be activated after an appropriate cure period.

The risk of failing to perform to the required standards and the associated risk of reductions in the value of the asset should be allocated entirely to the private party, except to the extent that express provisions in the contract may reallocate some part of the risk to government.

5.3 The role of payment and pricing structures

The importance of payment regimes as a tool of risk allocation and mitigation is frequently overlooked. Development of a robust payment mechanism is vitally important:

- in establishing the necessary degree of risk allocation in a project; and
- to appropriately incentivise performance by the private party.

The second outcome is particularly important. If payment mechanisms are out of tune with government objectives for a project, the private party may pursue a course of action geared to revenue flow which does not necessarily meet government's project objectives. Payment mechanisms are therefore a vital tool for aligning public and private service objectives and minimising the risk for government that the project will serve different ends from the public sector objectives sought at its inception.

The case of the A13 roadway in the United Kingdom illustrates this graphically.[10] The aim of the UK Highways Agency in putting this project to the market was not to encourage increased usage, but to relieve congestion caused by road closures and accidents along a critical 20 km section of the predecessor to the A13. Usage-based payments (such as 'shadow tolls') could therefore run directly counter to the project goals. Instead, a payment mechanism addressing the policy objective of relieving congestion was developed by linking approximately 70 per cent of the private party's revenues to the availability of the project road. Availability was defined as the absence of lane closures and accidents and other incidents making sections of the road impassable. The road was divided into eight sections and each day into nine 2-hour time

[10] Nick Chism, 'A13 — DBFO with an urban twist', *Private Finance Initiative Journal*, UK, Vol. 5, No. 4, Sept/Oct. 2000.

segments. The private party receives a flat availability payment for each section during each time interval, provided the section is fully available. The balance of the payment system reflects other policy objectives and is based on safety performance objectives benchmarked against similar roadways, and heavy goods vehicle usage as a measure of economic regeneration of the local area.

This notable innovation in the payment schedule mirrors the availability-based abatement regime in the Victorian County Court contract, where again there was an understandable hesitancy to base financial rewards primarily on usage.

The ability of government to enforce its objectives through payment mechanisms is of course much greater where government is the service purchaser. The user-pays model may have limited applicability where government objectives have a strong policy focus on factors other than usage. This need not be so where there is a mixture of user-pays and government subsidies, such as in rail franchises. In those circumstances, government can still set payment incentives (by way of the subsidies or abatements) for the private party to meet specific government obligations.

No payment before completion

Payments should only begin to be made when services begin and for as long as they continue under the terms of the contract.

'No service, no payment' is an uncompromisingly effective means of allocating risks away from government. In this context, the payment schedule is also a mitigation tool from a government point of view, because it gives the private party the strongest possible incentive to meet the project specifications, complete the project on time, develop an asset that is fit for its purpose and begin service delivery at the earliest possible date to enable payment to start.

Unitised payment for ongoing service delivery

Depending on the project, elements of the payment mechanism may include:

- service-based elements with payments based on a combination of availability of the service and service performance levels;
- transaction- or usage-based elements for which payment is made per transaction unit; and
- benefits-based elements where payment is linked to improvements in the business or organisational environment, such as safety or efficiency improvements.

Government should be paying for the quality and quantity of service delivered (including accommodation services in relation to the area from which core services are delivered by government). There should not be any form of rental or lease payment for the actual infrastructure.

Given the range of government objectives involved in *Partnerships Victoria* projects, payment mechanisms generally include at least the first two, and perhaps all three, of the elements described above. In the case of the Victorian County Court, for example, payment is made on the basis of the availability of courtrooms (involving both physical and functional availability to specified performance standards) in combination with actual usage.

Service-based payments are particularly suited to accommodation services, from which government may deliver core services, where usage may be variable but availability is important to the smooth running of those services. The most effective payment mechanism in such circumstances is one that buys 'availability' to the estimated peak needs of the service and then provides for a component of the charge to be based on usage rather than availability.

A similar model based on capacity rather than availability may be appropriate for water-industry infrastructure. It is important to remember, however, that availability (or capacity) should be defined to include performance elements. Payment should not be geared to physical availability without performance requirements to ensure the contracted services are effective.

Usage-based payment models are a direct means of exposing the private party to demand risk. They can also be effective in measuring customer satisfaction and reflecting service quality. For example, in information technology services, the number of transactions may reflect the speed of the service, where speed comprises part of the performance criteria of the service. Usage or transaction based payments are also appropriate in contexts such as privately-owned rail franchises, where high usage may serve government objectives by diverting traffic from, and relieving congestion on, government road networks. However, there is potential for usage to become an end in itself as the private party seeks to maximise its return, perhaps contrary to government's social policy objectives and other service performance criteria.

Benefits-based elements can be an important component in the payment mechanism for some projects. This occurs where improvements in safety, efficiency and natural or business environments are important government objectives for a project and are measurable.

It is, however, important that each of these elements is not the subject of separate payments but contributes by way of a formula to a unitised payment. In this way, payments are made according to overall performance and are not prey to anomalies such as where payment is made for volume without regard to the quality of the services.

Abatement/reduction regimes

Whatever the combination of the three elements, payment for ongoing service delivery is best structured to create a regime that is financially responsive to variations in service availability or standards. The contract may then provide for the loss or a reduction in the payment stream if service delivery fails or is of a poor standard. This creates an incentive for the private party to perform in accordance with the project requirements and mitigates the consequences for government if performance is substandard. Payments should only be abated in line with objective standards set out in the contract. The level of abatement should reflect the loss of amenity.

Payment sanctions for minor default

In addition to abatement of the service charge for failure to provide services which meet key performance indicators, in some projects it may be appropriate to include a separate schedule of payments to be made to government if certain unwanted eventualities occur. An example could be instances of Legionnaires disease traced to a facility owned and operated by the private party. This can be an effective incentive to provide the required service quality and can impose discipline around identified issues and events without impacting on the regular payment mechanism or exposing the private party to unspecified damages. However, unless the schedule of payments realistically reflects the likely scale of the loss or inconvenience to government, this aspect of the contract may prove unenforceable.

Mechanisms to relieve consequences of certain materialised risk events

In rare circumstances, such as a force majeure event, the payment regime may also provide for variations to give relief to the private party for unexpectedly extreme financial consequences of materialised risks. This might mean agreeing to continue payments under the contract for services delivered temporarily from another facility and/or to grant or extend a grace period that applies to deficient service provision before payments for service are fully or partly abated. Such concessions should be conditional on the private party using its best endeavours to restore full service availability and should apply only within a specified timeframe.

Payment by tolls or tariffs on third parties

Payment by end-users for the service can allow scope for the costs of certain materialised risks to be passed through to those end-users rather than to government. However, as previously indicated, such pass-through may be subject to appropriate contractual restrictions or regulatory requirements, to ensure that the increase in cost is reasonable. It is also important to retain an incentive for the private party to manage and mitigate risks, rather than allowing it a full pass-through, which may compromise that objective.

Even where costs are passed through (at least in part) to end-users, commercial considerations may not allow full cost recovery within the contract term. In such a circumstance, the risk to the private party may be mitigated or shared with government by including other contractual mechanisms to allow for cost recovery, such as allowing the contract term to be extended. The usefulness of such a mechanism of course depends on when the risk event occurs.

Government payment of a service charge

If the unit price payable by government for the contracted services is fixed for the contract term (apart from escalation for inflationary pressures), the private party effectively bears the cost of delivering the contracted outputs. Hence, if the operating costs are higher than anticipated, they are to the cost of the private party, not government, which has agreed to pay for services delivered at an agreed price.

The only exception to this is that the private party may be provided relief if certain pre-specified risks eventuate that increase the cost of delivering the contracted outputs, such as change in law or a change in government's service requirements. (These kinds of provisions are dealt with in more detail in Chapters 15 and 21.) Even where government may bear some of the costs associated with these risks, care must be taken to ensure that the private party has an incentive to manage and minimise these costs.

Effect of default on payments

The private party generally seeks to insulate the payment stream it has earmarked to service its debt from minor and immaterial service defaults. Failure to do so generally causes the cost of debt to rise. It may be appropriate to quarantine enforcement, termination and the revenue abatement provisions from a default relating to a service not considered critical for delivering major government outputs.

Notwithstanding this, the contract needs to provide for minor defaults (regardless of the service they relate to) which, in aggregate, lead to a major default and payment abatement. Government’s output specification should identify appropriate response times for rectification of minor and immaterial service defaults that, if rectified within the stated response times, will not give rise to a default. In addition, the output specification should specify the aggregate number of minor defaults allowed within a discrete period of time, before minor defaults are reclassified as major defaults.

5.4 Identifying risks to be taken back by government

The principles and processes for determining risk take-back by government may be summarised in the following steps:

- **Step 1**: Identify all the project risks. These include the general risks which are described in detail in Part Two and the project specific risks (for example, the risk to public health in a water project).
- **Step 2**: Identify the core services which are to be provided by government and for which risk cannot be allocated to the private party.
- **Step 3**: Examine each risk and identify those which government is best placed to manage as a result of the level of control it exercises, and those which it may otherwise not be optimal to leave with the private party. These should in each instance be taken back by government.
- **Step 4**: Determine whether any of the remaining risks should be shared in accordance with risk sharing mechanisms as a result of market convention or specific factors relating to the project.
- **Step 5**: Finetune the risk allocation inherent in the *Partnerships Victoria* structure in light of steps 3 and 4 and use the contract to reflect that fine tuning and to adjust any power imbalance between the parties arising from special government powers.

Government identifies the risks it will take back before it puts the project to the market, as part of the process of determining government's risk allocation position. These risks are identified on a project by project basis. (The discussion in Chapters 3 and 4 on risk identification, assessment and allocation is a sound starting point.)

Generally speaking, the risks assumed by government are likely to include items such as the risk of State legislation or a policy change discriminating against the project, the risk of government wishing to change (e.g. increase) the service standards or volumes, some elements of native title risk and some elements of pre-existing latent defect and contamination risk. Reference should be made to Part Two where these risks are considered in detail.

Addressing concerns about extent of government power

In part, concerns about government powers are addressed in the way certain risks are allocated — for example, where government assumes the risk of new State legislation which discriminates against the project.

This concern can also be addressed through mechanisms such as 'act of prevention' clauses,[11] in the drafting of termination and step-in provisions and by ensuring that defaults in the provision

[11] These are similar to material adverse effect clauses in operation. They address the adverse consequences of government's own actions which impact negatively on the project.

of certain 'less important' ancillary services do not affect availability payments which service debt.

Act of prevention provisions can afford appropriate comfort to the private party in respect of government activities. However, such provisions should only expose government to matters critical to project viability, to avoid excessive take-back of risks by government.

Such provisions discourage government from acting negatively towards the project because ultimately it may be required to make redress or compensate for the liability it creates.

Termination and step-in

The private sector's anxieties concerning termination and step-in, as described in Chapter 2, can be addressed through contractual clauses which:

- in the case of step-in, relate only to emergency access and where there has been a material service default (which includes continuous or repeated non-material defaults); and

- in the case of termination (or security enforcement, if government has been given security), seek to ensure that cure periods are fair and that, as far as possible, the conditions under which termination or government step-in may occur are clearly specified and limited to material defaults so as to avoid hair-trigger termination events.

When drafting these clauses in a *Partnerships Victoria* contract, regard must also be paid to the potential effects of lengthy cure periods and particular defaults, on government's capacity to deliver core services and its ability to deliver or procure the delivery of replacement ancillary services which the private party is unable to provide.

Given the sensitivity of the interface between government and the private party in those *Partnerships Victoria* projects in which government delivers core services, step-in clauses are likely to require careful drafting. An appropriate balance needs to be found between the parties' interests and the policy priority accorded to core services. These step-in provisions also need to accommodate the financiers' step-in rights.

Early termination (arising from a default) is of particular concern to the private party where it may result in the asset being transferred to government, potentially for nil consideration. This concern is addressed in Chapter 26, where it is acknowledged that appropriate compensation may be payable to the private party in circumstances where failure to do so would unfairly benefit government and prejudice the private party.

The issues of termination and step-in are discussed further in Chapters 25 and 26.

6 Risk mitigation

6.1 What is risk mitigation?

Risk mitigation is any action that can be taken to reduce:

- the likelihood of a risk materialising; or
- the consequences to the contracting party taking the risk, if it does materialise.

Risk mitigation is an attempt to reduce the relevant party's exposure to the risk and inherently increases the likelihood of achieving (or bettering) the project's base case scenario. Mitigation practices vary depending on the risks being considered and whether the party concerned is a private or public one.

The way a project is scoped can also act as a mitigant. For instance, giving control of certain raw water storage facilities to the private party in a water treatment project can lessen the interface risk between the private and government parties.

As noted, risk mitigation is not separate from risk allocation, because an ability to mitigate may lead a party to assume a risk it would not otherwise assume. Similarly, awareness of the other party's mitigation opportunities might make it appropriate to insist on the risk being allocated to that party and/or paying a smaller premium.

6.2 Private sector risk mitigation mechanisms

Pass-through to third parties

The most commonly used and readily available risk mitigation option for private parties is to pass the risk on to other parties who are able to control it at a lower risk premium. This supplementary risk allocation creates a chain of risk bearers, each best placed to control the particular risk, and each insulated from the collective risks which the private party would otherwise have to bear. In this situation, however, it is important to point out that, notwithstanding the chain of risk bearers, the private party (as the contracting party) still retains the primary liability for the risk under the contract.

Typically, the private party would contract with:

- a builder who would bear the construction/completion risks;
- a facility operator who would bear the operating risks; and
- a supplier of input materials who would bear the risk that the quality of the materials is inadequate to meet the project needs.

Other risks, including demand or market risk, might be shared with the private party's financiers. Risk is further reduced if the private party chooses the best and most experienced partners for each aspect of project delivery.

Insurance

Insurance is a specialised form of passing through risk to a third party. The private sector has recourse to a wide range of insurance products covering project risks such as owner's liability, some force majeure events, owner's risks (to the asset) and business interruption. Insurance may also be available for some legislative and government policy risks relating to the convertibility of local currency, and other, limited, change of law events.

Financial market instruments

Financial risks arising from inflation, interest rates and foreign exchange rates can often be mitigated through financial market instruments.

Diversifying project portfolios

The private party can also create a buffer against the effects of risks materialising by developing diversified project portfolios. Barring a general economic downturn, the premiums accumulated from unmaterialised risks on one project may sustain the private party through liabilities accumulated when a risk eventuates on another. This could be seen as a form of self-insurance.

6.3 Public sector risk mitigation mechanisms

The public sector can also mitigate risk using similar mechanisms:

- through a range of insurance products;
- through financial market instruments (although such instruments should not be used without prior discussion with the Department of Treasury and Finance);
- by diversifying its project portfolios; and
- in certain limited cases, by passing on the risk in the form of higher costs to consumers.

Public sector mitigation generally emphasises the following measures:

(i) research before issuing tenders;

(ii) strategic planning and, where appropriate, development of an independent regulatory framework;

(iii) best practice tender and evaluation processes;

(iv) obtaining best legal, commercial and technical advice;

(v) reducing scope for agencies to take back risk unintentionally;

(vi) developing a contingency plan in case of default;

(vii) insurance as appropriate (and subject to the restrictions described above); and

(viii) best practice control monitoring and management (discussed in Chapter 7).

(i) Research before issuing tenders

This research has a number of components, including:

- specifying desired outcomes for the project (taking into account government policy);
- application of the public interest test;
- confirming legal ability to contract with the private party;
- public sector benchmarking, building up the Public Sector Comparator and determining what constitutes value for money;
- identifying and facilitating required government approvals;
- anticipating and identifying appropriate procedures for resolving land tenure issues, including native title;

  (i) preparing and implementing a community consultation plan; and

  (ii) fully understanding all community service obligations and interface issues.

The government agency undertakes this research, to a large extent, during the options appraisal and business case stages of the procurement process. (See the *Practitioners' Guide* for details of the steps in a *Partnerships Victoria* procurement process.)

The ‘desired outcomes’ are the actual benefits to be secured through the project. The overarching risk for government is that the private party will not achieve these outcomes. The risk analysis conducted by government must focus, first and foremost, on achieving the project objectives.

As discussed, all projects under *Partnerships Victoria* are assessed against the public interest. The ‘public interest analysis’ focuses on matters such as the effectiveness of the project in meeting government objectives, honouring the rights of affected individuals, securing public access and equity of access to the infrastructure, preserving community health and safety and protecting consumer rights. A properly applied public interest test assists government in risk mitigation.

To avoid later legal complications leading to challenges and delays, it is also vital to check before tendering the ‘legal ability of government or the agency to contract with the private party’ in the envisaged circumstances, or to perform all of its obligations under the contract. In some circumstances, enabling legislation may be required.

Thorough preparation of the business case and construction of the Public Sector Comparator clarifies infrastructure and service delivery options and the technologies available for achieving the desired outcomes or outputs.

The range of ‘government and agency approvals’ required and the potential problems in obtaining them should be investigated prior to tender. These may include planning approvals by local councils, approvals under the Victorian *Environment Effects Act 1978*, Ministerial consents under various statutes and Commonwealth tax rulings or Foreign Investment Review Board (FIRB) approval. While Commonwealth tax and FIRB approvals (among others) are best left to the private party, government should consider what action it should take to facilitate other approvals.

Potential 'land tenure issues' should also be investigated early. If, for example, the project may require closure of public roads, the grant of easements over Crown land or the grant of Crown leases beyond the statutory norm, these may create sticking points and involve lengthy procedures which need to be factored into the project timetable and considered for their possible risks and additional costs. Native title, in particular, is an area with which private parties are still largely unfamiliar and uncomfortable, and has the capacity to cause major delays and generate unanticipated costs. This is an area in which government expertise and an early indication of expected procedures and default processes may be critical to risk minimisation. (This issue is discussed further in Chapter 8.)

Finally, where government chooses the site or region for the project or indicates a preferred site, it may begin 'community liaison' under a community consultation plan. This may address development and environmental concerns and assist in minimising community opposition and its possible flow-on into approvals and industrial relations risks.

(ii) Strategic planning and development of regulatory framework

It is difficult for the private sector to bid with confidence to provide infrastructure and associated services to the public over an extended period of time when regulatory arrangements and government intentions for the future of the industry are unclear. This is particularly so where monopoly franchises are granted, such as in electricity or gas distribution or rail/tram routes. Therefore, strategic long-term industry planning and the development of an economic regulatory framework can be critical in achieving value for money outcomes or outputs.

(iii) Best practice tender and evaluation processes

Best practice tender and evaluation processes should be adopted to ensure selection of the best bidder. Best practice processes include developing clearly defined bid criteria, creating a framework to handle probity issues and constructing clear and informative bid documents.

It is important that government develops and maintains clear and open communication with bidders to ensure that the risk allocation required by government is fully understood.

The bid documents should contain sufficient but not excessive information. Over-supply of information can cloud government's primary messages. It can also lead bidders to a particular project option and unnecessarily restrict their incentive for innovation. At the same time, government must be clear about its requirements and any constraints that it imposes. The more information provided (within reasonable boundaries) to enable bidders to assess risk, the more the bidders are able to quantify and accurately price that risk.

Government should not as a matter of course always accept the lowest bid as representing maximum value for money. Appropriate evaluation processes should be adopted to help ensure that bids are financially robust and the bidder is not aggressively valuing risks simply to win the bid, thereby compromising long-term value for money to government.

Appropriate tender and evaluation processes are dealt with in further detail in the *Practitioners' Guide*.

(iv) Best legal, commercial and technical advice

The best possible legal, commercial and technical (e.g. engineering) advice should be sought in structuring the project and drawing up bid documents. This helps to identify and deal with risks/problems that arise sooner rather than later.

(v) Reducing scope for unintentional risk take-back

The contract should be structured and managed so as to lessen the scope for a government agency to unintentionally take back risks for which it has paid a risk premium to allocate to the private party. This may be achieved by, for example, preventing unnecessary involvement by government in the design and construction or in the ancillary service delivery processes. Under the *Partnerships Victoria* model, the incentive for the private party to get the construction right is that it receives payment only when the infrastructure and ancillary services are provided to the predetermined quality and quantity.

For example, the private party looks for a consultation process during the design phase to obtain some assurance that it is on the right track. Similarly the project director (on government's behalf) also wants to have that assurance. Care must be taken to ensure that any consultation process is only to assist the private party and is undertaken without prejudice to government's rights under the contract, so that government does not implicitly take back the design risk. (This aspect of design risk is considered in more detail in Chapter 9.)

During the contract management phase of the project, government needs to ensure that its monitoring of the provision of services does not of itself involve any take back of operating risk.

Where government assumes particular design risks or service delivery obligations as part of its obligation to deliver the core services, it must bear the primary risk for those aspects of the project and unintentional take-back is not an issue.

(vi) Developing a contingency plan for lack of service delivery

If a major risk allocated to the private party eventuates and the private party cannot effectively deal with it, or the project vehicle becomes bankrupt so that service is disrupted, it may be vital for government to be able to ensure continuity of service. A contingency plan should be prepared for implementation if the project becomes unviable. This plan is to be consistent with the contract provisions for default, step-in and termination as discussed in Chapters 25 and 26. The plan should, however, extend beyond the contract provisions to consider government options after step-in or termination, and strategies for dealing with major force majeure events which the private party is unable to redress.

The contingency plan needs to consider potential pressures on government to continue to provide core services and any ancillary services. The contingency plan should also include a strategy for communicating events and progress to the public.

If service is disrupted, the cause, extent and likely duration of that disruption determines the steps to be taken. For example, if the private party fails to deliver a contracted service, but the particular contracted service and any affected core service (as appropriate) can be delivered effectively at another site or by another party, the private party should pay any additional cost to government of the alternative arrangements. If the service is disrupted and the private party cannot restore the service within the applicable cure periods, government may require step-in rights to restore the service. Government's need to exercise its step-in rights may depend on whether the private party's financiers have prior step-in rights which they wish to exercise to minimise the abatement period.

(vii) Insurance

Many of the risks retained by government are not insurable, but some may be. For example, the risk of a force majeure event damaging a State-owned network essential to the operation of the private component of the project may be insurable.

Insurance should be taken out where it represents good value for money.

7 Monitoring and review

Once risks have been allocated and a contract has been signed, the procurement team needs to establish a risk monitoring system to ensure that:

- services are delivered according to contracted performance specifications;
- commissioning issues are minimised and rectified;
- payment for services is appropriately verified; and
- unforeseen risks are identified and assessed expeditiously.

Implementing a monitoring and review process involves two steps to manage both contracted and unforeseen risks effectively:

(i) development of a risk management plan; and

(ii) review and implementation.

Risk monitoring and review are enhanced if the members of the contract management team are involved in the tender process. This gives them an understanding of the philosophy behind the risk allocation, as well as familiarity with the individual risks. The contract management team should become involved in the tender process as early as possible.

Risk management plan

The risk management plan sets out the measures to reduce and control risks and summarises the results of the risk management process to date. The plan should be updated at regular risk review meetings to record risks avoided (where these can be identified), risks realised and the revised strategy for risk management moving forward. The plan also aids future project teams by providing a record of successful or unsuccessful risk handling.

At a minimum, a risk management plan should detail:

- the identified risks;
- action and detailed strategy to prevent or mitigate risks;
- mitigation costs;
- key or critical dates; and
- responsibility for the risk management strategy for particular risks.

Electronic systems are available to assist the contract manager in this role.

Risk review and implementation

The risk management process established in the risk management plan should be reviewed at regular risk review meetings to ensure that:

- each risk is controlled, unless it is no longer a risk;
- the risk management process adopted for each risk is effective;
- resources are made available to deal with risks at the appropriate times; and
- any potential new risks are identified and appropriate measures are taken to mitigate and avoid them.

The frequency of and responsibility for monitoring are issues that should be specified in the risk management plan. The scope and frequency of the risk review meetings will vary depending on the size, stage and complexity of the project. The review process should not only be seen as a means of reviewing past performance, but also as an opportunity to incorporate consideration of changed circumstances which may affect the project in the future, and to develop strategies to improve risk management in line with changing circumstances.

Where a new risk is identified, a risk management strategy should be drafted, including actions to mitigate the consequences of the risk. The risk and the strategy for managing it should be incorporated into the master risk management plan and be reviewed regularly using the approach adopted for reviewing all project risks.

Part Two: *Partnerships Victoria* risks and government-preferred positions

8 Site risk

8.1 Introduction

Site risk is the collection of risks that flow from the project land. It extends to site suitability, issues that may arise in site acquisition, environmental liabilities arising from site features, requirements related to planning and other approvals and native title issues. Environmental, native title and planning risks, if they materialise, can have significant consequences for a project's viability. This factor, together with the lack of control over these risks, is the reason private parties and their financiers often either misprice these risks or are unwilling to take them.

As an initial premise (see Section 4.1), site risk lies with the private party, as part of the risk allocation implicit in the structure of a *Partnerships Victoria* project. However, government may share part of that risk in certain circumstances, such as when:

- the site is an existing government site, perhaps with existing asset defects or environmental liabilities;
- government retains ownership of the underlying land asset or is to acquire it at the end of the contract term;
- site approvals are likely to be particularly complex, as in the case of linear infrastructure involving an environmental impact assessment; or
- native title issues arise over the project land.

Project development agreements, which have been used in the United Kingdom, give both government and the preferred bidder a measure of pre-contractual certainty, particularly in relation to approvals issues.

Under a project development agreement, the private party can agree to seek (and as far as possible, expedite) the relevant approvals in the context of an agreed risk profile concerning the outcomes of the approvals process. Government may agree to share additional costs above a specified level arising out of the approvals process. The preferred bidder would then be bound to proceed with the project (in accordance with the approvals received), subject to government sharing the additional costs.

The question of whether government will retain or acquire a proprietary interest in the project land, and whether or not such an interest is necessary to underpin its rights in the event of early termination, is discussed in Section 8.3.

8.2 Definition

Site risk is the risk that the project land will be unavailable or unable to be used at the required time, in the manner or at the cost anticipated, or that the site will generate unanticipated liabilities, with the result that the contracted service delivery and/or projected revenues are adversely affected.

Site risk is a significant issue at the inception of the project and during construction, and becomes less important in the operational phase. However, environmental risk may materialise during the operational phase if previously unidentified problems come to light or the project operation itself gives rise to pollution or to land or groundwater contamination.

Examples of site risk are:

- the risk of unanticipated land acquisition costs and delays in acquisition;
- the risk that planning permission will be refused or granted on onerous terms;
- the risk of delays and costs arising from environmental impact assessments, including the risk of route-diversion of linear infrastructure and the costs of special measures to protect environmental values;
- contamination risks and liability for clean-up;
- the risk of liability for contamination of adjacent land;
- the risk of costs and delays associated with archaeological and cultural heritage discoveries;
- the risk of costs and delays arising from negotiating indigenous land use agreements (ILUAs) on land which may be subject to native title;
- the risk that the site subsequently proves to be an inefficient/unsuitable location for delivery of the services; and
- the risk that any existing infrastructure on the site proves to be unsuitable for the project proposed for the site, e.g. it may not complement the proposed infrastructure.

These may be broadly grouped under five headings:

(i) land interests and acquisition

(ii) statutory approvals

(iii) environmental issues

(iv) indigenous issues

(v) suitability of the site and any existing infrastructure.

Each of these is treated in turn below.

8.3 Land interests and acquisition

Site selection is one of the first determinants of the risks to which a project may be prone.

Generally, government calls for submissions in relation to an identified site, which may be either vacant government land or contain existing public infrastructure. However, government may also encourage or accept variant bids involving alternative sites owned by others. Such alternatives may carry additional risks, especially if the site needs to be acquired from third parties.

Alternative sites may, however, offer innovative solutions — the kind of solutions *Partnerships Victoria* aims to promote among other objectives.

Another issue which arises particularly in the case of alternative sites is whether government should own the underlying land asset or be content to purchase services from a private party which owns both the facility and the land on which it is built.

Government's proprietary interest in the project land

Government has shown a tendency to retain ownership of government land and to grant leases to private parties, giving them exclusive possession and control of the land during the lease term. In the simplest arrangements, the lease co-extends with the contract term (and terminates on early termination of the contract), so that the land and any improvements on it revert to government. This puts government in a relatively strong position with respect to service continuity, and has the security and appeal of close analogy with a traditional lease.

However, as the major project market has evolved, the need for government to retain a proprietary interest has come increasingly into question. In some cases, leases of government sites have been granted for terms twice or three times the contract term, as part of financing arrangements which rely on the asset having a substantial residual value to the private party on termination.[12] The leases do not necessarily terminate on early termination. A 99-year lease such as was granted in the case of the County Court is equivalent to a freehold grant in value and has a similar effect in potentially excluding government from the site for the foreseeable future.

It should not be automatically assumed that the underlying land asset needs to be in government hands. Whether or not the land asset — as distinct from the project infrastructure, which is invariably privately-owned — should be in government ownership, depends on the degree of government's anticipated need for the site. This may not be black and white, but will generally fall within the following categories:

- sites which government clearly wants into the future, e.g. major roadways;
- sites from which government *may* wish to receive or deliver future services; and
- sites in which government has no special interest and from which it can, if need be, walk away.

If continuing access to a particular site is important to government, ownership of the site and lease to the private party is the obvious course. Ownership will give government important rights under the lease and may help underpin step-in rights under the contract. Projects in this category are likely to be projects where the asset reverts to government on termination.

If government may wish to continue its involvement with the site, but is unsure, it may either own the land and lease it to the private party, or allow the private party to own the land — subject to government having first option to purchase the land (and presumably the facility) at the end of the contract term or on early termination, according to an agreed valuation method.

[12] These cases are discussed in the context of asset ownership risk in Chapter 17.

If government has no special interest in the site and can source similar services elsewhere, it should consider allowing the private party to build, own and operate the facility on private land, without being obliged to transfer the site to government either at the start or end of the contract.

Determining which scenario will apply depends primarily on government's future intentions in relation to the land and the facility and, to a lesser extent, on the financing structure that most suits the project circumstances. This is especially relevant in the second category, where government's position is flexible and residual site value (and residual asset value) may be factored into the project financial structure in a variety of ways. (The question of residual value and the role it plays in the project financial structure are dealt with in detail in Chapter 17, Asset ownership risk.)

Acquisition of sites in third-party ownership

If the preferred site is in third-party ownership, or includes sites in third-party ownership, the risks associated with site acquisition generally fall to the private party. However, in certain instances, where voluntary acquisition may prove difficult or costly and where government is to become the land-owner, it may be more cost-effective for government to take charge of the land acquisition process, using (if necessary) its statutory powers of compulsory acquisition.

In the case of linear infrastructure, especially if the precise route definition depends on the outcome of an environmental assessment process, government may need or wish to take a role in coordinating acquisitions, even where it does not act as the acquirer of the project land. In such cases, the 'hands on' process of acquisition is generally directed by a coordinating committee of government and private party representatives to minimise the risks of incorrect or incomplete acquisitions along the project route, and to ensure that (if compulsory acquisition becomes necessary and government is the acquirer) government assumes access and ownership to sections of the route in a sequence that fits the private party's construction schedule.

8.4 Statutory approvals

Planning approvals

A key risk for major infrastructure is that planning approval will not be obtained or will be subject to conditions which make the project significantly more expensive to construct and/or operate.

Ordinarily, the relevant planning authority is local government. However, for project-specific legislation, it is possible to designate the Minister for Planning as the planning authority in relation to project land. In this sense, government may be in a position to exert limited control over the approvals process, and generally facilitate the project, without abrogating public rights of participation in the approval process (including rights of appeal to an independent tribunal). These public rights are integral to the public interest aspect of *Partnerships Victoria* projects.

In many cases, a planning scheme amendment is required prior to the planning permit process. This is necessary where the planning scheme applying to the project land does not permit development of the kind proposed. The advertisement and public advisory process allows any controversy about the suitability of the land use in the overall strategic planning context to be identified and taken into account in implementing or refusing the amendment, well before the project detail is submitted for planning permission. All planning scheme amendments, however, are ultimately approved or refused by the Minister for Planning. As a matter of policy, the Minister is unlikely to depart significantly from the advisory recommendations of the independent panel that he or she must appoint to review planning scheme amendments which attract objection.

In this context, where there is a potential for conflict between a Minister's statutory obligations and the interests of the project, it is appropriate that any necessary planning scheme amendments be processed before tenders are called for government-selected sites. The risk of obtaining planning scheme amendments for alternative (privately owned) sites is, however, the responsibility of the private party.

Development approvals

In many cases, the effect of a planning scheme amendment is to make the project use 'as of right' within the zone or zones affected by the amendment. In such a case, development approval (i.e. approval of the detailed works) is likely to be required. In other cases, a planning permit is also necessary. The task of securing these approvals should belong to the private party, since it is the party in control of the design, construction and operation of the project facility and is in the best position to negotiate, or consent to, the project detail.

Other approvals

Approvals other than site-based approvals — such as industry or quality accreditations and Foreign Investment Review Board approvals — are also generally for the private party to obtain.

8.5 Environmental issues

Environmental issues arise where there is site contamination, where the contracted services or method of service delivery has a potential to pollute, and where the project infrastructure may impact adversely on the environment. Changes in environmental regulation may also create significant additional costs by introducing monitoring or management regimes which were not anticipated when the contract was entered into. A graphic example of the latter is the waste management regime[13] applied by the Victorian Environment Protection Authority (EPA) to Coode Island silts extracted from several major project sites in Melbourne, which at the time of its extraction was officially sanctioned for disposition as clean fill. Changes such as this would generally fall within change in law and are discussed in the context of legislative and government policy risk.

Environmental clean-up

Under the *Environment Protection Act 1970*, the EPA may serve a Notice to Clean Up Pollution (a clean-up notice) on a variety of parties — the occupier, a person who has permitted or caused the pollution to occur, any person who appears to have dumped or abandoned waste, and any person handling waste in a manner likely to cause an environmental hazard. Alternatively, the EPA may undertake the clean-up and recover costs from the occupier or polluter or, failing that, impose a charge on the land or on the occupier's property to the value of those costs. In practice, the occupier is the first port of call for most clean-up notices and pollution abatement notices, although other parties may be served in conjunction with the occupier. For this reason,

[13] Industrial Waste Management Policy (Waste Acid Sulfate Soils)

the private party is likely to resist taking control of a site without an indemnity from the previous owner (whether private or government) in respect of pre-existing site contamination.

In the *Survey Report*, concern was expressed that there is generally no time during the bidding phase for project bidders to undertake the detailed and exhaustive studies necessary to sufficiently quantify contamination risk.[14] It was also considered cost-inefficient for each bidder to commission such investigations. The combination of potential cost and lack of time means that most bidders bid in ignorance of the true site condition. Unless provided with an appropriate indemnity, bidders may bid at very high premiums to cover their worst fears about the possible condition of the land.

Contamination risk is also seen as open-ended. There is no knowing where a problem may lead, especially if there are off-site impacts from on-site pollution, making the occupier of the project site liable as the polluter of the adjacent site.

Clearly, government should not indemnify the private party against contamination risk for any site that the private party brings to the project.

Identified contamination should also be excluded from any indemnity with respect to a government-owned or designated site, since that will have been priced into the bid. Further, depending on the nature of the project, it may not be necessary for the site to be pristine. A broad indemnity in that instance may generate wasteful, unnecessary clean-up. It may therefore be appropriate for government to provide a limited indemnity, or subject environmental liabilities to a material adverse effect clause which deals with them only if and when a risk eventuates.

By limiting the scope of such indemnities, and creatively applying a material adverse effect regime to contamination risk, contamination risk — even at sites previously owned by government — may be shared and incur a lesser premium. Capping government's liability under the indemnities may also assist government in ensuring that the private party efficiently complies with its contractual obligation (if any) to clean up.

The County Court project is illustrative. If the private party discovers contamination of the site (whether before or after the completion date), the parties must confer and agree on the necessary action to address the contamination, including a process for undertaking remedial works and deciding by whom they are to be undertaken. All costs of any remedial works are to be met by the private party as and when they fall due, except the cost of any remedial works relating to contamination which has migrated from the land to any other land prior to the date of the contract. This is the responsibility of the Minister. Remedial works are defined as all works required to satisfy an environmental auditor to issue a statement of environmental audit under section 57AA of the *Environment Protection Act 1970* stating that the land is suitable for use for its current purpose. Effectively this limits government liability to that owed to third parties in respect of off-site contamination. This approach reflects government’s preferred position in limiting government's environmental liabilities as much as possible, consistent with the goodwill and cooperation implicit in the partnership concept.

[14] Department of Treasury and Finance, Victoria, and Department of Civil and Environmental Engineering, The University of Melbourne, *Private Provision of Public Infrastructure, Risk Identification and Allocation Project*: *Survey Report*, Melbourne, 1999, p. 41.

Environmental audits

If an environmental audit has been undertaken and is included in the Project Brief or provided in the data room established for the project, the private party should agree — as one of the terms of the project contract or, where appropriate, its lease — that it will not take any action against government in relation to the matters contained in the audit. This is whether or not the audit proves to be defective or invalid. Such undertakings are desirable to protect government from liability for the quality of audits (over which is has no control). They should be seen as a trade-off for the opportunity an independent audit gives the private party to price contamination risk more accurately, without incurring the costs of the audit. If necessary, it may be agreed that the private party will inherit government's rights to sue the investigator if the audit has been undertaken negligently. These rights can be novated to the private party under the project contract or a project development agreement.

Pollution from project services: works approvals and licences

Where a project may itself generate pollution, it generally requires works approvals and licences under the *Environment Protection Act 1970*. It is very important that these approvals are obtained by the private party and that government stands back from the approvals process. Works approvals and licences are the means by which the facility technology and operational specifications are reviewed externally and checked for conformity with State environment protection policies. As an independent statutory body, the EPA imposes conditions on activities with the potential to cause pollution, and has enforcement powers with respect to those conditions, as well as powers of prosecution for pollution offences.

To encourage best environmental design and practice, and to insulate government from legal liability for project operation, policy dictates that the private party alone must bear this risk, even though government could expedite the process by alerting the EPA to the project and the likely type of asset/operation which may be built.

Environmental impact assessment

In Victoria, public works which may have a significant effect on the environment are assessed through environment effects statements (EES) under the *Environment Effects Act 1978* (EE Act). Some private works — especially those involving major infrastructure — are also assessed under the EE Act. If the construction and/or operation of the infrastructure could have a significant impact on designated matters of national environmental significance, the project may also be assessable under the Commonwealth *Environment Protection and Biodiversity Conservation Act 1999* (the EPBC Act). These assessments can be long and involved processes causing significant delay in project start-up and imposing conditions which may critically alter the project specifications, including the project route in the case of linear infrastructure. The risks associated with these approvals are borne by the private party, subject to the qualifications below.

While government cannot intervene in environmental assessment processes once they are under way (except through agency participation), it may be in a position to coordinate Commonwealth and State approvals, and it may agree to assume the risk of delays in the process. This is possible since the advent of Commonwealth-State bilateral agreements under the EPBC Act, bringing even the Commonwealth assessment (but not approval) processes broadly within State government control.

In addition, where government has designated the project site or had critical input into the project route, but circumstances prevent the EES/EPBC process from being completed before the bidding process begins, government may agree to share some of the costs of the EES process and outcomes. This may be done through a project development agreement.

8.6 Indigenous issues

This category involves risks associated with indigenous cultural heritage and the existence of native title. Although several years have passed since the Mabo decision and the passing of the *Native Title Act 1993* (the Native Title Act), native title is regarded by most sponsors as an area of significant uncertainty and unspecified threat. The perception of risk is not dissipated by the complexity of the Native Title Act and the lack of settled administrative procedures, particularly at State level, to meet the Act’s requirements.

Any site that is or includes Crown land may be the subject of native title and, in the absence of a proven or outstanding claim, there is a presumption that native title may exist (unless there was an obvious act of extinguishment before 1993, such as erection of a building covering the site). Land in coastal and conservation reserves, and rail, road and waterway reserves is particularly at issue. A project approval granted in the absence of notification to, and consent from local Aboriginal representatives may be invalid if native title is subsequently found to exist on project land.

Related risks include civil injunction for breaching the Native Title Act, the risk that development approvals may be invalid through non-compliance with procedures under the Act, and the risk of significant delay and substantial costs in negotiating an indigenous land use agreement (ILUA), which is the State government's preferred procedure under the Native Title Act.

From experience to date, an ILUA is likely to contain undertakings related to Aboriginal cultural heritage. These undertakings and the requirements of cultural heritage legislation require the private party to cease work immediately if, in the course of construction, any item of cultural heritage significance is found. Cultural heritage survey work prior to construction may also form part of the ILUA and cause additional costs and delay.

Government has powers to compulsorily acquire the native title interest in land, and other powers to use native title land for infrastructure which serves a public purpose. These powers, and government's greater understanding of procedures required by the native title legislation, are reasons for government to take and manage native title and Aboriginal cultural heritage risk — unless the site has been selected by the private party in preference to a government-selected site. In the latter instance, the risk is borne by the private party unless otherwise agreed to by government given the particular circumstances. For the M2 Motorway in New South Wales, the government agency agreed to acquire any affected land and pay compensation in accordance with the provisions of the Native Title Act.

Where policy frowns on compulsory acquisition of native title interests and favours voluntary agreements (by which indigenous people may consent to the private party's use of the project land without extinguishment of native title), government is generally best placed to undertake these negotiations.

8.7 Site suitability and rectification of site deficiencies

The private party bears the risk that the location of the site may prove unsuitable for delivering the proposed services, regardless of whether the site was originally selected by government. The private party's bid is based on its own assessment of site suitability — effectively representing to government that services can be delivered to the requisite standard from that site on a commercially viable basis. Shifts in demographics and other changes which may make a site commercially unsuitable are part of the private party's risk modelling and are priced into its bid.

Where a site has ageing infrastructure or identified contamination, there may be a need to address site deficiencies before the project begins or within the project itself. In determining which party will bear the costs of this process, it is relevant whether the property was brought to the project by the private party or is an existing government property. Generally speaking, government requires the private party to assume 'ground risk' and the residual risks of assumed infrastructure, except perhaps where there is identified contamination on a government site or known defects in existing government infrastructure.

In cases where government land or infrastructure has identified liabilities, government may either pay a direct financial allowance for their repair or allow the private party to price that repair cost into its bid, especially if such a payment (made directly or indirectly through a higher service charge) discharges further liability for ageing infrastructure — and in effect allocates liability for unidentified defects to the private party.

Alternatively, unidentified liabilities may be made subject to a material adverse effect clause, requiring the parties to cooperate in mitigating the consequences of a materialised risk adversely impacting on the project returns, as in the case of unanticipated ground contamination discussed in Section 8.5.

8.8 Mitigation

The obvious way to mitigate site risk is careful site selection, backed by intensive investigation of history of the site and its characteristics to assist in quantifying the risk. It is critical that bidders are provided with as much information as possible to be able to assess the risks. An investigation of past uses of the site, coupled with knowledge of its proposed use, should disclose whether there is a significant danger of land contamination and liability for clean-up. Desktop investigation of Commonwealth Department of the Environment and Heritage and the Victorian Department of Infrastructure databases of environmentally sensitive sites should also be conducted to estimate the likelihood of requirements for an EES or Commonwealth environmental assessment, and to assist in defining development corridors which minimise environmental risk.

Defects in existing infrastructure to be transferred should be identified and quantified. Title searches and investigation of Native Title Tribunal records should disclose land interests and whether there is an active native title claim.

With respect to land contamination, government could commission investigations into site contamination and distribute results with the Project Brief, as suggested by respondents to the *Survey Report.*[15] While consultants' reports of this nature may mean an upfront cost to government, they may enable bidders to substantially reduce premiums associated with this risk over the life of the project, to the extent that they relieve the bidders from the need to conduct their own intensive site investigations. The bidders will still need to employ their own independent experts to review the reports.

[15] Department of Treasury and Finance, Victoria, and the Department of Civil and Environmental Engineering, The University of Melbourne, op. cit., p. 41.

As pointed out in the *Survey Report*, however, such government-commissioned audit reports do not necessarily lessen the risk premiums required by private parties, unless those parties are at least able to inherit government's legal rights to sue the investigator if the information proves incorrect. These rights could be novated under the project contract or, if a planning development agreement precedes the contract, under that agreement.

However, mitigation of site risk largely depends on the risk management achieved through the preferred allocations set out in this chapter. Government can seek to minimise the risk of planning refusal through community consultation at the proposal stage (which should minimise community opposition) and by adopting a generally facilitative approach. Together with the transparency and openness requirements and public interest test advocated by *Partnerships Victoria*, this should lessen the risk of planning refusal, notwithstanding the greater scope for public participation and appeal favoured by the policy.

The use of a project development agreement, as discussed in Section 8.1, may also act as an important mitigant.

9 Design, construction and commissioning risk

9.1 Introduction

The private party under a *Partnerships Victoria* project usually incurs substantial up-front design and construction costs to develop project assets. Any unanticipated increase in these costs, whether through delay or otherwise, may have a significant impact on the financial outcomes of the project. This forms the basis of design, construction and commissioning risk.

In approaching this risk, it is important to remember that *Partnerships Victoria* projects differ significantly from traditional 'design and construct' contracts. Under the traditional approach, government appoints design and/or construction companies to design and build the asset on government's behalf. Payment is typically made in stages, following government inspection and certification of the works. When the works are fit for use or occupation, government or, more usually, an independent certifier issues a certificate of 'practical completion' to the contractor, which allows use to start, subject to the contractor rectifying any minor defects during the 'defects liability period'. Apart from that obligation, the contractor has no ongoing responsibility to maintain or service the facility once it has been built.

Although there are some similarities between the development obligations imposed on the private party in a *Partnerships Victoria* contract and the builder in a public procurement, there are critical differences. As noted in earlier chapters, under *Partnerships Victoria*, government is not procuring the asset but the services delivered through it. This means that:

- government makes no payment during the development period;
- the scope for government-initiated change to design and construction processes is likely to be limited;
- government rights during the design, construction and commissioning will focus on reporting and monitoring rather than the broader rights exercised under a design and construct contract;
- 'commercial acceptance' takes the place of 'practical completion', i.e. acceptance by government that service delivery (to agreed service standards) from a technically complete facility can begin and, therefore, so can payment of service charges; and
- if there are defects, correction of these during a specified ‘defects liability’ period will be less relevant to government, as payment will be abated if the service falls short of the specified outputs (because of the defects).

Terminology such as 'practical completion' and 'defects liability' are generally used in *Partnerships Victoria* contracts, but not in the usual context. Completion generally occurs when the capital works and service outputs are tested under the full range of operating environments (i.e. commissioning and operational commissioning) and a final certificate of completion is issued. This indicates that the project assets are able to deliver the services to specification. Government accepts that the private party will look for objectivity in issuing certificates at commissioning/operational commissioning.

9.2 Definition

Design, construction and commissioning risk is the risk that the design, construction or commissioning of the facility or certain elements of each of these processes, are carried out or not carried out in a way which results in adverse cost and/or service delivery consequences. The consequences if the risk materialises may include delays and/or cost increases in the design, construction and commissioning phases, or design or construction flaws which may render the infrastructure inadequate for effective service delivery, either immediately or over time.

Design, construction and commissioning risks are the core risks of the development phase and are among the most likely risks to materialise.

9.3 Allocating design, construction and commissioning risk: government-preferred position

Design, construction and commissioning risk is implicitly allocated to the private party by the structure of a *Partnerships Victoria* project. It is government's preferred position that they remain with the private party. This is generally acceptable to the private party, provided that the ability of government to interfere with the design, construction and commissioning processes is then extremely limited. If government imposes detailed obligations on the private party relating to the design, construction and commissioning of a project, the risk allocation to the private party is jeopardised, as is the private party's ability to make decisions about how best to manage these risks.

Government will not take back or in any way share design, construction and commissioning risk with the private party, unless it is a risk associated with a government-initiated design or construction change or some other government interference (whether an act or omission) in the design and construction process. In these circumstances, it may be appropriate, using optimal risk allocation principles, for government to bear the cost of such changes.

The private party mitigates the possible consequences of these risks by sub-contracting elements of the risk to its sub-contractors (and their indemnity insurers), who are familiar with the specialised territory and used to dealing with its risks. Notwithstanding this chain of risk bearers (i.e. the third parties to whom the private party transfers particular risks), the private party retains the primary liability for the particular risk under the contract with government. If a risk eventuates, the private party will seek to meet the costs by exercising its rights against the sub-contractors under the sub-contracts, but if for any reason this fails, the private party must meet the costs itself.

Unintentional design take-back

Under a *Partnerships Victoria* contract, by buying services at pre-agreed prices and paying for them only on service delivery; limiting the circumstances in which the contract term may be extended; and having an agreed damages regime for late delivery, government implicitly allocates to the private party the cost consequences of delays in design or construction or of any failure to meet the agreed standards.

However, this starting position may shift if, for example, government interferes in the detailed design process or requests a change to the agreed service standards leading to additional costs and/or delays in starting service delivery. Such interference may result in government unintentionally taking back design and construction risk which it thought it had implicitly allocated to the private party. The same situation may also arise if government accepts some of the risk of innovative technological solutions, on the understanding that it will share in the benefits of their successful implementation. (The technological aspect is discussed further below.)

It can be difficult for government to maintain the balance between communicating its needs by specifying service outputs, and standing back from direct involvement in the design and construction process so that it does not effectively take back design and construction risk. This is especially so if the services delivered under the contract are accommodation services providing the functional space from which government itself will deliver core services. Unless government clearly conveys its functional requirements for particular areas, the contract may not succeed in delivering the accommodation services to the level or suitability necessary to ensure efficient delivery of core services from the facility. As part of that process, government needs to secure a level of confidence in the suitability of the design (and any inherent technology) to meet the outputs specified. The risk to government in all of this is that its detailed intervention in the design may make government, in a practical sense, responsible for the design and make the allocation of design risk to the private party ineffective.

One means of treading this fine line is a consultative process on design and construction aspects, in which government assists the private party to meet government objectives, without either formally endorsing or approving design elements. A United Kingdom arbitrator held that a consultative process of this kind did not constitute an approval which might otherwise have prevented the government agency from insisting on design modifications necessary to achieve specified outputs. The onus of ensuring that the design is capable of delivering the specified outputs must remain with the private party. It is imperative that no action taken by government is able to be construed as offering assurances as to the efficacy of a design and discharging the onus on the private party.

If, however, the design is efficacious but government — for its own reasons — seeks a variation, it is appropriate that government meet the costs of modification. To the extent that this causes delays in service delivery or other loss of revenue, government may also bear consequential costs. For example, government may request variations to the project design, or request new connections to privately or publicly owned roads to integrate a privately-operated road into the public roads system, subject to reasonable notice being given and government agreement to bear all costs of the works and to indemnify the private party for any related revenue losses or expenditure arising from the variation.

A more moderate, shared approach may be to allow government to request variations during the development phase, provided they do not affect the commissioning date, with the cost of variations borne by the private party being capped. Caps on the private party’s liability for the cost of government-initiated variations should be limited to relatively small sums to ensure value for money, as the private party will be likely to factor these potential costs into its bid price.

It is important to note that government-initiated requests for variation will inevitably lessen the totality of the risk allocation to the private party by interfering with the private party's liberty to determine a commercially effective design. For this and other reasons outlined above, government's ability to initiate change to design and construction processes should be limited. (Government-initiated modifications are dealt with in further detail in Chapter 21.)

Cutting-edge technology

One of the virtues of *Partnerships Victoria* is the opportunity created for the adoption of innovative solutions to service needs, with potential service quality and cost benefits to the

Victorian community. A good example of this is water treatment plants, where the range of technological solutions in water treatment expanded significantly with private sector involvement.

However, the benefits of innovation carry an innovation risk that cutting-edge technology will not deliver the intended results and will require further refinement. Although the risk that innovative technology will fail to deliver the required services falls primarily on the private party, which will not receive payments (or will receive abated payments) until appropriate outcomes are achieved, government also bears the risk that service provision or full service provision will not be achieved within its required timeframe.

In some cases, innovation risk may be priced at a high premium because the project is highly technology-dependent, with a high likelihood that the risk will materialise. Alternatively, the private party may see the contract as an opportunity to trial and demonstrate new technology and discount the risk premium to win that opportunity. In any event, government should ensure any premium paid for the option of cutting-edge technology is not excessive compared to the benefits. Whether it is a concern that government may be locked into a particular technology depends on the nature of the project. For example, it may be more of a concern in an IT-based project than for a building management services contract.

In either event, since government inescapably bears some part of the risk, it is appropriate that government is treated equitably in respect of the future need it may have for the technology — whether within the facility (if the facility is ultimately to be transferred to government) or within other government facilities. Without laying claim to intellectual property in the technology or the upside benefits of its further commercial exploitation, government should seek contractual recognition of its right to future use of the technology on reasonable terms. This is to prevent undue advantage being taken of the fact that government may be locked in to a particular project technology, and to recognise that government has in fact taken a share of the innovation risk and is entitled to some upside benefit.

9.4 Allocating design, construction and commissioning risk: contractual issues for government

Fitness for purpose versus output specifications

It has been suggested that the model whereby government delivers core services from a facility developed and operated by the private sector shifts the emphasis away from service provision and back towards a concept of 'fitness for purpose', as in a traditional design and construction procurement. For example, in the Victorian County Court contract there is a warranty by the private party that, at completion, the facility was to be fit for use as a venue to meet the functional requirements of the County Court under the *County Court Act 1958.*

However, while such a warranty may offer some comfort to government, fitness for purpose in this context comes back to whether the built asset meets commissioning tests which test the functional availability of the specified services. In the case of accommodation services, it is not the physical existence of the asset and the meeting of design specifications that triggers the payment regime, but the availability of accommodation services of the specified functionality. Such functionality — which is incorporated into the County Court definition of availability — must meet the output specifications of the services required by government and (directly or indirectly) the output specifications of the core services to be delivered by government.

The concept of accommodation services is in fact vital in keeping government at arm's length from design and construction risk in relation to privately constructed and operated facilities which it proposes to occupy. Provided payment for those services is based on performance standards in addition to availability, the fitness for purpose of the design is in fact open to sanction through the payment regime. An inadequate design will produce inadequate services which is not to be paid for. Similarly, construction delays or defects which defer service provision or compromise service delivery attract financial sanctions through non-payment or abated payments for deficient service.

The effect of this emphasis on payment for services without formal intervention in design and construction matters is to require government to take great care in developing well-articulated output specifications for the services, including accommodation services.

In the context of accommodation services, where there is an obvious interface risk that inadequate service provision, or even a particular mode of service delivery, may impact adversely on government's ability to deliver its core services, government may also need to specify in the tender documentation, in more detail than it has in the past, the operational outputs government itself hopes to deliver from the facility. This will enable the private party to manage the interface risk by designing its delivery of accommodation services (through the design and construction of the asset) around both the output specifications for the contracted services and the output specifications for the government core services.

Design criteria, construction milestones and commissioning deadlines

Regardless of the fact that design and construction risk is allocated wholly to the private party, nothing prevents government from seeking design and construction warranties and setting construction milestones to meet project timeframes and manage delay risk. Appropriate standards of workmanship, an appropriate design life for the asset and the quality of finishes may all be specified without compromising the risk allocation. Similarly, construction milestones and commissioning deadlines impose a discipline on the project and set the parameters for the construction sub-contract, without implicating government in taking on construction risks.

Delays: liquidated damages and termination

Where delays in completion and commissioning and the consequent unavailability of the service occasion hardship and/or cost to government, construction delays may attract liquidated damages, as a genuine pre-estimate of the daily damages government will suffer as a result of the unavailability of the contracted service. Government often requires the private party to provide security for liquidated damages through bonds or guarantees issued either by the private party or its construction sub-contractors.

In addition, failure to achieve any construction milestones or to commission by the commissioning deadline may be specified as a construction default which, after an appropriate cure period, should in most cases enable termination of the *Partnerships Victoria* contract. Any deadlines imposed must, however, be reasonable, to minimise the risk of a default and not unnecessarily increase the private party's premium. This will help ensure value for money is maximised.

However, government recognises that all security for the private party’s contractual liabilities has a cost attached. This is the case whether the security involves liquidated damages, bonds, or parent company guarantees. A considered view should be taken in project development as to the value for money consequences of each decision to require liquidated damages, or any other form of security.

Project time extensions

While the cost of construction delays (except where arising from government-initiated design variations or specified acts of government interference) in most cases falls to the private party, there may be some circumstances where extensions of time for completion (and other milestone dates) may be granted to avoid what would otherwise constitute a default by the private party, enabling termination.

A contract may specify such circumstances, including:

- breach of project documents by government;
- specified acts of government interference;
- pollution causing delay to works;
- industrial action directed at the project;
- cultural heritage events;
- force majeure events;
- certain court or tribunal rulings;
- compliance with federal environmental impact statement requirements; and
- works required to rectify defects in government structures.

Unless government has some responsibility for their occurrence (for example, the first three in the examples listed above), these circumstances should not give rise to any redistribution of risk. If government does have some responsibility they may be made subject to a material adverse effect regime or some other regime under which government can share the consequences of such events by, for example, extending the contract term. In limited circumstances where government interference has caused the delay, government may agree to pay delay costs based on incremental construction and finance costs.

Construction defects

Rectification of construction defects identified during commissioning tests is generally addressed under the sub-contract between the private party and its construction sub-contractor (although, as noted earlier, the private party continues to bear the primary liability through its contract with government). Under the principal contract, commissioning generally does not take place until rectification of any identified defect (with the possible exception of minor defects). Although this is always the case with defects affecting service delivery, in cases where service delivery is not affected it may be appropriate for operational commissioning to occur and service delivery (and payment) to commence even though defects are outstanding. It may be in government's interest for this to occur. However, government should always maintain sufficient financial sanction by way of abatement to ensure that defects are rectified on a timely basis.

In respect of latent defects which manifest after commissioning, it is usual for the construction sub-contractor to assume liability to rectify any latent defects for a specified period of time from the date of practical completion (for example, 12 months). Nevertheless, as with identified defects, latent defects which arise at any time will remain the liability of the private party.

If a latent defect in the project assets does not affect service delivery, the private party may not be obliged to rectify it, but, depending on the circumstances, the particular contract may require it. For example, there may be aspects of the amenity of the building which should be the subject of financial sanction but which are not an essential component of service delivery. If government is to acquire ownership of the asset when the contract term expires, the private party should be obliged to rectify all defects. The private party should also be obliged to rectify defects where such defects (even though they may not directly affect service delivery) affect energy use or thermal efficiency in projects where government has agreed to bear the energy costs.

Where a latent defect in the project asset does affect service delivery but abatement is not a sufficient remedy for government nor a sufficient financial incentive for the private party to rectify the defect, a contractual obligation on the private party to rectify all or particular defects would be appropriate.

Keeping pace with technological change

Design and construction risk embraces the extent of design adaptation that may be necessary to keep service delivery efficient over time or to meet service delivery specifications, particularly where these are set by reference to external benchmarks. Where a project is technology-dependent, the private party has usually priced-in periodic upgrades as a means of managing the obsolescence and operational risks associated with technical innovation.

As discussed in Chapter 17 (Asset ownership risk), the risk of major technological change which could not have been foreshadowed at the time the contract was entered into, may be shared by including a process in the contract for either party to propose a major technological conversion, with an appropriate cost allocation including adjustments to the service charge. In extreme circumstances, where it is no longer efficient for either party to persist with an outmoded facility, the parties may agree to terminate the contract on mutually acceptable terms.

9.5 Mitigation

Although design and construction risk is essentially borne by the private party, materialised risk events impact on government in the form of delays or interruptions to service and/or less efficient service. It may be in government's interest to contribute what it can to the management of these risks. However, government needs to be careful not to become too involved in the management of risks and in doing so take back risks it thought it had allocated to the private party.

The first necessity in managing design and construction risk is the proper specification of project outputs and of the core services government will be delivering. It also requires linking the contracted services to key performance indicators and, in turn, to the payment mechanism. This puts both parties in the best position to achieve their objectives. Incorrect or ambiguous specifications obviously multiply the project risks.

In addition, government should consult with the preferred bidder when detailed service options are being developed and ensure that government is briefed on the proposed design and kept abreast of design evolution. Without involving it prescriptively, this gives government the opportunity to comment where it considers that a design proposal may create difficulties in meeting the service specifications.

Clear commissioning tests should be used to enable government to test the ability of the asset to deliver the required outputs to the specified performance standards under the full range of operating environments and to have design and construction defects put right before service delivery commences.

To mitigate the private party's exposure to commissioning delays caused by government inaction, the private party may seek to put in place an inspection and commissioning program, backed by clauses in the contract deeming the asset to have been commissioned if government fails to complete its testing program within the agreed timeframe. Alternatively, testing may be agreed to be carried out jointly by government and the private party through an independent commissioning tester. The concern of the private party and its financiers for objectivity in the commissioning process is recognised by government.

It also assists effective management of design, construction and commissioning risk if the contract provides for the appointment of a representative of the private party to oversee the design and construction schedule and keep a watching brief on the construction sub-contractor. The fact that design, construction and commissioning risk is reallocated to the sub-contractor under the sub-contract is not reason for the private party to abrogate the important task of risk-managing this critical area on behalf of the project consortium (given its direct liability to government under the principal contract).

Finally, and most importantly, government should invest resources in appointing a high quality contract manager for the project. The contract manager can monitor the project progress on government’s behalf (including ensuring that government meets its obligations during commissioning) and be available to consult with the private party on risk management.

10 Sponsor and financial risk

10.1 Introduction

In establishing a project consortium, the sponsor(s) typically establishes the private party in the form of a special purpose vehicle (SPV) which contracts with government (even though, as mentioned in Part One, the private party may take other forms such as a subsidiary of an existing company, a legal partnership or a joint venture). As noted earlier, the SPV is simply an entity created to act as the legal manifestation of a project consortium. The SPV itself has no historical financial or operating record which government can assess. Government therefore relies on the historical performance of the consortium members to fulfil the project obligations.

The SPV is supported by external equity contributions often provided by portfolio investors with no relationship to the project beyond their commitment of equity and expectation of financial return. The SPV also raises debt or debt/equity (hybrid) finance. The debt providers are concerned to ensure repayment of the debt plus interest and other returns as agreed. They provide term sheets offering finance subject to conditions precedent which must be fulfilled before the financing can be drawn down.

To facilitate the establishment of a project (and because government may require it), many sponsors contribute equity to encourage other investors — in the expectation of selling their investments when the project becomes a lower risk venture after commissioning. This creates the prospect of changes of ownership of the project and raises questions about the impacts of refinancing.

For some projects, such as lower capital cost water treatment plants, the private party may finance a number of different projects on its balance sheet. After commissioning, these too may be aggregated and refinanced.

While these are typical financial models for *Partnerships Victoria* projects, other forms of finance that facilitate optimal risk allocation should be considered where appropriate.

Sponsor and financial risks stem from the complex structure of these arrangements.

10.2 Definition

Sponsor risk is the risk that:

(a) where the SPV and/or its sub-contractors are unable to fulfil their contractual obligations to government, government will be unable to enforce those obligations against the sponsors or recover some form of compensation or remedy from the sponsors for any loss sustained by it as a result of the SPV's breach; or

(b) that the sponsor(s) is, for security or other probity reasons, inappropriate or unsuitable to be involved in, or (through the private party) connected with, the delivery of a *Partnerships Victoria* project, and in so being may harm the project or bring it into disrepute.

The typical tasks performed by the SPV in preparing a project bid and negotiating a project, include:

- establishing the project vehicle structure with reference to the most efficient tax, accounting and risk parameters;
- identifying and recruiting parties that best complement each other's skills and resources and at the same time provide innovation, efficiency and strong competitiveness;
- satisfying the necessary legal requirements for the project;
- bearing tender costs, which may be substantial with a high risk of not being recouped;
- marketing the relative strength of the consortium;
- satisfying probity requirements;
- providing adequate project documentation;
- arranging finance for the project; and
- coordinating and preparing a bid strategy and submissions for Expression of Interest and the Project Brief stages.

Upon contract execution, the SPV becomes the 'vital centre' of the project, coordinating and overseeing the work of the sub-contractors, providing the formal liaison with government over contractual issues, and ensuring that the financiers receive their revenue returns. Incompetence or a lack of probity in the SPV is therefore a key risk for all parties, one which all parties have an interest in managing. Both the project financiers and government will scrutinise the SPV, lifting the corporate veil to ascertain which persons or companies have controlling interests in it.

As alluded to above, SPVs are likely to have little substance, particularly during a bidding phase. This is not necessarily a negative as long as:

- it is relatively clear that equity providers and financiers are in place, understand the project and, given the stage of the project, have demonstrated an acceptable level of commitment; and
- the sub-contractors nominated by the SPV to perform key aspects of the project have the requisite level of skill, expertise and financial capacity to perform their role in the project.

10.3 Mitigating sponsor risk

Sponsor risk is essentially a risk which falls on government as a result of contracting with the private party. Obviously, this is a risk which cannot be implicitly allocated to the private party by the structure of a *Partnerships Victoria* project. Accordingly, it is imperative that government take thorough and extensive steps to mitigate this risk.

The following are some traditional mechanisms for mitigating sponsor risk, which government may use when entering *Partnerships Victoria* contracts to protect itself against what could be very severe consequences if a sponsor risk was to materialise.

Parent guarantees and performance bonds

If, after financial close, the private party is not expected to be significantly capitalised, government should generally seek security either in the form of guarantees from the sponsors or from the private party’s parent companies where they differ from the sponsors (parent guarantees) or performance bonds, to ensure that the private party is fully committed to delivering the required outputs. These are particularly significant in the operational phase when construction guarantees under the construction sub-contracts are no longer in place and the sponsor may seek to walk away from the contract rather than address operational difficulties — leaving the SPV to be liquidated in circumstances where it lacks the resources to compensate government for the contract breach.

However, a requirement for parent guarantees may be an inefficient method of providing security to government. Depending on the nature of the guarantee and the accounting practices of the party providing it, a parent guarantee may have a balance sheet cost which will be passed through to government in the form of a premium (particularly where the guarantee is open ended).

In many circumstances, it may be more efficient to use performance bonds. Performance bonds are transparent from a pricing perspective, and also may be preferred from a project management point of view because they are much easier to enforce than a parent guarantee. An unlimited parent guarantee is also inconsistent with the preference of many project sponsors for infrastructure projects to be of a non-recourse or limited recourse nature.

The need for sponsor guarantees or performance bonds also depends in part on the nature of the project. Where the contract is for accommodation services from which government will deliver core services, there may be less need to secure operational performance. The reason for this is that the foundation of the accommodation services is the completed facility and the abatement regime will mitigate government's losses from underservicing. Where project assets will transfer back to government at the end of the contract term, there may be less need for sponsor guarantees or performance bonds where the asset is valuable to government than where the project assets have minimal or no residual value for government, e.g. information technology services.

Where government does require a parent guarantee or performance bond, it must ensure that it continues to receive value for money. One way of doing this is to keep the cost of the guarantees/bonds down by ensuring the amount of the guarantees/bonds is at the minimum required to cover necessary costs (such as the cost of installing a new operator).

Change in ownership provisions

As previously noted, the financial involvement of a sponsor in the SPV may be relatively short-lived. A sponsor's equity capital is likely to require a higher rate of return than an investment in a typically lower risk *Partnerships Victoria* project will yield (particularly post-commissioning). It is thus highly likely that a sponsor will convert at least a part of its equity capital once the higher risk development phase is completed.

A sponsor seeks to avoid any restriction on the parties to whom it may be able to sell its interests in the SPV, because such restrictions mean a fall in the value of its asset. It also attempts to preserve flexibility for its equity-holders to transfer their investments and create capital for other projects.

Notwithstanding the sponsors’ position, government needs to ensure that it retains an appropriate level of control over any changes to the ownership of the private party, in order to mitigate sponsor risk.

A change in ownership is of particular concern to government if:

- the transferee (new owner) does not meet probity requirements;
- the transferee is inappropriate or unsuitable in the context of the particular project for public interest or security reasons;
- the transferee is not of strong financial capacity; or
- the transferor (previous owner) has unique qualities and was approved by government because of these qualities.

Government-preferred position

As a general rule, government does not seek to obstruct changes in ownership, but nevertheless requires the opportunity to minimise the risk of sponsor unsuitability. The *Partnerships Victoria* contract should therefore include guidance on the types of parties acceptable as transferees (in terms of credit ratings and proven expertise) and should require government consent to any ownership change, with consent not to be unreasonably withheld.

It is important that controls on the transfer of equity be imposed on the basis of different considerations to controls on changes to the parties performing the services.

Changes in passive equity ownership should only be restricted in exceptional circumstances, such as when security or probity issues arise as a result of substantial control by the passive equity owner. Sponsors and equity owners should clearly understand that changes in ownership (whether passive or otherwise) may be subject to probity requirements, and that unsatisfactory outcomes to probity enquiries would constitute a reasonable basis for government to withhold consent to a change of ownership.

Equity transfers may be of particular concern where a party within the consortium has not fulfilled key obligations under its sub-contract — such as where the change affects the construction sub-contractor and construction is incomplete. In this circumstance, the transferor should provide security (such as a letter of credit) to underwrite the outstanding obligations, and the intended transferee should expressly agree to assume those obligations on terms which closely parallel those in the sub-contract.

In appropriate cases, it may be a desirable feature of a *Partnerships Victoria* project for parties with a long-term interest in the project, including major sub-contractors such as the operator, to be required to hold an equity interest in the private party (and therefore an ownership interest in the project). Where this is the case, and it was assessed as an important factor during bid assessment, government consent would be required for any sale or transfer of that equity interest.

It is recognised that imposing restrictions on the transfer of equity (in whatever form) comes at a cost. The benefits from imposing restrictions must justify their cost, to ensure value for money is maintained.

Other mitigating options

A variety of techniques is used to mitigate sponsor risk. The techniques may vary from project to project. For example, probity tests may be different for parties involved in the delivery of prison accommodation services than for a party involved in the delivery of, say, facilities for a waste water treatment plant.

The techniques used include:

- ongoing tests of probity;
- ongoing tests of capability; and
- ongoing financial requirements such as providing a topped-up letter of credit or performance bonds to meet claims or to underpin operational performance obligations.

Many *Partnership Victoria* projects also seek to mitigate the risk of SPV or sponsor failure by providing that government may step in to ensure delivery of the contracted service as a last resort. (See Chapter 25.)

10.4 Financial risk

Definition

Financial risk **refers to the following risks:**

(a) the risk that the financiers (debt and equity) will not provide or continue to provide funding to the project (risk of financial uncertainty);

(b) the risk that financial parameters will change prior to the private party fully committing to the project, potentially adversely affecting price (financial parameter risk); and

(c) the risk that the financial structure is not sufficiently robust to provide fair returns to debt and equity over the life of the project (and hence calls into question the continuing viability of the project) (risk of robustness of financial structure).

Each of these is discussed in detail below.

10.5 Risk of financial uncertainty: government-preferred position

Fully-funded bids

As far as possible, providers of debt and equity should be fully committed at bid stage, although not at Expression of Interest stage. For debt, this is unlikely to take the form of fully detailed financing documents, but rather a firm credit approval or a term sheet signed by authorised officers with clearly defined conditions which government can assess and evaluate. The financiers are required to acknowledge their offer and the fact that government is relying on it in considering the bid, so that any resiling from the offer (where the conditions precedent have been met) will be equivalent to the financier resiling from an offer to government. A bid supported in this way is considered to be a ‘fully funded bid’, although the funding is not strictly cashed up.

Under the Private Finance Initiative in the United Kingdom, where certain project types are well established within a known market for debt and/or equity and where there has been a relatively smaller degree of risk allocation to the private party, the UK government has been prepared to rely on the depth of the market to accept bids, without any need for the bids to be fully funded. Because there is confidence that the risk allocation will be eminently bankable, the expectation is that the successful bidder will subsequently obtain competitive bids to finance the project. Currently, this approach is not suitable in Australian conditions.

All bids for *Partnerships Victoria* projects from shortlisted parties in response to a Project Brief are to be fully-funded. Fully funded bids give government comfort that the proposal submitted by the bidder is financeable. They also limit the scope for the preferred bidder's financiers to delay project commencement by reopening the range of issues for negotiation after the preferred bidder has been selected.

It is important to ensure any conditions precedent in a term sheet are such that they can be satisfied by the project bidder without difficulty.

Where debt and/or equity instruments are to be sold into the capital markets, it is appropriate for a capable and reputable institution to underwrite the funds to be raised.

A bond or other financial commitment may be sought as security that financial close does in fact take place. However, this is expensive for the private party and may discourage bids, as well as increase their pricing.

Taxation rulings

Another issue which often causes difficulty is the requirement of many debt and equity providers for a binding tax ruling as to the tax effectiveness of the structure adopted for project delivery, before providing debt and equity. The Australian Tax Office (ATO) will not provide a binding tax ruling until final executed documents are provided to it. This too creates a measure of uncertainty.

This risk can be partially addressed by government ensuring that any structure is not taxation aggressive and by requiring bidders to obtain a preliminary non-binding taxation ruling from the ATO. Where this occurs, it is important for government to clearly specify the content of the tax ruling being sought. It is noted, however, that the system of taxation rulings is under review. Ultimately, tax risk is taken by the private party.

10.6 Financial parameter risk: government-preferred position

Between the time of making a bid and financial close, many of the financial parameters on which the bid is based may change. The most significant risk is that interest rates may change during that period.

It may be argued that these risks — which are both external to the project and the project sponsors and arise from timing issues — are only able to be borne by government by, for example, permitting flexibility in pricing before financial close. Typically, projects have recognised these issues in various ways, usually by government and the project bidders sharing the risk to some extent, though the greater part of the risk is generally accepted by government. For example, in major projects with a large debt component in the financing structure, interest rate hedging contracts may be entered into by the State prior to financial close. These may be novated to the private party on financial close in consultation with the private party to ensure an appropriate hedging profile for the level and term of debt proposed. These risks may ultimately be more conveniently dealt with under a project development agreement as described in Chapter 8. This allows commitments which may benefit the project overall to be entered into before financial close and provides for a sharing of the risks associated with these commitments.

It permits the private party to commit to a specific pricing regime before signing the project agreements.

The allocation of financial parameter risk depends on the circumstance of each project, but is ultimately driven by value for money considerations, i.e. which party is best positioned to take the risk at least cost. It is relevant that both parties are in a position to influence the timing of financial close. For this reason, sharing this risk is often more appropriate.

10.7 Risk of robustness of financial structure: government-preferred position

Experience has shown that if the partnership does not work financially for the private party — where, for example, the private party has materially underpriced its bid to win the project — it is unlikely that the project will operate satisfactorily for government. Where a private party drives a bad bargain for itself, which it may do when under intense competitive pressure or under internal pressure because of the loss of other contracts, the project sets off on a wrong trajectory which is likely to result in continuing difficulty, if not commercial disaster.

It is important that government reads the signals which bids transmit and as far as possible undertakes a reality check, so that a significant under-bid is not automatically accepted. One of the danger signals may be where the sponsor is dependent on a refinancing at more favourable rates to make the contract commercially viable in the longer term. While ordinarily this may be possible where the project enters a lower risk phase, if a risk materialises and risk is assessed as remaining at comparatively high levels, the private party may find itself in an untenable commercial situation, prompting a desire to default and walk away. Despite the perception among some private sector parties that government benefits from step-in and termination, this outcome is not consistent with the *Partnerships Victoria* philosophy which sees value for government in private sector service delivery and in maintaining a sustainable, productive partnership.

10.8 Mitigation

Government should seek to mitigate sponsor and financial risk by ensuring that only reputable and capable parties are part of shortlisted bidding groups. Government should also seek to ensure that it does not simply choose the lowest cost bid, but the bid with a financially robust structure, and which is likely to earn appropriate returns from the project while achieving value for money for government.

As mentioned earlier, any conditions precedent in letters of support from project financiers should be limited as much as possible and readily capable of fulfilment, to restrict the risk that the expected cash funding will not eventuate.

Government’s concern for the private party’s ability to deliver the contracted services is shared by the financiers. To mitigate their own risk, debt and equity providers typically need to ensure a robust and financially attractive structure with a clear pass-through of contractual obligations to contracted parties capable of complying with them. Debt financiers often take security by assignment of the SPV's rights under the project contract, collateral warranties or guarantees from equity holders or sub-contractors. This relationship between financiers and the private party provides some comfort to government that the private party has incentives to deliver the contracted services.

However, government may request additional, more direct forms of comfort from the private party (and in turn from the sub-contractors), including guarantees (such as parent guarantees), indemnities and provisions for contractual damages claims.

In summary, the steps to mitigate the risk have a number of common themes:

- contractual and financial commitment certainty;
- strength of commitments by the project sponsor(s);
- the capability and reputation of the project sponsor(s), other contracting parties and the providers of debt and equity;
- the robustness of the financial case or model on which the private party has based its participation in the project;
- government acceptance of appropriate risk in the bidding, establishment and operational phases of the project, where it is best placed to assess and manage the risk (interest rate risk between submission of final bids and financial close may fall into this category);
- government consideration of the consequences of failure to perform by any part of the private party consortium and agreement on appropriate rights. This may include a government right to take over some or all of the contracts the private party may have entered into; and
- government establishment of a structure which helps ensure that, over the course of the project, the sponsors are of appropriate stature and the key sub-contractors remain well capable.

10.9 Upside benefits of refinancing

Whether government is entitled to share in the benefits of a refinancing which results in cost savings is a matter of some debate.[16] As an example, because a large component of risk is removed once the project moves from construction to operation, projects may be refinanced to obtain cheaper funding reflecting the reduced risk profile. If this does not result in any adjustment in the service charge paid by government, 'the refinancing may have the effect of creating incremental profitability in which the awarding authority does not share'.[17]

The benefits of refinancing may be shared once the rate of return to the private party reaches an agreed level. Government may share in the benefits by way of reduced service charges.

Government's general position is that, except as discussed below and even though its consent is required before any refinancing by the private party can proceed, it does not seek to share in benefits arising from a refinancing. Government assumes that, in putting up its most competitive bid, the private party has already passed to government any savings it thinks it will derive from

[16] *See* Jason Fox and Nicholas Tott, *The PFI Handbook*, Jordans, Bristol UK, 1999, pp. 141-2, p. 311.

[17] ibid., p. 311.

refinancing, in which case requiring a subsequent share in the benefits of refinancing would amount to double dipping by government.

Exceptions to the general principle that government will not seek to share in the benefits of cheaper finance during the project term, are:

- where lower margins are available because the finance markets have re-rated the risk of a particular type of project asset because a number of similar projects have been undertaken by government in the intervening period; or

- where a benchmark rate has been fixed (as a cost to the project) and floating rates have subsequently fallen so that, even after paying break costs, there is a cost saving to the private party in refinancing.

In each of these exceptions, government should share in any windfall gain to the private party as a result of the refinancing, in accordance with and to the extent of an agreed pre-determined formula which is documented in the contract. It may be appropriate to set a date beyond which any refinancing would not give rise to government sharing any benefits.

However, where the private party takes interest rate risk during construction and margins fall on refinancing after completion, government does not seek to share in the consequent cost saving.

Whether or not government seeks to share in any benefits arising from a refinancing, it does require its costs for assessing (and where appropriate, approving) a refinancing proposal to be met by the private party.

11 Operating risk

11.1 Introduction

The consequences of operating risk are that the costs of operating the facility will exceed projections and therefore diminish projected returns and/or that the facility will not perform to the required standards.

Operating risks typically relate to production and operation, availability and quality of inputs, quality and efficiency of management (including contract management) and operation, maintenance and upgrade requirements.

Operating risk is one of the key risks allocated to the private party by the structure of a *Partnerships Victoria* arrangement under which the responsibility for the delivery of the contracted services to specification lies with the private party (see Section 4.1). Government frees itself from the operating risk that would attach to it if it were to own and operate the facility. As will be seen later in this chapter, this 'starting risk' position needs to be adjusted to deal with interface issues which may arise in some types of core services projects and to take account of the impact of various government directives.

Further, while government is freed from traditional operating risks in a *Partnerships Victoria* arrangement, operational failure still poses a risk to government in that it may be left without the services for which it has contracted. If the contract is breached and the private party is not highly capitalised, the sponsor(s) may seek to walk away, limiting government's ability to obtain redress. For this reason, guarantees from the sponsors or the private party's parent companies (where they differ from the sponsors), or performance bonds may be required to cover performance obligations in the operational phase of the contract. (The issues involved in imposing a requirement for operating guarantees are discussed in the context of sponsor and financial risk in Section 10.3.) If the contract is correctly structured and the sponsors have invested a large amount of capital, the low risk of them walking away may not warrant the cost to government of requiring operating guarantees.

11.2 Definition

> **Operating risk** is the risk that the process for delivering the contracted services — or an element of that process (including the inputs used within or as part of that process) — will be affected in a way which prevents the private party from delivering the contracted services according to the agreed specifications and/or within the projected costs.

By definition, it applies only to the operational phase of the project. Possible sources of operating risk are:

- operating costs may vary from original budgeted projections due to:
  - higher production costs
  - higher input costs
  - reduced input quality

  - unsuitable design
  - reduced equipment reliability
  - higher maintenance costs
  - occupational health and safety issues
  - unplanned equipment/plant upgrades
  - inherent defects
  - technical obsolescence
- performance standards may deteriorate below project specifications or may not be maintained due to:
  - reduced input quality
  - unsuitable design
  - reduced equipment reliability
  - inherent defects
  - force majeure events

Inflation risk has not been included in this list on the basis that inflation forms part of market risk. It is discussed in that context in Chapter 12.

11.3 Allocating operating risk: government-preferred position

Government should seek to retain as little operational control over, and responsibility for, the delivery of the contracted services as possible. This ensures that the operational risk (for the delivery of the contracted services) remains with the private party and is not inadvertently taken back by government.

Complete removal of direct government involvement in operational matters may not always be possible. Government may be bound, as a matter of policy, statutory obligation or practical necessity, to ensure that certain operational criteria are met. For example, it may be bound as the owner of the land on which the facility is located to prevent pollution or contamination, or may have to insist on certain operational characteristics of a rail facility to achieve compatibility with the State-owned feeder network. It may even have obligations to inspect and enforce conditions of operation. This kind of government intervention, which may impact on the ultimate allocation of operating risk in particular projects, is dealt with in further detail below.

Government intervention

Government intervention may take various forms, including changes in regulatory requirements, general change in law or policy, and government-initiated changes to output specifications. These are often defined collectively in the contract as 'changes in policy'. (Risk allocation in respect of changes in policy is discussed as part of Chapter 15, Legislative and government policy risk.)

Such intervention during the operational phase differs from the specification of particular modes of service delivery in the service specifications, upon which the private party bids. In that circumstance, the risks associated with the required mode of service delivery are assumed by the private party as part of its bid price (unless otherwise provided in the contract).

Having said that, however, government should take care not to be overly prescriptive in its service specifications (i.e. the method of operational delivery for which bidders will bid), except where regulatory or policy requirements dictate otherwise. There are two reasons for this. First, since the private party bears the operating risk of such requirements, the private party should generally retain sufficient flexibility to enable it to manage that risk consistently with its bid. Second, it reduces the risk of government unintentionally taking back operating/design risk it thought it had successfully allocated to the private party. In the limited circumstances where it is necessary for government to prescribe elements of how the services are to be delivered, the risk implications need to be carefully considered, as discussed in Section 5.2.

If government intervenes during the operational phase causing the operating costs to increase, optimal risk allocation principles would require government to share such increased costs if the contract terms prevent the private party from reconfiguring its process for delivering the services, or its business operation generally, so as to maintain its returns. The costs may be shared by adjusting the service charges accordingly or by increasing the term of the contract in a way which allows the private party to achieve its anticipated returns. The Prospect Water Treatment Plant agreement, for example, allocates the cost of implementing government-initiated changes to water quality requirements to Sydney Water (the government party) by allowing it to adjust tariffs to take account of such costs.

In addition or alternatively, the parties may agree that where the private party fails to comply with specified service obligations because of a government directive or other government intervention, service charges will not be abated. Under the Prospect Water Treatment Plant agreement, Sydney Water can direct the private party to vary the levels of various chemicals, but if the water quality criteria are breached as a result, the service charges payable by Sydney Water will not be abated.

Government providing core services within a private facility

If part of the contract is for the provision of accommodation services from which government itself will deliver a core service (as, for example, in the case of the Victorian County Court), government bears the operating risk of the core service, except to the extent that operational deficiencies arise because the facility is unfit for purpose and/or because the private party fails to deliver (or delivers deficient) ancillary services on which the core services rely.

Government also bears the risk that the provision of core services will impact adversely on the private party's ability to deliver the contracted services. In the event that such a risk materialises, government will be prevented from abating the relevant service charge.

Some sharing of risk associated with energy use may be appropriate under an accommodation-based project, where the government is providing core services out of a privately operated facility.

Government inputs

Where government provides the raw materials to be processed by the new infrastructure — for example, raw water in the case of a water treatment plant — government may agree to bear the additional costs of production when the quality of its inputs varies from agreed standards.

In the case of the Prospect Water Treatment Plant, for example, Sydney Water is responsible for providing raw water to the plant and for extra costs if raw water turbidity is outside a specified range.

11.4 Allocating operating risk: issues for government

Importance of correctly specifying service standards

It is critical to the implicit allocation of operating risk to the private party that the performance standards are clearly specified in the contract and that an appropriate payment regime (including payment abatement for non-delivery) is established. The private party's liability to meet the agreed performance standards at the agreed price is integral to value for money under *Partnerships Victoria*.

If service standards are ambiguous or inadequate to meet government objectives, government may effectively be locked in to paying for a deficient product over the long contract term unless it renegotiates with the private party to achieve the necessary changes. Failure to renegotiate will mean that government has not, in reality, allocated operating risk to the private party but must bear the realised risk of sub-optimal performance in relation to its declared objectives. Even where renegotiation occurs and succeeds, additional costs are likely to be incurred.

(These issues are raised in Chapter 5 and are discussed in detail in Chapter 22 which deals with payment structures, abatement and other performance incentives.)

Continuity of core service delivery

A key operational risk for government, in delivering core services from private infrastructure facilities, is that core services will be frustrated or compromised by some aspect of the private party's delivery, or non-delivery, of the contracted services. To help ensure continuity of core services, government must have appropriate access to the private facility at all times during the contract period and must be able to depend on those privately-provided services which are essential in underpinning the core service.

The risk of core service delivery being frustrated or compromised by the activities of the private party is within the control of the private party, which must bear it. At the lower end of the spectrum, this can be achieved though abatement or non-payment of the service charge and other forms of financial compensation. If disruption is prolonged or the effect on core services severe, government step-in (and eventually termination) should occur to maintain the continuity of its core services. Costs of operation during step-in should be reimbursed to government. (Step-in is discussed in detail in Chapter 25.)

11.5 Mitigation options

To avoid ambiguous operational outcomes, service standards should be drafted with clear outputs which can be objectively identified and measured. It helps to engage in a consultative process with the preferred bidder when detailed contractual specifications are being developed. During this process, government should be given the opportunity to comment on the preferred bidder's service delivery plan, provided that government does not put itself in the position of approving a plan and thereby assuming the risk it intends to allocate to the private party. (There is a fuller discussion of these issues in Chapter 9, Design, construction and commissioning risk.)

Given the term of the contract, the service standards should take account not only of government's present service delivery needs, but also, where practical, future service demands. However, as forecasting future service delivery may be a difficult process, there may also need to be a mechanism for government to request changes to service standards during the contract term, or for the private party to propose changes. (These are discussed in Changes in service specification, Chapter 21.)

As a corollary, and as appropriate, the technology involved in service delivery should be state of the art with options for upgrading as the contract term proceeds. This enables the private party to adopt new and more cost-effective operating processes while mitigating the extra costs of an upgrade, and will facilitate continued service delivery to the requisite standard (including adjusted standards). In the interests of operational efficiency, and as appropriate, it is important to incentivise the private party to incorporate the latest technology at the outset of the project by allocating to it the risk of technological upgrade and obsolescence. This is easier to achieve if, as is generally the case in *Partnerships Victoria* projects, the designer/builder and the operator are the same party, or the party which has ultimate liability to government for design and operation is the same. In these circumstances, the private party has a vested interest in ensuring the design allows for the most efficient/cheapest operating outcome.

If government shares part of the operational risk, because of its intervention or because of the potential impacts of its own core services on the private party's contracted service, the nature and extent of the risk should be clearly identified and quantified. There should be consultation with the private party on the difficulties that may arise at the interface between government-provided services and those provided by private parties with agreement to forewarn the other party of any proposed operational change and to consult as to its impact. (These matters are addressed more fully in the context of Network and interface risk, Chapter 13.)

To protect government's interest in service continuity, and to compensate it if the sponsor seeks to walk away from the contract rather than rectify operational deficiencies, operating guarantees or performance bonds from the sponsor or the private party’s parent companies (where they differ from the sponsors) may be required. As stated elsewhere in this guide, government recognises that requiring guarantees or bonds comes at a cost. Accordingly, government must ensure that it continues to receive value for money where it requires security in the form of bonds or guarantees.

12 Market risk

12.1 Introduction

Market risk is the risk that the demand or price for a service will vary from forecast levels, generating less revenue from users than expected. Issues affecting market risk are closely linked to those affecting operating risk. Market risk arises in the operating phase of the project when the contracted services are offered to the end-user, which may be government (for example, in the case of a hospital or education accommodation project), government on behalf of consumers (for example, water treatment plants), or the public directly (as in the case of a road). Wherever payment for service is volume-based and thus depends on the level of usage, the project is exposed to market forces and their accompanying risks.

The extent to which market risk is allocated to a private party under a *Partnerships Victoria* project depends on the value for money question. However, government's strong preference is to consider the opportunity for allocating market risk to the private party in a way which improves value for money, even where government itself is the service consumer and is delivering core services from privately provided and serviced accommodation. In the County Court project, demand risk for courtrooms — over and above the minimum of 8 400 courtroom days per annum committed to by government — is taken by the private party. In that project, third-party usage is also permitted (subject to the Department of Justice's right of first refusal of the services), to give the private party the opportunity to maximise demand for its accommodation services. Additional floors not presently used for court purposes may be fitted out for a range of third-party uses specified in the contract.

The payment structure of a *Partnerships Victoria* arrangement should be used to maximise the allocation of demand risk to the private party where this can improve value for money. As was done in the County Court example, the private party should also be encouraged to generate revenues from the facility independently of the revenues it earns from government through third-party usage of services (including accommodation services) not required by government.

12.2 Definition

Market risk is the risk that:

(a) *demand* for a service will vary from that initially projected; or

(b) *price* for a service will vary from that initially projected,

so that the total revenue derived from the project over the project term varies from initial expectations.

Private businesses and government are exposed to various levels of market risk in delivering services. Events which may result in the materialisation of market risk are shown in Table 12.1. Each of these events may have demand or price consequences, or both.

Table 12.1 Events with potential for market risk materialisation

Event	Example
General economic downturn	Reduction in commercial activity reducing demand for a *Partnerships Victoria* road
Change in government policy	Change in government crime policies impacting on demand for prison accommodation and/or judicial functions
Competing substitute products or introduction of new competitors	Alternate transport options (alternative highways or public transport) competing for traffic with a *Partnerships Victoria* road
Competitive pricing for alternate services	A *Partnerships Victoria* car park project attached to a hospital competing with external car parking options
Change in target market composition or demographics	An ageing population or increase in population above expectations increasing demand for healthcare services
Technical obsolescence or innovation	Demand for *Partnerships Victoria* services declining if competing service options adopt the latest technology and innovation, unless the project's services are upgraded to keep pace with technological advancement
Shift in industry activity/focus	Reduction or transfer of economic activity from a particular geographic region, marooning *Partnerships Victoria* infrastructure (such as a port terminal project)

12.3 Allocating demand risk: issues for government

Demand or volume risk relates to the variability in demand for a project's services from the forecast levels on which revenue expectations are based. Even in the case of a project with monopolistic characteristics (such as a water treatment facility) where competitive pressures are not a major consideration, demand for the service may still vary owing to volume factors affecting that industry.

The project specifications issued by government during the initial project tender stage should outline required service volumes based on well-developed demand projections. The capital and operating costs of meeting those and other requirements, such as potential third-party demand, are factored into the bid and form the basis on which the private party determines whether the project is a viable investment.

As indicated above, *Partnerships Victoria* projects should be scoped where possible to service additional demand, both from government (if there is elasticity in the government market) and from third parties using the facility services in ways that may differ from, but are compatible with, government usage.

12.4 Allocating demand risk: government-preferred position

The degree of the private party's exposure to lower returns through lower than expected demand depends on the extent to which the project as a whole is market-exposed — i.e. whether government has contracted to pay for a specified quantity of the service (based on availability or capacity), or whether the payment mechanism relies wholly on usage. Where the private party has little or no control over the level of service demand, it is not optimal to structure the payments to include a significant usage component. However, wherever possible, there should be a volume component with some volume risk being borne by the private party.

Under *Partnerships Victoria*, the primary market for the contracted services takes one of three forms:

- public buys services directly (direct market exposure);
- government receives services on behalf of consumers (intermediated demand); and
- government receives services for itself, which it then may provide to the public or use in the provision of core services (government demand).

The first of these is a straightforward user-pays situation where revenues depend on usage. It is extremely market-sensitive and may require government to take measures designed to lessen the chance that rival government-subsidised services will reduce usage of the contracted services materially below projected levels, jeopardising the viability of the project. While such measures may encourage demand for the contracted services, they do not guarantee it. Accordingly, in this scenario the private party remains fully exposed to demand risk.

Demand risk can be fully allocated to the private party even where a government subsidy is involved, for instance, in the case of a rail project where a government subsidy is required to make it commercially viable. The government subsidy should be a bid element, set before the contract is signed. In such cases, the private party fully bears all fluctuations in patronage revenue and is therefore fully exposed to demand risk.

The second model is market-sensitive to the extent that government pays for the level of public consumption of the contacted services. For example, government may pay 'shadow tolls' which reward the private party according to the level of consumption of its services, or pay for treated water according to the quantity demanded by its end-consumers. However, the fact that payment is 'intermediated' through government may result in government structuring the project, and more specifically, the payment structure, in a way that allows it to achieve policy objectives beyond (or even at odds with) simply maximising usage of the contracted services. Where this is the case, it is likely that service charges will include payments for capacity or availability which buffer the effects of demand volatility. Nevertheless, to the extent that there is a usage component in the service charge, the private party bears that level of demand risk.

The third model applies where government receives the contracted services on its own behalf — for example, accommodation services from which to deliver core hospital or correctional services. In this model, demand may well be sourced exclusively within government (although, in the case of accommodation services in particular, the facility should be structured to be able to service other demand in conjunction with government demand). Where government is the sole (or major) source of demand, there is pressure for it to underwrite demand risk by committing to a minimum quantity of services per annum or to undertake not to create or use similar facilities within the project region. Such measures, if implemented, lessen the private party's exposure to demand risk (particularly if a minimum consumption is specified). Government, in these circumstances, generally shares the demand risk. However, setting the minimum below the level of optimal government usage and the level of usage required to achieve the desired project returns, may also help maximise value for money by ensuring that the private party retains a continuing incentive to optimise usage.

The level of demand government agrees to commit to in this model depends on the dynamics of the particular project, i.e. the projected level of government demand and the level of demand required by the private party to achieve its required returns; the opportunities available for third-party use; and the level of projected third-party use. In each instance however, the underlying objective for government in considering what level of demand to commit to and what level of demand risk the private party is to be exposed to, should be to maximise value for money. A rigorous assessment of the value of allocating the demand risk to the private party should be undertaken.

12.5 Demand risk: mitigation options

Where the private party is required to accept demand risk, quantifying demand is critical. During the bidding process, providing as much information as possible on levels of demand helps provide certainty to bidders and is likely to increase the competitiveness of bids. Demand forecasting should be developed using scenario and sensitivity analysis on significant demand drivers, to promote accuracy. Where the private party is fully exposed to demand risk (as may be the case for a *Partnerships Victoria* road), government may agree to implement measures as discussed in Section 12.3 to stimulate use by consumers (such as traffic management measures) or to provide redress to the private party if government acts to increase competition to the project by, for example, subsidising alternative public services. (The very complex considerations involved in such government undertakings are set out in the discussion on Network and interface risk in Chapter 13.)

Where services are received by government only, so that the demand risk to the private party is in government hands, it may give the private party a level of comfort if government enters into exclusive concession arrangements granting the private party an exclusive geographic right to provide the contracted services for a specified period of time up to the length of the project period. Potential losses to the private party due to increased competition to the contracted services would need to be justified in light of the gains achieved through reductions in service costs.

However, it is important that *Partnerships Victoria* projects do not assume too monopolistic a character and that, as discussed above, the private party is exposed to an appropriate quantum of demand risk, even where government is the sole off-taker. The measures above should be adopted with caution and undertakings by government should be limited to the minimum necessary to underpin project viability and optimise value for money.

Government should also take care not to over-estimate its own demand for services, when paying for services on an availability basis and/or contracting to pay for a specified (minimum) level of usage. Overestimating will in effect result in government paying to insulate the private party from demand risk and jeopardising its own value for money.

12.6 Price risk

Price risk is the risk of volatility in the price of the contracted services over the life of the project. As far as practicable, the pricing mechanism should encourage the private party to bear real increases in project costs and allow it to retain any cost savings arising from decreases in project costs. Avoiding full pass-through of cost savings encourages innovation and should deliver cost savings to government through lower service charges. A key method of allocating price risk to the private party is for government to fix the service charge payable by it for the contract term, subject to indexation adjustments as appropriate.

Indexation

If the service charge is set for the project term, the private party typically seeks to protect itself against the effects of inflation through appropriate adjustments to the service charge. To achieve this, the service charge agreed with government is usually indexed over the project term. This could be at a full or partial — e.g. CPI-x — indexation rate. If indexation is not incorporated into the pricing mechanism, the private party tends to build contingencies into its initial bid to cover inflation risk. Owing to uncertainties in forecasting future inflation rates, this approach does not generally yield a value for money outcome for government. For this reason, an indexation mechanism is preferred.

The type of indices to be applied should be clearly agreed and specified in the project documents and be capable of objective observation. Allowing competing bidders to propose alternate indices generates difficulties in comparing competing bids.

The indices may be nationally based, based on a specific region or an appropriate industry sector (for example, a construction index). Government should consider the most appropriate index to apply and the proportion of the service charge which is to be subject to indexation. In practice, different cost components of the service charge may be subject to different indices — for example, average weekly earnings for the wages component and a chemicals index for chemical inputs. Choosing an index which is not independently published, has a narrow focus or has a short life span, may produce complications.

The extent of the service charge subject to indexation should reflect the underlying cost exposure of the private party, but may be structured to promote real costs savings which can be shared with government.

Unforeseen price variations, benchmarking and market testing

For some projects, it may also be appropriate to establish price variation mechanisms to address unforeseen changes in operating costs. Price variation mechanisms may involve formal periodic benchmarking or market testing exercises to test the private party's cost structure. While, in theory, benchmarking and market testing assist in maintaining value for money, government recognises that sometimes they are difficult to undertake in practice.

Benchmarking is the process by which the private party compares its own costs (which may include payments made to a sub-contractor) against the market costs of the contracted services. If the costs differ significantly from those charged by the market, a variation of the service charge may be proposed under an agreed benefit/cost sharing mechanism.

Market testing is the periodic re-tendering in the market by the private party to test the value for money of the sub-contracted service. Usually only ‘soft’ services are subject to market testing. Soft services do not involve a significant outlay of capital, for example, information technology, cleaning and security services. Where market testing of sub-contracted services results in the replacement of a sub-contractor, this should be reflected in a price adjustment. Market testing is likely to be more disruptive to a private party than benchmarking, as it may involve replacing a sub-contractor.

Benchmarking or market testing of parts of the services may be particularly valuable when applied to facilities management services.

A proper benchmarking and market testing mechanism should:

- incorporate a regular timetable for conducting benchmarking or market testing (say every three to five years);
- ensure the market cost comparison only incorporates the services being benchmarked;
- ensure the market services share a similar risk profile to the contracted services;
- determine whether it is more appropriate to benchmark services collectively or individually; and
- ensure the reliability of the benchmark material.

12.7 Price risk: mitigation options

As discussed, indexation provides some price protection for the private party by maintaining the adequacy of the service charge to meet the private party's operating and financial obligations.

From government's perspective, periodic benchmarking or market testing should ensure that the service charges under the contract do not become seriously out of kilter with the current state of the market. Alternatively, contracts for soft services like the ancillary services under the County Court contract may be awarded for a significantly shorter term (three years in the example given), so that they are effectively put to the market at regular (and comparatively short) intervals.

13 Network and interface risk

13.1 Introduction

Network and interface risk are distinguishable but have much in common. They relate to points of intersection between privately provided services and government-controlled networks or services. As these risks have unique characteristics for each project, there is a particular need for flexibility in applying the principles of risk allocation.

Network risk arises where the contracted services or method of delivery of those services are linked to, rely on or are otherwise affected by certain infrastructure, inputs and other services or methods of delivering the contracted services (collectively referred to as a network).

Interface risk arises where a private party (or parties) and government both provide services from within or in relation to the same infrastructure facility. This risk is especially pertinent to the *Partnerships Victoria* model where government delivers core services from within an infrastructure facility constructed, owned and otherwise operated by a private party (as in the County Court project). Clearly, co-extensive operation gives rise to issues concerning the impacts one service has on the provision of the other and the possible impacts of such a situation on risk allocation.

13.2 Definitions

Network risk is the risk that the network(s) needed for the private party to deliver the contracted services will be removed, not adequately maintained or otherwise changed — including being extended to include additional infrastructure or services not foreseen or anticipated at the date of the contract — in a way that either prevents or frustrates the delivery of the contracted services, affects the quality of the specified outputs or in some other way affects the viability of the project.

Interface risk is the risk that the method or standard of delivery of the contracted services will prevent or in some way frustrate the delivery of the core services or vice versa.

Examples of network risk are that new government-subsidised roads will draw custom from a *Partnerships Victoria* road project, or that a government agency controlling bulk water distribution may be unable or unwilling to supply raw water to a *Partnerships Victoria* water treatment facility in the necessary quantity or quality. A more abstract example of network risk is the risk that government will enter into other arrangements for accommodation services competing with those supplied under the contract.

An example of interface risk is that sub-standard ancillary service provision (such as sub-standard maintenance and/or cleaning in hospital wards) may prejudice government's ability to deliver its core hospital services. Conversely, the private party may face interface risk if changes in clinical practice favouring a high turnover in operations ties up operating theatres and impacts on the time available for cleaning services to be provided or on the amount of cleaning required, inhibiting the private party's ability to deliver the contracted services to specification or at their projected cost.

13.3 Different forms of network risk

Network risk can take various forms, but for the purposes of this guide, the discussion concentrates on the following two manifestations of this risk, the consequences of which are quite different:

- network risk of a complementary nature; and
- network risk of a competitive nature.

Network risk of a complementary nature

This is the risk that the network or part of the network which underpins or complements the provision of the contracted services will be removed, not maintained or otherwise changed so as to prevent or frustrate the private party's ability to deliver the contracted services. This includes issues relating to the private party's access to and from the relevant government controlled network. Where the private party relies on government inputs, this form of network risk includes risks relating to the availability and quality of the government inputs.

Network risk of a competitive nature

This is the risk that the existing network will be removed, developed or extended to include new systems or services or changed in some other way which, in each case, creates or increases competition with the contracted services, jeopardising project revenues. The issues arising from this type of network risk are closely related to demand risk and how that is allocated in the project.

Whether or not government bears network risk of a competitive nature is essentially a question of whether, and to what extent, government should give undertakings about the development of rival public services or facilities from which such services are to be delivered. Government clearly has the potential to mitigate the demand risk taken by the private party, but must weigh competing priorities in determining whether to do this.

13.4 Allocating network risk: issues for government

To the extent that government controls and manages the network from which the network risk may materialise, on optimal risk allocation principles it would seem appropriate for government to bear this element of the risk.

However, this approach fails to take account of government's competing responsibilities to manage public networks in the overall interests of its citizens and according to a range of statutory requirements which may not always be consistent with the needs of the private party. It also implies a monolithic view of the public sector, which is at odds with the diversity of government responsibilities, the various layers of government, and the variety and extent of government's commercial partnerships.

Further, in reality, all businesses suffer the risk that systems on which they rely will change to their disadvantage, and there is no reason in principle why the private party should not bear this risk as one ordinarily inherent in the business environment. This is particularly so if government itself is the service receiver, because the risk that government will act in a way that prejudices the quality or provision of the contracted services would be minimal in that instance.

The question for government practitioners is how far government can or should assume network risk by agreeing to manage the network it controls so as to increase demand and operational certainty for the private party. The answer involves balancing the desirability of having the private party deliver the contracted services successfully, against each of the factors set out in the two previous paragraphs.

13.5 Allocating network risk: government-preferred position

Network risk of a complementary nature

In a *Partnerships Victoria* project, where network risk of a complementary nature exists, government may in appropriate cases undertake that if it:

- removes, changes or fails to maintain the government network (including if it fails to maintain the quality of inputs), or
- acts in any other manner which impacts (whether directly or indirectly) on the network,

in a way which discriminates against the project, it will provide appropriate redress to the private party.

Depending on the circumstances and other competing obligations (if any) which government owes to the public, these undertakings may need to be limited.

Access element

For *Partnerships Victoria* projects to succeed, there must be *access* to and from the government networks necessary for the delivery of the contracted services. Government must secure appropriate access arrangements.

Where the private party does not have access to an existing government network necessary for providing the contracted services, the liability for connection to the network belongs to the private party. This is so whether access entails physical connection (in the case of a water treatment plant or a road project), or accreditation and entry into an administrative or IT system. In the latter example, government would need to set clear criteria for accreditation and entry into the particular system. The risks associated with maintaining the private party's connection to the network (in line with the access arrangements maintained by government) reside with the private party.

Inputs

To the extent that government is able to control the quality of inputs to be used by the private party for providing the contracted services, optimal risk allocation principles require government to assume the part of network risk that relates to the availability and quality of the inputs.

Where government is not entirely able to control the input availability and quality, but can do so better than the private party, government may agree to take or share the risk if this is in the public interest or would improve value for money.

In a raw water project, for example, government may take the risk that at the point where the government network delivers the raw water into privately operated water treatment plants, the water will have a turbidity outside certain specified standards. If the risk materialises, there may be an increased charge (to government) under the contract. Alternatively, the water may be processed to a lower output level, without financial penalty to the private party.

Network risk of a competitive nature

In *Partnerships Victoria* projects involving network risk of a competitive nature, government's preferred position is to undertake that, where it provides or subsidises competing public services which discriminate against the contracted services, it will (depending on the circumstances) provide appropriate redress to the private party.

Agreeing to reduce network competition can in fact be part of a broader government policy or government plan, pursued for the public benefit. For example, in a road project, government's agreed position in respect of network risk may be part of a wider plan to improve traffic management.

This type of risk is at its most pronounced where the project revenues depend on use, and government itself is not the ultimate consumer. The key is to ensure that 'network' is interpreted narrowly, so that only those things upon which the viability of the project *immediately* hinges are the subject of any assurances or undertakings and that, generally, those are limited to matters which would effectively frustrate the project if they were not as agreed.

Subject to competition policy and anti-competitive laws, government may enter into an exclusive service agreement with the private party. This sort of undertaking is more likely to be given for contracted services in regional areas.

An example of network risk arising in both forms (i.e. complementary and competitive) is a road project where government requires freedom to manage the public transport network. At the same time, however, the private party and its financiers require an underpinning for the project traffic projections, particularly where the project is to be financed on a non-recourse basis. In practice, the result may be a compromise in which government assumes network risk to the extent that it agrees to adopt common laws and policies across the transport system (so as not to discriminate against the relevant road); maintain connecting roads to the project road as it would for public freeways; adopt traffic management measures in the surrounding road network; and compensate the private party if the agreed traffic management measures are not implemented by a particular date or are later removed.

13.6 Allocating interface risk: issues for government

As noted elsewhere in this guide, the *Partnerships Victoria* model under which core services are delivered by government from within a privately built, operated and serviced infrastructure raises special issues concerning the interface between government and private party service delivery. Such interface risks are in fact new manifestations of conventional risks, but conceiving them as interface risks provides useful encouragement to think about the interaction and interdependency between the services provided *to* government and those provided *by* government, especially when the former determine the environment and capacity for delivering core government services.

In a *Partnerships Victoria* project involving interface risk, the parties should — irrespective of the underlying risk allocation position — acknowledge and agree that the provision of the contracted services needs to be integrated with the core services, and that the parties must develop, agree and implement an effective communications strategy. The strategy should be acceptable to both parties, to ensure that the objectives of the agreement are met. It should include an obligation to regularly review and plan the development, operation and provision of the contracted services and core services, having regard to the likely requirements of each party. This management tool, which is essentially a mitigant, is vital for ensuring the effective and timely delivery of the project.

13.7 Allocating interface risk: government-preferred position

Notwithstanding the recommendation that the parties work together to manage interface risks, the risks at the interface between the contracted services and government core services fall to the private party, except where the risk relates to the effect the core services have on the contracted services, in which case the risk falls on government.

Some particular manifestations of interface risk and how they can be dealt with in the contract are discussed below.

Suitability of the facility for core service delivery

In assuming design risk, the private party must ensure that the accommodation services being provided under the contract allow for the successful provision of core services. It is therefore just as important for government to identify and clearly specify its core services in the Project Brief and the project contract, as it is for it to clearly identify and specify the contracted services. This allows the private party to better identify the interface risks that it has been allocated. In a project for court accommodation services, for example, the private party will be obligated to provide court accommodation services which allow for the delivery of specified core services. Failure to comply should result in abatement of the service charge (and possibly a claim against the private party under an indemnity provision for any consequential losses).

Need for right of access to the facility

To ensure continuity of its core services, government must be able to access the facility and to have the benefit of the contracted services whenever necessary. Safeguards should be incorporated into the contract to deny the right of any other party to prevent government and, in some cases, the public from accessing the facility to deliver and receive core services. This applies to any party which may assume rights to the facility, including the private party.

Impact of deficiencies in ancillary services upon core services

In addition to non-payment or abatement of service charges where contracted services (in particular, infrastructure-related services) are not delivered or are delivered below the specified service standards, it may be appropriate to require payment of liquidated damages or other compensation if the deficiencies prevent or otherwise hinder government from delivering the core services, or delivering them to the necessary standard.

Because liability to pay liquidated damages is likely to be priced into the unitary charge, liquidated damages will only be value for money in situations where the cost impacts on the delivery of government core services are so great that they warrant the additional expense. Such measures, if adopted, allocate to the private party the cost to government of any adverse effect on the delivery of core services arising from non-delivery or sub-standard delivery of the contracted services. The private party will, in most cases, pass the risk of such a cost to an appropriate sub-contractor.

Impact of core services on ancillary service delivery

The risk that the core services or method of delivering them may prevent, hinder or disrupt the private party's ability to provide the contracted services is comparatively remote. So too is the risk that there may be unanticipated changes to the frequency and/or type of core services which will have cost implications for the private party in providing the contracted services. Where such risks exist, however, optimal risk allocation principles require that they be borne by government.

Acts of government having this potential may be identified in the contract as Intervening Events, under which, depending on the circumstances, government may remain liable for all or part of the service charge and the private party's obligation to provide the services may be suspended. If the Intervening Event increases the service costs to the private party, these costs should be able to be passed through to government.

If the private party is unable to provide all or part of any required temporary measures because of an Intervening Event, the measures are to be deemed to have been provided. Similarly if, because of an Intervening Event, a default cannot be cured within the applicable cure period, the period should be extended. In effect, government bears the risk of any adverse effect that its core service functions may have on the private party's capacity to perform its contractual obligations, by being deprived of its remedies for a private party default.

Any Intervening Events identified in the contract should, at a minimum, exclude government acts taken in good faith and in the proper exercise of government's rights and obligations under the project documents or at law. Intervening Events should also only include omissions made in bad faith.

Government must compensate the private party for any loss or damage to the facility (other than fair wear and tear) arising from carrying out, or the manner of carrying out, core services.

13.8 Mitigation options

Network risk mitigation options

Network risk may be mitigated by a thorough investigation of network dependencies before tender and the identification, during the competitive tender process, of dependencies which are critical to the project. This should narrow the potential scope of government undertakings and heighten both parties' awareness of network issues and the critical status of particular features of the network.

The following are additional network risk mitigation factors which should be considered in individual projects:

- use of 'network discriminatory' clauses under which government undertakes to provide appropriate redress to the private party where government acts in certain specified ways which discriminate against the project (see the discussion on network risk of a complementary and a competitive nature in Section 13.5);

- a material adverse effect regime, where such a regime is used to allocate part of the network risk to government; and

- from government's perspective, clear and specific identification of which network risks it will assume.

Network risk taken by the private party is also mitigated in practice if (for example, in a water treatment project) government is the intermediate purchaser of the service and has a vested interest in effective service delivery (provided, of course, there are no competing government interests).

Interface risk mitigation options

An important part of the process of initial risk evaluation of a *Partnerships Victoria* project where government is to retain delivery of core services is to identify and assess the special interface risks which may arise from the interrelationship between services delivered to government and those delivered by it. These must be continually reviewed, and a communications strategy should be developed and implemented in respect of the day-to-day delivery of the two sets of services.

If service failure by the private party causes failure to deliver core services, government's key mitigation option is its contractual right to step in to facilitate effective delivery. The costs to government during step-in should generally be borne by the private party, as it is the defaulting party. If the default is material and is not cured within the stipulated cure period, termination of the contract may be an option of last resort, to allow government to procure appropriate services from another provider.

The private party's interface risk is comparatively easily mitigated by providing for service payments to continue unabated if interference by government delivery of core services affects the private party’s capacity to perform its contractual obligations.

13.9 The way forward

Although enlightened by example, this generic discussion cannot begin to address the specific interface and network risks raised by real life projects. Victoria's experience of the core services model is, to date, very limited and the full scope of interface risk particularly and creative solutions for mitigating it still await disclosure.

This is at the cutting edge of public-private sector partnerships. It will be the focus of commercial and legal innovation as *Partnerships Victoria* throws out new challenges to effective risk allocation in the context of service delivery to and by government within a privately-owned and operated infrastructure facility.

14 Industrial relations risk

14.1 Introduction

Industrial relations risk may materialise at both the construction and operational phases of the project, but is likely to be most pronounced at the construction phase. Where the risk does materialise, it may have a major effect on the economics of a project and may affect both inputs and outputs.

During the construction phase, delay in delivering construction materials (caused by industrial action) and on site stop-work action may cause delay costs, including increased finance and construction costs. Delay through industrial action (whether affecting the project directly or indirectly) may also result in loss of revenue to the private party by delaying the start of the payment regime. During the operational phase, industrial action may delay or frustrate service delivery and may cause interface risks to materialise where, for example, provision of core services is dependent on the service that is being disrupted.

This guide treats industrial relations risk as a distinct risk, acknowledging that, in context, it may form part of construction risk, operational risk, interface risk or change in law risk.

14.2 Definition

> **Industrial relations risk** is the risk of any form of industrial action — including strikes, lockouts, work bans, work-to-rules, blockades, picketing, go-slow action and stoppages — occurring in a way which, directly or indirectly, adversely affects commissioning, service delivery or the viability of the project.

Generally the losses arising from industrial action are attributable to delays in obtaining supplies, delays in construction and/or delays in delivering the service, leading to increased costs, reduced or lost revenue to the private party and possibly a contractual liability to pay damages to government.

Because of its similar impact on the project, civil commotion and unrest (usually in the form of civil demonstrations) is commonly conjoined with industrial relations risk in contract clauses.

14.3 Allocating industrial relations risk: government-preferred position

The burden of industrial action falls on the employer and/or service-provider (that is, the private party) and will remain where it falls unless government takes it back, wholly or partly.

Government's preferred position is for all industrial relations risk to be held by the private party. The rationale is that the private party is best placed to manage its workforce and to influence the reliability of its suppliers. In some projects and under limited, prescribed circumstances, it may be appropriate for government to take back specific categories of industrial relations risk. In such cases the risk should be shared between the private party and government according to optimal risk allocation principles. In some projects it may be appropriate for specific categories of industrial relations risks to be dealt with in a similar way to the allocation and management of force majeure risk. (See discussion of Force majeure risk in Chapter 16.)

14.4 Mitigation options

The core services concept within *Partnerships Victoria* means that the risk of strikes by staff delivering the core services continues to be borne by government in its role as core service provider. The effect of ancillary services industrial action on core services and vice versa is a matter to be addressed within the framework of interface risk.

Government's exposure to industrial relations risk as a core-service provider can be ameliorated through a number of means, including consultation when considering service delivery options, creating productivity incentives and adopting policies favouring early mediation rather than confrontation as a means of resolving industrial disputes.

It is in government’s interests to consider and ensure it is comfortable with the bidders’ industrial relations records and their industrial relations strategies in relation to the project.

15 Legislative and government policy risk

15.1 Introduction

The risk of changes in legislation, changes in government policy and the election of a new government are often viewed by the private party as critical risk factors when contracting with government.

The powers and immunities of government may be categorised as follows:

- special powers and immunities;
- legislative powers;
- power over policy settings; and
- other government influence and 'interference'.

Each of these carries an implication of unequal power in the commercial relationship between government and the private party.

The risk of legislative and policy change is complicated further by Australia's character as a federation, where powers are divided between the Commonwealth and the States. This means that, even if a State government takes the risk of its actions causing detriment to the project, there remains the vexed question of who is to bear the risk of detriment arising from Commonwealth action.

Partnerships Victoria contracts are made with the Victorian government. The Commonwealth government generally has no involvement at all, or is involved only to the extent that Commonwealth approvals may be required, rather than as a contracting party. The distinction between State and Commonwealth governments is sometimes not appreciated by private parties and there is an incorrect perception that Commonwealth government is 'at the other end of the phone' ready and able to meet State government requests.[18] Local governments also have autonomy from the Victorian government, which may be an issue in some projects, e.g. land transport projects. These matters are explored further in the paragraphs that follow.

[18] Department of Treasury and Finance, Victoria, and the Department of Civil and Environmental Engineering, The University of Melbourne, *Private Provision of Public Infrastructure, Risk Identification and Allocation Project. Survey Report*, Melbourne, 1999, p.38.

15.2 Definition

Legislative and government policy risk is the risk that government will exercise its powers and immunities, including but not limited to the power to legislate and determine policy, in a way which negatively impacts on or disadvantages the project.

Specific areas of legislative and government policy risk are:

- the risk that government or the contracting agency (on behalf of government) will not have the power to enter the contract or its ability to do so will be limited;
- the risk (from the private party's viewpoint) that government will be immune from legal action;
- the risk of no remedy being available at law to prevent government from legislating to affect the rights of the private party (often identified as sovereign risk);
- the risk that the relevant Minister(s) will grant or refuse to grant statutory consents in a way which disadvantages the project;
- the risk that government will use its power to propose or alter legislation and subordinate instruments, or that Parliament will reject, accept or amend such legislation and subordinate instruments, in a way that negatively impacts on or disadvantages the project;
- the risk that government will adopt or change policy, including policies with respect to the project, in a way which impacts on the project's mode of operation or alters the relationship between the project and competing public infrastructure;
- the risk that statutory regulators will exercise their powers to disadvantage the project; and
- the risk that government will require changes in service specifications or will otherwise interfere with the private party's business operation in a way which negatively impacts on or disadvantages the project.

The first four categories above are discussed immediately below, followed by a discussion in Sections 15.6-15.11 of the more complex issues raised by changes in law, policy and regulation.

15.3 Ability to contract

It is important to review the powers of the contracting agency, since these may be limited by its governing statute. This was a major cause of delay in United Kingdom hospital projects, where it was unclear whether the National Health Service trusts had the necessary power to contract. In this context, statutory bodies have powers and functions limited by their governing statute whereas Ministers of the Crown have broad powers to contract for matters falling within the normal functions of government and no legislation will generally be necessary.

Unless the circumstances of the particular project justify another approach, it is preferable that government bears the risk of being unable to execute the project documents due to limitations on its power.

Generally, enabling legislation will not be required, but in limited circumstances legislation may be needed to authorise a project. The government-preferred position is for government to warrant that it has the power to contract in the circumstances of the project.

15.4 Legal action against government and sovereign risk

Entering into a *Partnerships Victoria* contract is commercial behaviour by which government places itself on the same legal footing as other commercial parties. This is reinforced by the *Crown Proceedings Act 1958* (Victoria) which allows actions for breach of contract to be brought against the State. There is a concept of executive necessity which may render certain action by government immune from suit, but this concept has very limited practical application.

Any uncertainty concerning the enforceability of the contract should be addressed in the contract. Where the issue arises, the government-preferred approach is for the government to warrant that it has entered the contract on a commercial (rather than sovereign) basis and that it will not claim immunity from future legal proceedings as a sovereign body.

A closely related issue is what is often identified as sovereign risk, in that there is no remedy available at law to prevent government from legislating to affect the rights of the private party. This risk can be addressed under the contractual regime that deals with changes in law.

15.5 Ministerial consents

Ministerial consents should be distinguished from the statutory approval processes discussed in the context of site risk, where government legally may not fetter its discretion.

Where the issue arises and it is considered appropriate for it to do so, government may agree to undertake all reasonable action necessary to help facilitate the provision of required consents.

15.6 Scoping and defining change in law risk

A *Partnerships Victoria* project must keep pace with all agreed legal, policy and regulatory requirements associated with providing the contracted services, as they change (regardless of who bears the compliance cost).

Change in law risk is therefore the risk that the agreed legal, policy and regulatory framework will change during the contract term in a way not allowed for when the contract was signed and which disadvantages or has a negative financial impact on the project. A change in law may, if complied with, impact on the form of modifications required to be made to the facility works (for example, changes in vent stacks in freeway tunnels or air filtration equipment). This in turn can have flow-on effects on capital expenditure, operating requirements (for example, requirements to undertake additional performance monitoring) and/or the way a service is required to be delivered. The critical question then becomes who is to bear the cost of such compliance.

Defining 'change'

Traditionally, 'change' has been defined to mean the enactment or making of, or change in a law, policy or regulatory requirement, which comes into effect after the date of the contract.

A bidder is expected to be aware of publicly announced changes that are formally underway at the time of its tender and to have made allowance for these and all existing requirements in its pricing structure. Accordingly, the risk of changes that are on notice or foreseen as at the date of the contract are automatically to be borne by the private party, unless expressly excluded.

The risk of changes in the interpretation of laws existing at the date of the contract should generally also be borne by the private party, unless the circumstances of the particular project dictate otherwise.

Defining 'law'

The term 'law' generally has a very broad application and consists of the following components:

- strictly *legal* requirements, emanating from both the common law and statute law, which Parliament has power to change;

- *policy* requirements, which are not enacted in laws, but may take the form of directives from government departments which directly or indirectly impact on specifications or project viability; and

- *regulatory* requirements set by an independent regulator deriving its powers from statute law. Government has ultimate control over regulators through Parliament's power to change the law, but their operation is otherwise self-sufficient.

A water treatment services project provides an example of the scope of change in law. The private party in these projects may be affected directly by a change in law or indirectly through changes which impact on the operators of the public water authority with which the private party interfaces.

Legal requirements affecting water treatment services projects include requirements under the *Water Industry Act 1994* and regulations. The regulations prescribe the means by which water quantity must be measured for the purpose of billing water usage and the process for setting the level of tariffs the industry may charge. If a new regulatory regime is introduced to apply to the quality of drinking water, industry members would have to conform to the new regulatory requirements or suffer penalty and/or loss of licence.

Policy may dictate that water distribution to particular market segments must be capped when water reservoir reserves reduce below a certain level. While a breach of policy will not give rise to a prosecution (as a breach of the law may do), there are vigorous commercial and other pressures on the private party to conform. An industry licence, for example, may oblige the licensee to comply with policy as determined from time to time.

Together, these elements determine the legal environment of the project and it is these, collectively, to which change of law risk (however titled) refers. Change in law may be defined along the following lines to encompass these various elements.

Example clause Definition of change in law

'Change in Law' means

(a) a Change in Policy; or

(b) the enactment or making of a new law (which expression includes a change of an existing law) after the Commencement Date with which the Contractor is legally obliged to comply;

which either

(c) requires an addition or alteration to the Physical Structures and Systems[1] of the Facility; or

(d) results in a substantial increase in the operating costs of the Contractor in delivering the Services;

but does not include:

(e) a change in the way a law is interpreted or applied;

(f) a change in the *Income Tax Assessment Act 1936;*

(g) a change for which the Contractor has rights to price or fee adjustment, compensation or an indemnity under other provisions in this contract; or

(h) a change in operating costs which does not have any greater or more adverse impact or affect on the Contractor or the Facility than it does on the business sector as a whole or on the industry sector of which the Facility forms part.

'Restricted Change in Law' means

(a) a Change in Policy; or

(b) the enactment or making of a new law (which includes a change in an existing law) after the Commencement Date with which the Contractor is legally obliged to comply;

which either

(c) applies solely to the Contractor; or

(d) impacts specifically and exclusively on the Facility or the delivery of the Services from the Facility;

and which

(e) requires an addition or alteration to the Physical Structures or Systems of the Facility; or

(f) results in an increase in the operating costs of the Contractor in delivering the Services;

but does not include

(g) a change in the way a law is interpreted or applied;

(h) any change in the *Income Tax Assessment Act 1936*; or

(i) any change for which the Contactor has rights to price or fee adjustment, compensation or an indemnity under other provisions of this contract.

'Change in Policy' means

(a) a significant and sustained increase in the frequency or quantum of Services requested by the Secretary;

(b) a change in the Services Specifications;[2] or

(c) a request by the Secretary to amend the Operating Manual[3] to comply with the Industry Best Practice;

but does not include

(d) an alteration of the Services Specifications which is for the purpose only of clarifying existing requirements of those specifications; or

(e) a Change in Law or a Restricted Change in Law other than as described in paragraph (a) of those definitions.[4]

1. Physical Structures and Systems will be defined to include improvements, fittings, equipment etc.
2. Service Specifications will be defined by reference to a detailed output schedule setting out all government's output requirements from the Contractor.
3. This is a reference to the manual or other mechanism prepared by the Contractor which contains the Contractor's operating philosophy and specifies how the Contractor will deliver the contracted services to the specified standards.
4. The Change in Policy definition may vary significantly between projects, depending on the nature of the facility and the industry sector within which the facility operates. Some sectors will be subject to a variety of policies which the 'Change in Policy' definition may need to specifically address.

15.7 Consequences of change of law in different phases of the project

Construction phase

One of the more obvious consequences of a change in law during the construction phase is the need for design modification. The capital expenditure consequences of design modification depend on the nature and extent of the changed requirements, the flexibility of the design in accommodating change, and the stage construction has reached. However, generally speaking, design flexibility and the relatively short duration of the construction period combine to make it unlikely that substantial modification will be required during this phase.

Operational phase: changes requiring capital expenditure

At the operational phase, changes of law requiring design modification may well have more serious capital expenditure consequences. It may also be difficult for the private party to raise the necessary capital, since private sector debt financiers are often reluctant to commit to fund additional capital expenditure during operation of the facility. Accordingly, if the revenue stream is relatively fixed, it may be appropriate to limit the risk to which the private party is exposed, especially if the concession term is comparatively lengthy.

There are various means by which capital and, where appropriate, operational expenditure required by a change in law may be shared by the parties or, when appropriate, allocated to government. The simplest such means is to provide opportunity for pass-through of costs to end-consumers or, where government purchases the services, adjustment of the tariff or availability element of the charge. There must always be an ability to ensure that costs passed through or tariff adjustments are justifiable and reviewable under the contract. More complex provisions will need to be tailor-made to the project in hand. These are discussed further in Section 15.8.

15.8 Allocating change in law risk: government-preferred position

Because of the structure of a *Partnerships Victoria* arrangement, change in law risk inherently falls to the private party unless government agrees to take back some part of the risk. For instance, if the State changes payroll tax or a regulator changes regulatory requirements, the burden of those changes falls directly upon the party building the infrastructure facility or delivering the services. The question is, therefore, whether it is more cost-effective and therefore more 'optimal' for government to take back all or some part (and if so, which part) of the change in law risk.

There are a number of different possible approaches to allocating or sharing change in law risk. In determining which approach should be adopted in a particular project, each of the following considerations should be addressed, as should government's preferred position where one is stated:

- methods available (if any) for mitigating the consequences of the risk;
- the source of the risk (which in turn is linked to the power to control it); and
- the nature of the risk and its consequences — i.e. whether it is a general change in law or one which specifically affects the project or the service sector, and whether the consequences are significant.

These are discussed in turn below.

Methods available (if any) for mitigating the consequences of the risk

The options available to each contracting party for mitigating a change in law risk (whether by way of transferring to a third party or otherwise) determines to a large degree whether the party will agree to entirely accept or in some way share that risk.

Under more traditional commercial contracts (between private sector parties), the service provider usually passes the costs of any change in law directly to its customers through an increase in price, to the extent that competitive forces allow. The difficulty in using this approach in *Partnerships Victoria* projects is that, generally, the services are not provided into a competitive market.

However, where the *Partnerships Victoria* arrangement is such that the contracted services are offered directly to the public (so that there is a direct commercial relationship between the private party and end-users), it may be appropriate for the cost of a change in law to be passed through to the public in the form of increased tariffs (within limits). The feasibility of this approach depends on the elasticity of demand, competition from substitute services and whether there are regulatory restrictions on increases in tariffs. If full pass-through can be achieved, the risk is effectively transferred to the public through the private party. If not, it is borne by the private party as discussed above, unless government agrees to share the risk.

The position is different where the contracted services are offered directly to and paid for by government. In these circumstances, it is not appropriate for the private party to bear all the change in law risk, as it cannot be passed on to the third-party end-users. Where, for example, the change involves capital expenditure which cannot be accommodated within the existing costs (or is above an amount specified in the contract), the contract may require the parties to negotiate a method of funding the expenditure which involves cooperation by both parties. It may, in the last resort, involve a capital payment by government.

A further approach, where government receives the contracted services on behalf of its customers, is for government to take the change in law risk, or part of it, where it can reasonably and legally pass through the cost and impact of that change of law to its customers. For example, in a water treatment project, the water authority may agree to compensate the private party for the net adverse financial effect of a change in law (whether of a capital or operating cost nature) by increasing the toll payable to the private party under the contract. This is limited to the extent that the authority is able to pass on the costs of doing so to its customers by increasing the water tariff paid by them.

Where in any of these three scenarios it is inappropriate for one or other of the parties to take the entire change in law risk, the parties need to consider appropriate ways of sharing the risk. The following sections provide further guidance on how the change in law risk should be shared in a *Partnerships Victoria* project.

The source of the risk

In Victoria, change of law may derive from several sources:

- Commonwealth government;
- State government;
- local government; and
- independent regulatory agencies.

Private parties can tend to view government as monolithic, or at least to regard each sphere of government as having strong influence with the others.[19] They can also find it hard to distinguish between the State government's role as a party to a commercial contract and its role as a law-maker. This gives rise to a fear of 'contracting with the umpire' and 'a general unease about changes to all areas of legislation and policy'.[20]

In reality, State government may have less influence with the Commonwealth government than a private party and even at State level can only enact laws through the multi-party vehicle of Parliament. Since, from time to time, other parties may hold a critical balance of power, the ultimate form of legislation is not always in government's hands.

Similarly, while the regulatory regime applying to a project may have been initially determined by State government, State government may not (without legislation) intrude upon the statutory independence of its regulatory agencies. A similar situation applies to local government which, although subordinate to State government, exercises independent jurisdiction under the *Local Government Act 1989*.

This means that State government is not in the position it is often perceived to be, to control change of law risk — even that part of the risk deriving from State laws.

Government does not take all change in State law risk simply because the changes relate to State-controlled laws. As a general position, government takes the risk of changes to State law where such changes are directed *specifically* or *exclusively* to the particular project. Further, and for the reasons discussed above, government generally does not accept the risk of change in

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[19] Department of Treasury and Finance, Victoria, and the Department of Civil and Environmental Engineering, the University of Melbourne, op. cit., p. 38.

[20] ibid. p. 40.

Commonwealth or local government laws or other regulatory requirements. There are a number of exceptions to this general position, which relate to changes resulting in capital expenditure or marked operating cost increases. These are discussed at length in the Summary section below.

Nature of the risk and its consequences

A private party should not be shielded from changes in law which apply generally to the business environment or to which its particular industry sector would ordinarily be subject, merely because it has entered a *Partnerships Victoria* contract with government.

Accordingly, costs arising from any change in law which applies universally to the business environment (such as a changes to the income tax legislation), or to the project's particular industry sector, should be borne by the private party.

Summary: government-preferred position

State change in law directed specifically or exclusively to the project

In keeping with optimal risk allocation and value for money principles, government should take on the risk of costs (whether of a capital or operating nature) arising from changes in State law which are directed *specifically* or *exclusively* to the particular project.

A change in law resulting in capital expenditure

Generally, it is also appropriate for government to share the risk of a general or sector-specific change in law where such a change requires significant *capital expenditure*, irrespective of the fact that the change was not directed specifically and/or exclusively at the project.

Government may meet the cost of any capital expenditure for which it is liable in several ways: by increasing the service charge payable under the contract (and in doing so, amortising the cost over the remaining contract term); making a lump sum payment (particularly if the cost is incurred late in the contract term); or making staged payments as the costs are incurred. Whatever payment method is used to pay for the capital costs, it should be structured in a way that ensures the private party completes all necessary works. Payment should not be made until the necessary changes are satisfactorily completed.

Where government elects to make a capital expenditure payment to pay for the capital cost of complying with the change in law, it may do so on a progressive scale. It may be agreed, for example, that the private party will pay 100 per cent of the first $x of required capital expenditure, 75 per cent of the next $x of required capital expenditure, until progressively the private party's contribution to capital expenditure over and above a certain maximum amount will be nil. Once the maximum amount is reached, government will take 100 per cent of any costs above it. The private party's exposure to this type of risk can therefore be quantified.

Alternatively, the parties could simply agree that the private party is liable for the first $x of required capital expenditure and that government is liable for any costs above that amount, instead of using the progressive scale method discussed above. However, the progressive scale approach gives greater incentive to the private party to minimise the cost of necessary capital expenditure (and therefore government's possible exposure).

The following example clause, applying the progressive scale method, is adapted from the United Kingdom guidance material. It may be appropriate to incorporate this wording into the example clause appearing at the end of this section, ‘Example clause: Change in law’.

Example clause: Capital Expenditure required by a Change in Law

(a) If the effect of a Change in Law is to require structural change to the Facility or its systems, Government is to pay the Government's Share of any capital expenditure required to implement those improvements.

(b) 'Government's Share' for the purposes of clause (a) means the percentage figure corresponding to the Cumulative Capital Expenditure at the relevant time, as shown in the first column of the table set out below.

Cumulative Capital Expenditure	Government's Share
$ 0 - $[a] (inclusive)	0%
$[a]-[b] (inclusive)	10%
$[b] - [c] (inclusive)	20%
$[c] - [d] (inclusive)	40%
$[d] - [e] (inclusive	60%
$[e] - [f] (inclusive)	80%
$[f] and above	100%

'Cumulative Capital Expenditure' means the aggregate of all capital expenditure that has been incurred as a result of each Change in Law that has come into effect during the Service Period.

The government must approve any capital works thought to be necessary by the private party as a result of a change in law, before they are undertaken. Government needs to satisfy itself that the proposed works are necessary and appropriate and that the cost for such works is reasonable. Government will usually require a competitive tender process.

A change in law resulting in an increase in operating costs

In some limited cases as indicated in the example clause, government will also take the risk of a change in law that leads to a substantial increase in operating costs, whether or not the change is directed specifically or exclusively at the project. However, in these circumstances government requires the exclusion of changes which result in increased operating costs that are part of the general operating environment (e.g. general taxation) or which may be included in the cost escalators permitted under the terms of the contract. An increase in operating costs which government has agreed to incur is normally met by an increase in the service charge.

To avoid unnecessary administrative costs in circumstances where it has agreed to accept a change in law risk, government generally only pays that part of the cost of complying with the change that exceeds a nominated monetary limit (i.e. the Significant Amount).

Example clause: Change in law

X.1 Notification

(a) If there is a Change in Law or a Restricted Change in Law, the Secretary must notify, where practicable, the Contractor in writing not less than one week prior to the effective date of the change ('Policy Notice').

(b) Where

(i) the Contractor considers that a matter which it is lawfully required to comply with is a Change in Law or a Restricted Change in Law;

(ii) the Secretary has not issued a Policy Notice under paragraph (a); and

(iii) the Contractor refers the matter to dispute resolution under clause [y] [Disputes] to determine whether or not the matter constitutes a Change in Law or a Restricted Change in Law,

then if it is determined by the dispute resolution process in clause [y] [Disputes] that there has been a Change in Law or a Restricted Change in Law, the Secretary shall be deemed to have issued a Policy Notice on the date of the determination.

X.2 Contractor's Obligations — Capital Expenditure

(a) **Capex Notice requirements**

As soon as practicable after receipt of a Policy Notice, where the Contractor believes the Change in Law or Restricted Change in Law will have capital cost consequences, the Contractor must notify the Secretary ('Capex Notice'):

(i) of the structural improvements that the Contractor proposes to make to the Facility to comply with the new Law, if any;

(ii) of the capital expenditure involved in making those improvements, if any;

(iii) of the change in procedures or systems that the Contractor proposes to adopt to comply with the new Law, if any;

(iv) of the increase (if any) in [*the relevant services charge*] proposed by the Contractor to reflect the capital expenditure payment (if any) made or to be made by the Contractor and any funding costs incurred or to be incurred by the Contractor in complying with the new Law (which may include any capitalised interest the Contractor will incur as a result of the proposed method of funding the capital expenditure payment, but not including a profit component to the Contractor);

(v) of whether or not any required capital expenditure can be accommodated within the next planned refurbishment or renovation of the Facility;

(vi) of the estimated financial cost to the Contractor of the Change in Law or the Restricted Change in Law, in the form of a financial statement certified by an accountant independent of the Contractor who is a member of the Australian Society of Certified Practising Accountants or of the Institute of Chartered Accountants or a successor body carrying out the same or similar functions;

(vii) of the time within, and the manner in which, the Contractor proposes to construct and complete any such structural improvements; and

(viii) of the proposed method of funding the capital expenditure.[1]

The provisions of Part [#][2] of this Agreement will apply to the execution of such works as are necessary to give effect to the Change in Law.

As soon as practicable after receipt of a Policy Notice, the Contractor must provide the Secretary with a certificate under the *Evidence Act 1958* from a director of the Contractor declaring:

(i) the Change in Law or Restricted Change in Law cannot be accommodated within the current Operating Manual and the existing costs; and

(ii) the accuracy of the estimated financial information provided to the Secretary.

(b) **New/additional funding**

Unless the Government elects to make the capital expenditure payment described in clause X.3(a)(ii), the Contractor must use all reasonable endeavours to obtain additional or alternative funding for the purpose of the capital expenditure. The parties agree that the proposed method of funding the capital expenditure must reflect the following principles:

(i) it must allow for lower construction costs (if any) due to the existing infrastructure on the Site;

(ii) the cost to the Contractor of securing additional or new funding:

(A) such that, if the additional or new funding is debt finance provided by a third-party financier, any increase to [*the relevant service charge*] is equal to the amount required to amortise the increased or new loan facility and interest by the expiration of the loan term; or

(B) such that, if the additional or new funding is provided by way of subscription of shares in the Contractor or the making of loans to the Contractor by its shareholders, the increase to [*the relevant service charge*] is equal to the amount required to give the new or additional equity an internal rate of return that is not greater than the prevailing market rate of return; and

(iii) the additional cost to the Contractor of appropriate measures during the construction period to provide a safe and secure environment in the Facility.

(c) **No obligation to implement the change**

Where the Contractor has complied with its obligations under paragraph X.2(b) and, notwithstanding that compliance, is unable to fund the cost of the structural improvements and the Minister does not elect to make the capital expenditure payment under clause X.3 (ii), the Contractor is not obliged to implement the Change in Law or Restricted Change in Law provided however that where the Change in Law or Restricted Change in Law is one to which paragraph (b) of the definition of Change in Law or Restricted Change in Law applies:

(i) The Contractor must implement the Change in Law or Restricted Change in Law; and

(ii) The Minister must make the capital expenditure payment required under paragraph X.2(a)(ii).[3]

X.3 Acceptance by Secretary — Capital Expenditure

(a) **Accommodation Services**

The Secretary may:

(i) Accept the Capex Notice issued under paragraph X.2(a):

(ii) Elect to make the capital expenditure payment[4] referred to in paragraph X.2(a)(ii) provided the Minister confirms this election; or

(iii) Withdraw the Policy Notice issued under X.1 unless the Change in Law or Restricted Change in Law is one to which paragraph (b) in the definition of Change in Law or Restricted Change in Law applies. If the Secretary withdraws the Policy Notice, the Contractor is not required to comply with nor implement the new Law the subject of the Policy Notice.

(b) **Implementation**

If the Secretary accepts the Capex Notice or, where the matter has been referred to dispute resolution under paragraph X.1(b), the dispute is resolved under clause [y] [Disputes] and the Secretary does not within 5 Business Days of resolution of the dispute withdraw the Policy Notice, then:

(i) The Contractor must, subject to paragraph X.3(c), implement and adopt the Change in Law or Restricted Change in Law in compliance with the proposals in the Capex Notice as modified by the resolution of any dispute under clause [y] [Disputes]; and

(ii) where the new Law relates to [*specify relevant type of Service to which the application of these provisions needs to be restricted, eg Accommodation Services*] and a Significant Amount[5] has been incurred or will be incurred (as a result of this Change in Law or Restricted Change in Law), then:

(A) where the Contractor has proposed an increase in the [*relevant service charge*] under the Capex Notice, the [*relevant service charge*] will be adjusted in accordance with the Capex Notice with effect from completion of the works required to comply with the Change in Law or the Restricted Change in Law; or

(B) where the Secretary has elected to make a capital expenditure payment under paragraph X.3(a)(ii) (and the Minister has confirmed that election), the Secretary will make such payment upon certification by the Secretary's consultants that the works required to comply with the Change in Law or Restricted Change in Law have been completed.[6]

(c) **Provision of Services**

In implementing and adopting the Change in Law or Restricted Change in Law under clause X.3(b) the Contractor must continue to provide the Services except to the extent that such Services cannot be provided in the ordinary course as a necessary and intended consequence of implementing and adopting the Change in Law or the Restricted Change in Law, provided the Contractor minimises any disruption to [*insert relevant us*ers] as a result of the implementation and adoption of the Change in Law or the Restricted Change in Law.

(d) **Commencement**

The Contractor must commence the necessary works within 3 months of acceptance by the Secretary of the Capex Notice or resolution of any dispute under clause [y] [Disputes] unless, in the latter case, the Policy Notice is withdrawn.

(e) **Significant Amount**

Notwithstanding any other provision contained in this clause if a Significant Amount is not incurred by the Contractor, then the Government will not be obliged to pay any increase in [*the relevant service charge*] or make the capital expenditure payment.

X.4 Contractor's Obligations — Recurrent Expenditure

As soon as practicable after receipt of a Policy Notice, (where the Contractor believes it will have operating cost consequences) the Contractor must notify the Secretary ('Recurrent Cost Notice') of:

(a) the new Operating Manual which the Contractor will implement to comply with the Change in Law or the Restricted Change in Law;

(b) the increase or decrease in each component of the [*relevant Service Charge*] the Contractor proposes will be necessary to allow the Contractor to comply with the Change in Law or the Restricted Change in Law;

(c) details of the review the Contractor has undertaken to allow the Change in Law or the Restricted Change in Law to be accommodated within the existing Operating Manual and costs of the Contractor;

(d) the estimated financial cost to the Contractor required by the Change in Law or the Restricted Change in Law, in the form of a financial statement certified by an accountant independent of the Contractor.

As soon as practicable after receipt of a Policy Notice (where the Contractor believes it will have operating cost consequences), the Contractor must provide the Secretary with a certificate under the *Evidence Act 1958* by a director of the Contractor declaring:

(i) the Change in Law or the Restricted Change in Law cannot be accommodated within the current Operating Manual and the existing costs referred to in paragraph (c); and

(ii) the accuracy of the estimated financial information provided to the Secretary.

X.5 Acceptance by Secretary — Recurrent Expenditure

(a) **Services**

(i) The Secretary need not, but may accept the Recurrent Cost Notice issued under clause X.4. Where the Secretary reasonably considers that the increase in [*the relevant component of the Service Charge*] referred to in the Recurrent Cost Notice does not reflect the cost of providing the relevant Service given the Change in Law or Restricted Change in Law, subject to any dispute resolution under clause [y] [Disputes]:

(ii) the Secretary may reject the Recurrent Cost Notice; and

(iii) the Government may terminate Part [#] of this Agreement [Services] to the extent it relates to the relevant Service, by giving not less than 6 months notice in writing to the Contractor. Where such notice is issued, the Contractor will be required to grant a licence to occupy relevant parts of the Facility to a person nominated by the Minister. With effect from that date the provisions of clause [w] [Obligation to Grant Licence] will apply.

(b) **Implementation**

If the Secretary accepts the Recurrent Cost Notice or, where the Notice was referred to dispute resolution, the dispute is resolved under clause [y] [Disputes], then:

(i) the Contractor must implement and adopt the Change in Law or Restricted Change in Law in compliance with the proposals in the Recurrent Cost Notice; and

(ii) subject to paragraph (c) and effective from the date the Contractor starts complying with the relevant Change in Law or Restricted Change in Law, [*the relevant part of the Service Charge*] will be adjusted to reflect the increase or decrease identified in the Recurrent Cost Notice or, where appropriate, determined by a dispute resolution process(whichever is the lesser or greater, respectively), as being necessary if the Contractor is to comply with the Change in Law or the Restricted Change in Law

(c) **Government Not Obliged to Pay Increase**

Notwithstanding any other provision contained in this clause, the Government will not be obliged to pay any increase in [*the relevant Service Charge*] notified in the Recurrent Cost Notice, unless the additional operating expenses incurred or to be incurred by the Contractor in implementing the Change in Law or the Restricted Change in Law are, in aggregate, at least equal the Significant Amount.

Where the additional operating expenses incurred or to be incurred by the Contractor to implement the Change in Law or the Restricted Change in Law are, in aggregate, greater than the Significant Amount, the adjustment to the [*relevant service charge*] under clause X.5(b)(ii) will take into account only that amount of the additional operating expenses which exceeds the Specified Amount.

X.6 Obligation to Grant Licence

If at any time the Minister exercises the powers under clause X.5(a) to require the Contractor to grant a licence to another party, then the Contractor must grant a licence in compliance with the provisions of the Lease.

1. A sharing of capital cost may be appropriate — see the example clause under ‘Capital Expenditure required by a Change in Law’.
2. Part # is a reference to that part of the *Partnerships Victoria* contract which deals with design and construction issues.
3. There may be a sharing of capital cost provision; see the example clause under ‘Capital Expenditure required by a Change in Law’.
4. There may be a sharing of capital cost provision; see the example clause under ‘Capital Expenditure required by a Change in Law’.
5. ‘Significant Amount’ is the monetary amount, agreed to by the parties, below which government will not be required to make a capital expenditure payment or fund the cost of compliance through the service charges. The ‘Significant Amount’ is to be a reference to the aggregate of all modifications requested by government in a given year or over the contract term.
6. There may be a sharing of cost provision; see example clause under ‘Capital Expenditure required by a Change in Law’.

The government and the private party may, in appropriate circumstances, agree that change in law risk be incorporated into a material adverse effect regime. Material adverse effect regimes are discussed in Section 18.2.

15.9 Upside benefits

As noted in Section 4.7, and discussed in Chapter 19, there may be upside benefits from changes instituted by the State government or its agencies. These should be credited against any downside risk government agrees to take. This might be done either (or both) in relation to particular changes — making the relevant concept the net change, balancing downside and upside consequences — or by effectively maintaining a ledger, so that any credits arising from government action can be banked against any later adverse changes. Though attractive in theory, it is acknowledged that this may be difficult to implement in practice.

Where such sharing mechanisms are used in relation to change in law, detailed contractual provisions are required to enable identification of the consequences of the change. Quantifying the true cost of a change in law is particularly difficult when it indirectly impacts on the project or requires modification of the operating regime.

Where symmetrical risk allocation is to be pursued, it is important to consider any taxation or balance-sheet consequences from profit-sharing in risk upsides. (The areas of taxation and financial reporting are dealt with in Part Three of the *Practitioners' Guide*.)

15.10 Particular areas of law

Some areas of law often figure specifically in risk allocation clauses. These include changes in goods and services tax and changes in environmental laws, discussed below.

Changes in goods and services tax

The contract should deal expressly with the consequences of a change in the rate of goods and services tax (GST). Unless there is provision for adjustment, or a mechanism to negotiate, the supplier of the service will bear the full risk of such change.

Changes in the rate of GST on input supplies with impacts on gross costs and cash flow are risks borne by the private party in the ordinary course of business. They should, in any event, have minimal impact, unless input tax credits for the increased sums are unable to be recouped.

The risk that changes in the scope of GST will affect the private party's ability to recover tax input credits should remain with the private party, unless the risk materialises through a direct change to the GST status of the service being provided, such as the service becoming GST exempt. In such a case, the contract may provide for tariffs to be adjusted or compensation to be paid.

Example clause: Goods and services tax

Goods and Services Tax (GST)

If, as a result of a Change in Law, a relevant authority determines that supplies to be made by the Contractor to the Government under this contract are exempt from GST and that input tax incurred and attributable to such supplies is not recoverable by the Contractor, compensation shall be paid in accordance with [*the compensation provisions*].

Changes in environmental laws

Government may wish to increase incentives for environmentally sound and flexible design by allocating compliance with changes in environmental law to the private party. Sound environmental design is a key aspect of design risk which is borne by the private party. Therefore there is an argument that the private party, in seeking compensation from government for the costs of structural alteration, should bear the onus of demonstrating that the design, when originally determined, was reasonable in not making provision for the outcome required by the legislative change. However, this will depend on the premium required by the private party, which may not be cost-effective, especially if no compensation is offered for change in law requiring physical change to the facility.

15.11 Mitigation action that may be taken by government

In the case of a change in law risk which government has accepted wholly or partly, the mitigation options open to government include:

- having a system in place to ensure that government is fully aware of the financial consequences of a proposed change for which it will inevitably be liable;
- where appropriate, devising a regulatory framework which provides a mechanism for tariff adjustments to assist pass-through to end-consumers (subject to public interest considerations);
- where the change has capital expenditure consequences, placing an obligation on the private party to fund up to an agreed limit, and thereafter to use its best endeavours to raise capital from fresh debt or equity so that a government capital contribution is an option of last resort. Any contribution above the agreed limit should be at government's discretion;
- graduating the costs for which government is liable;
- providing a mechanism for joint review of, and agreement with the private party on, the proposed expenditure to meet the changed requirements;
- where appropriate, pursuing symmetrical risk allocation and monitoring the potential for upside benefits;
- discussion with the Commonwealth government where the Commonwealth is the source of the proposed change; and
- requiring greater flexibility in the design of the facility so that it can more efficiently accommodate the impact of the change in law. This is likely to result in government paying more up-front for the facility, but over the whole of the life of the project, it may result in better value for money.

Of these options, the mechanism for reaching agreement with the private party on the nature of the capital works required by a change in law and the reasonable costs of implementation, may be of critical importance.

15.12 Mitigation action that may be taken by the private party

To the extent that a private party has accepted the risk of change in law, the mitigation options available include:

- attempting to cost the consequences of an adverse change in law into the initial pricing structure through market analysis, scenario modelling and providing for price indexation and benchmarking;

- agreeing with government during the contract negotiation phase on an appropriate regulatory framework to adjust tariffs in the event of a relevant change in law, thereby passing the costs through to the end-consumer;

- taking reasonable actions to minimise the cost of implementing a foreseeable change in law (e.g. through project design prior to completion); and

- discussion with the relevant legislative/regulatory body to alleviate, where appropriate, the effects of the change in law.

16 Force majeure risk

16.1 Introduction

During the course of a project, an event outside the control of either party may occur which prevents the private party from complying with its obligations under the contract. Such an event may be, for example, a storm, an earthquake or the outbreak of war.

If such an event occurs, government needs to ensure that there are appropriate arrangements in place to deal with its consequences so that the adverse impact on the project and, more specifically, on the delivery of services, can be minimised.

16.2 Definition

> **Force majeure risk** is the risk that a specified event entirely outside the control of either party will occur and will result in a delay or default by the private party in the performance of its contractual obligations.

Force majeure events traditionally fall into two categories. The first refers to events which can be described as an 'act of God' or a 'superior force'.[21] Such events are generally:

- storms, lightning, cyclones, earthquakes, natural disasters and actions of the elements;
- tidal waves, floods and droughts;
- landslides and mudslides; and
- nuclear, chemical or biological contamination.

The second refers to events which can be described as 'political', such as:

- civil riots, rebellion, revolution, terrorism, civil commotion, insurrections and military and usurped power;
- malicious damage;
- acts of a public enemy; and
- war (declared or undeclared).

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[21] Force majeure as defined in P. Nygh & P. Butt (eds), *Butterworths Australian Legal Dictionary*, Butterworths, Melbourne, 1997, p. 498.

However, what is considered to be a force majeure event for particular projects varies greatly, and may be either narrower or broader than the traditional meaning. A *Partnerships Victoria* contract expressly defines events which will constitute force majeure events, to limit any catch-all effect, even where the starting point is apparently very broad.

Regardless of its ambit in the context of a particular project, however, the definition of force majeure event should not include:

(a) any event, the risk of which the private party has expressly agreed to accept (so that the inclusion of force majeure provisions will not affect the agreed allocation of any other project risks); or

(b) any event which could have been prevented by the private party engaging in good practice in carrying out the relevant activity and exercising reasonable care and diligence (so that force majeure events, for the purposes of the project agreement, remain those events genuinely beyond its control).

An example of a suitable force majeure event definition is set out in Section 23.1.

16.3 Different forms of force majeure risk

The chance of a force majeure risk eventuating is generally more remote than the chance of most other project risks eventuating. However, the consequences of the force majeure risk, if it eventuates, may be more severe and have a greater impact on the project. Its consequences may go beyond merely having a financial effect on the party bearing the risk and strike at the heart of the project, preventing, or at the very least significantly affecting, the provision of the relevant services.

A force majeure event may impact on the delivery of the contracted services directly, or indirectly by impacting on the project asset. Owing to the *Partnerships Victoria* structure, government is concerned primarily about any major event which may adversely impact (directly or indirectly) the provision of services.

Impact on the project asset

Traditionally, this occurs where a force majeure event causes damage to or destruction of the asset (for example, where the asset is damaged by earthquake).

Under a *Partnerships Victoria* arrangement, the private party bears the risk of damage to the project asset given that it owns the asset.

Damage to the project asset generally only concerns government to the extent that the damage affects service delivery, unless the asset is to be transferred to government at the end of the contract term. In that event, the effect the damage may have on the residual value of the asset is also of concern.

Impact on service delivery

This may occur either because the project asset is damaged in a way that affects the provision of the contracted services, or because the force majeure event directly affects the provision of services. For example, the consequences of an act of God force majeure event, such as a hurricane, may impact on both the project asset and services — by damaging the project asset and rendering it unsuitable for providing the contracted services. On the other hand, the consequences of a political force majeure event, such as revolution, may only impact on service provision. It may be that following a force majeure event, the project asset is left intact but the services cannot be provided from the project asset because the private party and the public are unable to gain access to the facility, or because access to a network on which the facility or service delivery relies, such as the supply of electricity services, is no longer available.

16.4 Allocating force majeure risk: issues for government

Traditionally, unless the contract expressly provides otherwise, the consequences of a force majeure event lie where they fall. In a *Partnerships Victoria* context, this position would have the following ramifications for the private party and government.

Effects of a force majeure event on the private party

Under the 'no service, no pay' *Partnerships Victoria* model, unless the contract provides otherwise, the service charge is abated and the private party is left with little or no revenue to cover its fixed costs if a force majeure event prevents or otherwise adversely affects the provision of the contracted services.

If the project asset is damaged, the private party is also left to deal with the consequences of that damage (although, as highlighted above, it may not always be the case that the project asset is damaged).

Effects of a force majeure event on government

From government's perspective, the impact of the force majeure event may be mitigated if government can obtain similar services from an alternative source at the same or similar cost. For example, in the case of a damaged water treatment plant, water may be able to be treated at an alternative site or by alternative means, or in the event of damage to a prison, government may obtain prison accommodation services by transferring prisoners to another facility (depending, of course, on the state of supply relative to demand and any security issues).

However, this position may not hold true in many cases. Government may in fact be faced with the following consequences if a force majeure event occurs:

- inability to obtain the relevant services from an alternative source. This might be the case because the services simply are not available from another source, or because the project asset is the only infrastructure of its type, locally or regionally;

- increased costs in obtaining the relevant services from an alternative source — which may be greater than the amount by which the service charge is abated as a consequence of the interruption to services. This consequence most obviously occurs during the operating phase of the project. However, it is a consequence that may also arise during the construction phase of the project if, for example, damage to the project asset delays its commissioning and government is forced to continue using an existing, more expensive facility during the period of the delay; and

- non-financial consequences, such as adverse public reaction to the service interruption or to government's inability to deliver services which it has a duty to deliver.

The costs of obtaining alternative services might be allocated to the private party by way of express compensation provisions in the contract. However, the other non-financial consequences cannot effectively be allocated to the private party.

16.5 Allocating force majeure risk: government-preferred position

In circumstances where the private party can insure against the force majeure risk at a reasonable cost, optimal risk allocation dictates, unless otherwise provided for below, that the force majeure risk be allocated to the private party. (The issue of insurance and the role it plays in the allocation of force majeure risk is dealt with in more detail in Chapters 23 and 24.)

Taking into account both the nature and impacts of force majeure risk (including force majeure risks which are non-insurable, or insurable but at an unreasonable cost), optimal risk allocation principles may dictate that better value for money can be achieved by sharing a risk between government and the private party rather than allocating it to only one party. There can be varying degrees of sharing of a force majeure risk, for example:

- government shares a force majeure risk only to the extent that the materialised risk prevents it from receiving the contracted services.

  As an example, force majeure risk can be shared to the extent that the private party is relieved of the risk of contract termination, but effectively retains the financial risk of the force majeure event. Where a force majeure event affects the private party's obligations to provide the contracted services, those obligations would be suspended (subject to certain time constraints). Government's obligation to pay for those contracted services would also be suspended until delivery of the contracted services is restored (causing the private party to lose some or all of its revenue from the contract). In addition, while the force majeure event continues to exist, the private party should be obligated to use its best endeavours (including implementing appropriate temporary measures that would allow continued service delivery) to remove the effect of the force majeure event and restore the provision of the contracted services. If business interruption and/or consequential loss insurances are available, the proceeds of such insurances can be used to mitigate the loss of revenue to the private party and any increased costs to government of alternative service provision;

- the parties agree to negotiate the necessary adjustments (if any) to the charges, volumes and, if applicable, any other provision of the agreement to reflect the effect or impact of the force majeure event. Where the parties are unable to reach a mutual agreement, the matter can be referred to dispute resolution or there may be an underlying presupposition that failure to reach agreement will result in the private party bearing the consequences of the materialised risk. In these circumstances, the risk is shared according to the level of risk each party is willing to accept at the relevant time; or

- the risk is shared in accordance with a material adverse effect regime (as described in Section 18.2).

Each of the regimes above contains a different level of risk allocation to the private party, starting with the first regime where there is a limited amount of risk taken back by government. The two subsequent regimes may both result in government taking back a greater level of risk. Each regime provides a measure of equity in recognising that neither party is responsible for, or able to control, the occurrence of the force majeure event.

Risk sharing (whichever form it takes) allows the parties in some way (and to a varying extent) to pool their resources in resolving the consequences of the force majeure event and to share the burden in a way that minimises ill-effects on both parties. The exact nature of the risk-sharing arrangement should take into account the ability of each party to manage the consequences of particular kinds of force majeure events.

A suitable force majeure provision for a *Partnerships Victoria* contract is set out in Chapter 23, together with a discussion of the government-preferred position reflected in that provision.

16.6 Allocating force majeure risk: insurance proceeds and reinstatement

A detailed discussion of the application of insurance proceeds, reinstatement and termination needs when allocating force majeure risk, and a proposed contractual provision for dealing with each of these issues, are set out in Chapter 24. The government-preferred position, in general terms, is that:

- as a minimum, the private party must maintain adequate insurance against all insurable events which are considered to be 'usual' in accordance with standard commercial practice; and

- where the project asset is destroyed and/or the provision of the contracted services ceases during the contract term, owing to a force majeure event, the private party must reinstate the project facility and/or the provision of the contracted services, unless government agrees otherwise under the circumstances of the particular project. In doing so, the private party must apply all insurance proceeds to effect reinstatement.

16.7 Mitigation

Since force majeure risk is by definition beyond the control of either party, the mitigation options available to the parties are almost exclusively concerned with minimising the consequences of materialised events.

One of the few courses of action that can be taken before a force majeure risk materialises is the taking out of insurance, which effectively transfers the risk to the insurer. Depending on the availability of alternative venues for providing the service or alternative services (or a combination of both) and the commerciality of business interruption insurance, insurance may assist with the immediate problem of the interruption to service resulting from a force majeure event, as well as providing funds for remediation or reinstatement of the facility.

To minimise insurance risk (the risk that cover proves incomplete or ineffective, or that a claim is rejected), the contract should provide that:

- insurance is with insurers approved by government;

- (if possible) government is a co-insured party, not merely that its interests are noted on the policy; and

- insurance is not altered without government approval.

Insurance policies should also be reviewed regularly to ensure that coverage is adequate and effective.

Both government and the private party should have an appropriate action plan for dealing with the consequences of a force majeure event, the most important element of which will be a consideration of whether temporary arrangements for providing the service can be put in place and, if so, how this can be done. As services provided under *Partnerships Victoria* projects are ultimately services to the public, government may generally, but not always, be in the best position to locate or make available temporary service arrangements and should preserve for itself the right to do this. However, remedies such as step-in, which government might look to in other situations, may be of little use in the context of a force majeure risk event. Depending on the nature and consequences of the event, government and its appointees may be in no better position to remediate the effects of the event than the private party. One situation where the right to step in may be critical, though, is when the asset can be reinstated but the private party declines to reinstate it.

Potential force majeure events and their consequences raise the need to check that government's operational requirements are appropriately defined in the contract to deal with such events and their consequences. A force majeure event may give rise to particular needs that should be included in the service specifications.

As seen elsewhere in this chapter, *Partnerships Victoria* agreements ordinarily provide for the obligations of the private party to be suspended for a limited time if the occurrence of a force majeure event prevents it from performing its obligations. This (which is also seen as a risk sharing mechanism) will relieve the private party of the threat of termination for failure to provide the services and limit the financial impacts of the event, at least in the short term. However, such mitigation measures apply only in the short term and either termination or reinstatement must occur after an appropriate, specified interval.

Partnerships Victoria contracts should exclude from the definition of force majeure events, those events that could have been prevented, overcome or remedied by the private party exercising a reasonable standard of care and diligence. This is an important mitigant, as it will help modify parties' behaviour so that they try to prevent a risk event occurring, rather than dealing only with the consequences once the risk has materialised.

17 Asset ownership risk

17.1 Introduction

Asset ownership risk encompasses:

- the risk that the facility design life or technical life will prove shorter than anticipated and/or that the maintenance and upgrade costs of keeping the facility serviceable will exceed expectation;
- the risk that the asset will be damaged or destroyed through a force majeure event;
- the risk (depending on the contract detail) that the private party may lose the asset through default and early termination;
- the risk that the facility will not have the value which the project financial structure has ascribed to it.

Risks arising from asset ownership can arise both during and on termination of a service contract.

It is one of the tenets of *Partnerships Victoria* arrangements that these risks, most of which government has traditionally assumed in a public procurement, are allocated to the private party, which invests its money in constructing or refurbishing the infrastructure facility as a means of providing the relevant services. By procuring services only, government generally allocates to the private party the 'whole of life' costs of maintaining or upgrading/refurbishing the facility and the risk that the facility will become obsolete for technical, demographic or other reasons. Government is also relieved of the adverse effects on the asset value arising from force majeure events (except to the extent that they affect the provision of the contracted services) and from the impacts of wider market changes on the residual value of the asset.

This risk allocation may need to be modified in individual projects, depending on government requirements for the particular site and/or the facility and for its ongoing receipt of services at the end of the contract term. If government decides at the outset that it needs the site and/or facility — whether because the asset is an integral part of a public network, is integrated with other government operations, is critical for government's own service delivery or simply to preserve a strategic site — it must ensure that the project structure delivers it into government hands at an appropriate point, at an acceptable price and in an acceptable condition. This determination in turn affects the decisions made about government ownership or otherwise of the underlying land asset, as discussed in Section 8.3. If the asset is to revert to, or to be transferred to government at the end of the contract term, government is potentially exposed to residual value risk.

17.2 Definition

Asset ownership risk is the risk that events such as loss events, technological change, construction of competing facilities or premature obsolescence will occur, with the result that the economic value of the asset may vary, either during or at the end of the contract term, from the value upon which the financial structure of the project is based.

The ensuing discussion considers asset ownership risk in two categories, during the contract term and at the end of the term.

Risks during the contract term

- maintenance and refurbishment risks;
- risk of obsolescence;
- risk of loss arising from force majeure events; and
- risk of loss through contractual default.

Risk at end of term

- residual value risk.

The occurrence of the risks during the contract term may have an adverse effect on residual value, unless properly managed.

17.3 Allocating asset ownership risk during the contract term: government-preferred position

Maintenance and refurbishment obligations

The costs of maintenance and any refurbishment needed during the life of the contract are borne by the private party. This is one of the cornerstones of value for money in private provision of public infrastructure-based services.

In the past, and partly as a result of the nature of budgetary allocation processes, government has addressed maintenance requirements by over-capitalising design and construction and under-budgeting for ongoing maintenance, with the result that the community has tended to inherit expensive, risk-laden assets which in a number of cases are progressively run down.

Under *Partnerships Victoria*, the design life of assets is often (but by no means always) significantly less than that of existing equivalent assets in public ownership. This is the case because there is generally a stricter correlation between design life and the immediate and projected service needs over the contract term. The exception is in projects where the asset will be handed to government upon contract expiry or early termination (with or without specific payment depending on the financial structure of the project) and government requires a significant useful life for the asset after transfer.

Where design life has regard to the contract term, maintenance and refurbishment requirements are more prominent, to ensure that the specified service standards can continue to be met.

To ensure that both asset performance over the contract term and asset life are maintained, and that asset maintenance risk is fully and effectively allocated to the private party, a clause[22] in the following terms should be included in the contract.

Example clause: asset maintenance risk

Maintenance[1]

The Contractor must ensure on a continuing basis that at all times, its maintenance and operating procedures are sufficient to ensure that:

(a) the [Service] is continuously available;[2]

(b) it can maintain the design intention of the assets [3] to achieve their full working life;[4] and,

(c) [the Assets are handed back to Government on the Expiry Date in a condition complying with the requirements of this clause].[5]

1. It may also be appropriate to include a further provision within this clause requiring the Contractor to keep the physical assets in good structural and decorative order (subject to fair wear and tear).
2. This provision should cross-refer to the relevant output specification.
3. These are the physical assets referred to in the definition of 'Assets'. In certain contracts, this may not be required. In others, such as IT contracts, equivalent provision may be needed in relation to any maintenance of intellectual property rights.
4. This will often be for the life of the contract. To the extent that a significantly longer period is required, then this should be made clear as soon as possible in the competitive process (and certainly not after the bid documentation has been issued).
5. Paragraph (c) only applies to the extent that government has at least an option to acquire the Assets and the Contractor does not bear the residual value risk.

Monitoring and survey

Maintenance schedules and periodic refurbishment should be incorporated into the service criteria governing the payment regime and performance of these obligations should be monitored. This is especially important where government is to assume the asset at the end of the contract term.

One mechanism for undertaking such monitoring, while minimising intrusion on the private party, is for the parties to agree that government may carry out or procure a survey of the asset, if it reasonably believes that maintenance and performance obligations as set out in the schedules are not being fulfilled. To prevent abuse of this power, the number of surveys that may be conducted over a given period will be strictly limited.

[22] This and the following sample clause is derived from Section 8 of the United Kingdom Treasury Taskforce, *Private Finance*, *Standardisation of PFI Contracts* , Issue 1, Information Technology, Butterworths, London, 2000.

Example clause: Monitoring and surveys

Surveys

(a) If Government reasonably believes that the Contractor is in breach of its obligations under clause x.1 (Maintenance) then it may:

(i) carry out; or

(ii) appoint a qualified, independent surveyor (reasonably acceptable to the Contractor) ('**Surveyor**') to carry out,

a survey of the Assets to assess whether the Assets have been and are being maintained by the Contractor in accordance with its obligations under clause x.1 (Maintenance).[1] This right may not be exercised more often than once every [two[2]] years.

(b) Government must notify the Contractor in writing a minimum of [14] days in advance of the date on which:

(i) it wishes to carry out the survey; or

(ii) it wishes the Surveyor to carry out the survey.

Government must consider in good faith any reasonable request by the Contractor for the survey to be carried out on a different date if such request is made at least [7] days prior to the notified date and the Contractor (acting reasonably) is able to demonstrate that carrying out the survey on the notified date would materially prejudice the Contractor's ability to provide the [Service].[3]

(c) When carrying out a survey or procuring a survey from the Surveyor, Government must use reasonable endeavours to minimise any disruption caused to the provision of the [Service] by the Contractor. The cost of the survey shall, except where paragraphs (d)(iii) and (f) below apply, be borne by Government. The Contractor shall give Government and/or the Surveyor (free of charge) any reasonable assistance required by Government and/or the Surveyor during the carrying out of any survey.

(d) If the survey (whether carried out by Government or the Surveyor) shows that the Contractor has not complied or is not complying with its obligations under clause x.1 (Maintenance), Government:

(i) may notify the Contractor of the standard that the condition of the [Assets] should be in to comply with its obligations under clause x.1 (Maintenance);

(ii) may specify a reasonable period within which the Contractor must carry out such rectification and/or maintenance work; and

(iii) will be entitled to be reimbursed by the Contractor for the cost of the survey and any re-survey required by Government to confirm that the rectification and/or maintenance work required under this paragraph and paragraph (e) has been carried out and that the Contractor is in compliance with its obligations under clause x.1 (Maintenance) and the Assets are in the condition notified by Government under paragraph (d)(i).

(e) The Contractor must carry out such rectification and/or maintenance work as is necessary to bring the condition of the [Assets] to the standard required in paragraph (d)(i), within the period specified. Any costs it incurs in carrying out such rectification and/or maintenance work shall be at its own expense.

(f) Where Government carries out a survey under paragraph (a)(i), the Contractor may at its own cost and within [##][4] Business Days of receipt of a notice under paragraph (d)(i), refer the results of Government's survey to a qualified, independent surveyor, whose appointment is agreed to by Government (acting reasonably), for review.

> Any finding by a surveyor following a review under this paragraph (f) will be binding on the parties, and where the review shows that the Contractor has not complied or is not complying with its obligations under clause x.1 (Maintenance), paragraphs (d) and (e) will apply as if:
>
> (i) the reference in paragraph (d) to 'survey' is a reference to the surveyor's review; and
>
> (ii) the standard the condition of the Assets should be in under paragraph (d)(i), is the standard determined by the surveyor to be required.

1. Any such survey should be based upon the original output specifications.
2. Other periods may be appropriate (e.g. for an asset that requires a high or low level of maintenance).
3. There may be other relevant considerations which need to be specified, e.g. in some sectors, the survey might prejudice security if carried out on a certain date.
4. where ## = nominated number (of business days).

Maintenance sinking fund

Because the anticipated costs of maintenance and refurbishment are priced into the service charge, the private party generally builds up a substantial sinking fund over time, in anticipation of significant capital expenditure at future intervals. While government should not require rights over the sinking fund, where the asset is to be transferred to government in the event of early termination, the contract should provide that, on early termination, either the balance of the fund is to be paid to government to assist it in discharging the maintenance liabilities it will inherit or the amount is to be offset against any termination payment required from government.

Technical upgrade and asset obsolescence

Together with the maintenance requirements of the contract, the risk of abated payments for under-performance obliges the private party to bear the costs of any technical upgrading necessary to allow it to continue performing its contractual obligations.

However, during the long term of *Partnerships Victoria* contracts (which may be up to 30 years or more) technology, in most sectors, can be expected to change substantially and a more cost-efficient solution for the provision of the contracted services may well become available. There is, therefore, a need for the contract to allow some flexibility in upgrading the infrastructure and to provide incentives for such an upgrade. In such instances, government may agree to share both the costs and cost savings arising from upgrading the asset.

There may also be extreme circumstances where the asset is still capable of delivering to specifications, but technological change has so transformed the market in particular services that terminating the contract is better value for money for government than persisting with it. The termination provisions of the contract should contemplate this eventuality and the nature of any compensation and/or cancellation payments to the private party.

Damage or destruction as a result of force majeure events

The allocation of force majeure risk is discussed in detail in Chapter 16. Essentially, the private party bears the risk of insurable events and is obliged to reinstate the asset following a force majeure event. Certain post-completion force majeure events (particularly non-insurable events, or those which are not insurable at reasonable cost) may be subject to material adverse effect clauses or other mechanisms through which government may agree to some risk sharing.

Asset ownership risk associated with contract breach

One of the matters of concern to the private sector is the risk of loss of the asset following early termination for contract breach.

The extent of this risk varies, depending on whether government owns the project land, whether the private party has the benefit of a government lease (and whether the lease terminates along with the contract), or whether the private party owns the land. If government owns the land, the project infrastructure technically constitutes an 'improvement' which — unless the contract provides to the contrary — will vest in government upon reversion.

Where the asset is to revert or be transferred to government on early termination, government accepts that it should not receive a windfall from this. The government position on this issue is that, post-completion, fair market value, less government's 'break costs' and compensation and other amounts payable or owing to government (which may include additional service costs, rectification costs, re-tendering costs and any balance in a maintenance sinking fund), is an appropriate basis for calculating an early termination payment.

If a default leads to termination pre-completion and government elects to take control of the facility under construction, a fair compensation payment would be calculated on the basis of compensating the private party for monies expended on completed works. The government’s break costs together with any increase in costs to government to complete the facility above the original contract sum (including additional finance and transaction costs) are to be deducted from the compensation amount.

It is important from the point of view of the private party and its financiers that there is an objective process for determining the level of compensation payable to the private party upon early termination (whether caused by a government or private party default).

Irrespective of default, the contract should always give government the option of unilaterally terminating the project contract, subject to an appropriate compensation formula.

17.4 Asset ownership at end of contract term: government-preferred position

As discussed, either or both the facility and the site from which the services are to be delivered may be of strategic importance to government. In making that assessment, government will have regard to:

- the nature and location of the site/asset;
- the desirability of the asset continuing as part of a public network;
- the potential design and technical life of the asset;
- the likely alternative sources of service supply; and
- taxation considerations.

A *Partnerships Victoria* roadway, for example, will be required to continue as part of the public road network. Water treatment projects also typically involve the transfer of the asset to government at the end of the contract term because of the strategic value to government of water authority land.

If the site is of strategic importance, government will seek to secure the facility or site for itself when the contract term expires or will require the asset to be transferred to a third party in order to re-tender the services. Where ongoing use of the facility is required at the end of the contract term, government will request that the asset meet various performance standards to ensure that it is in reasonable condition and fit for ongoing use by government at that point. These requirements implicitly protect the value of the asset.

As previously discussed, these objectives can be achieved through imposing maintenance obligations which are general, but are based on agreed maintenance and refurbishment schedules, and a right to survey the asset and compel performance if maintenance obligations are not being met. If, immediately prior to its transfer to government, the asset is considered unlikely to have the useful life required by the contract, any reserve in the private party's maintenance sinking fund should be payable to government under the contract to defray the costs of refurbishment.

The means by which government may seek to resume the facility or site may take a number of forms, which include:

- granting a lease to the private party for a term co-extensive with the duration of the contract;
- being granted a right to purchase for an agreed price or a price determined in an agreed manner (for example, fair market value); and
- contractually requiring the private party to transfer the site to government at the expiry of the contract term (which may be for nil consideration or an agreed price).

The form in which government seeks to ensure the continuing availability of the site/facility to it will depend on the value for money aspects of the financial structuring sought by government and the private party. There is no preconceived approach. However, typically, with dedicated public infrastructure, the private party places little residual value on the property and seeks to amortise its asset and site costs fully over the contract term through the service charge. In certain projects, however, (such as some accommodation services projects), where there are other uses for the asset, the private party may be prepared to place a higher residual value on the asset, which may deliver better value for government.

Where government is considering what useful life to seek for an asset being delivered under a *Partnerships Victoria* contract, it is only in those cases where the infrastructure involves low risk technology that it is appropriate for government to consider paying for an asset with a useful life significantly beyond the contract term. The risk of obsolescence posed by higher technology assets is one that government should not normally take.

Where the asset is to be transferred to government at the end of the contract term, government should be protected from inheriting an asset which has negative value, i.e. has significant liabilities attached to it or significant costs associated with its rehabilitation or removal from the project land.

There are circumstances where government may regard its ownership or control of the site or facility as unnecessary for the delivery of the relevant services. An example may be a sports venue provided for internationally competitive games for which there is no long-term expectation of sustained demand. In such a case, government has no interest in owning the site or facility and it is for the private party to determine its approach to the future use and value of the site/facility in a manner which gives best value for money to government and thus increases the competitiveness of its bid.

Whether or not government ultimately has need of the site, the private party should be encouraged to devise a structure which maximises value for money for government and promotes acceptance of its bid, without prejudicing the commercial viability of the proposal. One such approach may be for the private party to seek tenure in the site which exceeds the contract term, to enable secondary use to be made of the site and/or the facility. Any residual value imputed to the asset flowing from that tenure may be used to off-set service charges to government, as in the case of the Victorian County Court project.

If the asset is to be transferred to government on termination and government through the service charge pays the capital cost of the asset during the contract term or agrees to pay a pre-determined price on termination, government has some exposure to residual value risk. Such risk increases with the additional useful life which the asset is to possess on termination. Generally speaking, the private party is not significantly exposed to residual value risk, since it is unlikely to attribute significant residual value to the asset in its financial projections. However, to the extent that the private party incorporates an expectation of residual value into its financial structuring or retains the asset on contract expiry, it will bear residual value risk.

17.5 Mitigation

Asset ownership risk is generally best mitigated by, first, carefully estimating the likely term of government's need for services delivered from an asset developed under a *Partnerships Victoria* contract and, second, carefully investigating possible secondary markets and trends in underlying land values. The design life of the asset should respond realistically to these estimations.

During the contract term

The risk of loss of asset value during the contract term may be mitigated by the private party having in place appropriate programs for maintenance and refurbishment and comprehensive insurance cover for all loss events for which insurance can be purchased on commercial terms.

End of term

Where government is to take a transfer of the asset at the end of the contract term, the risks it needs to mitigate are:

(a) that the asset it inherits has been inadequately designed, maintained or refurbished, so that it does not have the useful life for which government has contracted. The mitigation available to government is through the monitoring processes and enforcement rights given to it under the contract. These include monitoring during the design and construction phases, the right to survey the asset during operation and compel performance of the private party's maintenance and refurbishment obligations, and access to the balance of any maintenance sinking fund upon early termination or upon contract expiry in the event that the asset does not retain the requisite useful life; and

(b) that the asset it inherits has a negative value as a result of significant liabilities attaching to it or significant rehabilitation or removal costs. This risk is best mitigated by imposing appropriate handover obligations on the private party under the contract. Where the private party is an SPV, those obligations should in most cases be supported by sponsor guarantees or financial bonds, particularly where the nature of the project may give rise to significant rehabilitation costs.

Part Three: Key contractual issues for *Partnerships Victoria* projects

Overview

The purpose of Part Three is to illustrate how the principles discussed in Parts One and Two are implemented within the structure of a *Partnerships Victoria* contract. To be legally effective, the agreed risk allocation must be reflected in the contractual provisions and mechanisms. Aligning the payment mechanism with the agreed risk allocation and achievement of government objectives is of particular importance. This is a complex exercise in which the combined effect of all contractual provisions must be constantly scrutinised. Accordingly, it is a task which requires the expertise of the parties' lawyers. Part Three does not replace the need for detailed legal advice and in fact highlights why such advice is necessary. It does, however, offer general guidance on some of the key contractual issues common to most *Partnerships Victoria* projects and the means by which they are often addressed.

18 Dealing with risks which are difficult to allocate

18.1 Introduction

Under a *Partnerships Victoria* arrangement, the private party bears all risks which government does not expressly take back under the contract. This is usually reflected in the contract as an express acknowledgment by the private party that it accepts all risks connected with the project except those for which government has agreed to be liable or to share. This puts beyond doubt the effect of the *Partnerships Victoria* structure and the risk allocation implicit in the payment mechanism.

Risks which can be clearly identified when the contract is entered into are allocated optimally to the party in the best position to control their occurrence and their consequences if they do occur. However, there is usually a category of risks which, although identifiable to some degree, are either not sufficiently identifiable in detail, or are too variable in their possible manifestations, to be adequately assessed for specific allocation. Alternatively, they may be sufficiently identifiable but beyond either party's control and unable to be optimally allocated completely to either party. In these cases, a contractual mechanism is needed under which:

(i) the consequences of difficult-to-allocate-in-advance risks falling within specified categories can be assessed when they occur and allocated in detail between the parties then; and/or

(ii) identifiable risks beyond the control of the parties can be shared to achieve optimal risk allocation.

Necessarily, these difficult to allocate risks (such as uninsurable force majeure) will be determined on a case by case basis and it is difficult to be prescriptive. The key issue is to recognise their existence and the need to specify their occurrence and, to the extent possible, their consequences. Much of the issue is to do with allocating consequences, and this is examined below.

Allocating the consequences when a risk materialises

The means available to achieve this are (broadly) as follows:

- material adverse effect regimes which specify outcomes (such as the maintenance of revenues) which must be achieved following a materialised risk of a particular kind, but which leave the manner of achieving them to the parties to decide as occasion warrants;

- agreement to negotiate clauses which do not specify an outcome, but oblige the parties to confer about managing the consequences of a risk. Given the risk-allocation effect of a *Partnerships Victoria* contract, this effectively means that the risk is allocated to the private party, but that government is open to discussion about the possibility of some risk sharing, depending on the nature of the materialised risk; and

- provision for particular categories of materialised risk to be referred to an independent arbitrator (or general project regulator), who will determine how the consequences of the materialised risk are to be addressed and where the financial consequences should fall, having regard to principles of equity and the good of the project.

Specific pre-agreed 'black letter' allocation

Specific pre-agreed 'black letter' allocation of identified risks outside the control of either party may be made through provisions which allocate different aspects of the risk to each party (for example, force majeure provisions discussed elsewhere). These provisions may in turn refer certain aspects of the risk to be dealt with under a material adverse effect regime.

Each of these mechanisms is discussed in further detail below.

18.2 Contractual provisions

Material adverse effect regimes

'Material adverse effect' is an effect that is 'material' in its impact on the project returns, and 'adverse' in its effect. It is generally defined as an occurrence which has a materially adverse effect on the ability of the private party to repay the project debt in accordance with the amortisation schedules in the financial documents (without regard to any acceleration of the obligation to repay) or on the timing or level of project revenues or outgoings.

Material adverse effect regimes designate particular categories of risks which, if they materialise, are to undergo a special process of assessment and allocation between the parties.

These regimes have achieved a certain status within the 'science' of risk management as a more flexible tool of risk allocation than most traditional means. They can provide important comfort to the private party by specifying an outcome (such as the maintenance of the private party's returns) which is to be achieved through various measures that may be adopted by the parties when a risk in the specified categories materialises. The private party bears those risks in the categories which are not material.

A material adverse effect regime can assist with allocating specific categories of risks by:

- specifying risks or categories of risks to which the regime applies;
- providing for the parties to negotiate to address the consequences of such a risk if it materialises;
- providing a pre-determined outcome which the parties must achieve in managing the consequences of the risk; and
- providing flexibility in the range and combination of measures which may be adopted to achieve that outcome, having regard also to the overall good of the project.

The usual effect of a material adverse effect regime is to allocate risk (at least in part) to government or, in any event, away from the private party, through a process of mitigation which involves aspects of risk sharing. In general, the outcome specified is to afford redress to the private party in the event of a risk materialising, to the extent of protecting both its debt servicing ability and the project's equity return to its investors. This may, in the last resort, require government to accept the consequences of a materialised risk, but the regime usually states that direct financial contribution by government will only be contemplated where all other measures have failed and then typically not for matters beyond the control of government.

If the agreed outcome is to maintain the equity returns of the project, it is important that, at the time of contract, the parties agree on:

- the level of private sector returns; and
- the financial model to be used to ensure those returns are maintained.

The risk events to which material adverse effect regimes are applied commonly involve:

- acts of government which prevent, hinder or disrupt the private party in implementing the project in accordance with its contractual rights and obligations;
- force majeure; and
- other matters determined on a project-specific basis.

The process required by the regime generally entails the following stages:

(i) Materialisation of a risk subject to the regime and notification by the private party, which must consider in good faith that such event has had or will have a material adverse effect.

(ii) Agreement by the parties that a material adverse effect event has occurred. Failing agreement, the matter is referred to expert determination.

(iii) Once agreement is reached or an expert determination is made, the parties must negotiate in good faith to agree on an appropriate method of redress to achieve the outcome specified by the regime for the particular category of event. Failing agreement at this stage, the matter is referred to expert determination.

(iv) Appropriate methods of redress would usually include:

  - varying any restrictions on the private party's ability to vary its service charge or pass-through costs to end-consumers;
  - varying the concession period;
  - varying any government rights to receive monies under the project arrangements;
  - requesting the financiers to restructure the project financing arrangements;
  - government making a financial contribution to the project; and
  - adopting any other method of redress which the parties consider appropriate.

  As noted previously, financial contribution by government is generally expressed to be a means of last resort and then only where there is a measure of government responsibility.

(v) In determining the method(s) and the extent of redress, the parties must refer to the following:

  - limitations on possible extension of the contract term;
  - the principle that no redress is to be made available if the material adverse effect event was the result of the private party breaching a project document;
  - that certain issues or elements are to be excluded in considering the level of redress;

- the agreed projections or model forming the basis for determining material adverse effect; and
- government actions that have benefited the project so that redress only applies to the net impact.

Agreement to negotiate

Agreement to negotiate clauses are more common in a European context and are not expected to be widely used in a *Partnerships Victoria* context. They operate similarly to a material adverse effect regime, and are triggered by materialised risks having a material adverse effect on the project, but they are more uncertain in outcome. This is because, unlike material adverse effect regimes, they do not specify the outcome to be achieved by the negotiations, which may be loosely expressed as 'resolving the hardships and difficulties' faced by the private party as a result of a materialised risk. Apart from conferring certain procedural rights, an agreement to negotiate clause is unlikely to have legally enforceable content.

Agreement to negotiate clauses are unlikely to be acceptable to financiers because their effect is to delay risk allocation until a risk materialises. In addition, they are less than optimal because the lack of clarity in the risk allocation means that neither party may take responsibility for controlling and mitigating the risk.

Referral to arbitrator

Referral to an independent arbitrator is another approach that may be used, but has not been tested in a *Partnerships Victoria* context. From the parties' point of view, it has the disadvantage of discouraging cooperative management and effectively puts the ultimate allocation of the materialised risk into third-party hands. This makes the risk allocation somewhat uncertain for all parties.

Black-letter provisions distributing parts of 'uncontrollable' risks between parties

This mechanism presupposes that a risk is divisible into identifiable ingredients and that, although neither party has complete or perhaps even effective control over the risk, parts of the risk are best managed by one or other party on optimal risk allocation principles. In devising these clauses, it is vital to define the ambit of the clause (what it includes and excludes). Once the primary definition of the area of risk is established, the clause dissects the components of the risk and makes a detailed allocation of those components between the parties.

18.3 Relevant issues

Risks to which material adverse effect and similar regimes apply

It is important to distinguish risks in categories which are difficult to allocate in advance, from unidentified residual risk. Certain writers have suggested that material adverse effect regimes are used to deal with an amorphous body of unspecified risks. This is not so. They are used to cover specified categories of risks, which have, as a common characteristic, either:

- the ability of government to influence their occurrence or to better manage them than the private party, although neither is able to fully manage them; or
- the inability of either party to adequately manage the risk; and
- where a sharing or pooling of mitigation resources will produce a better value for money result.

A similar issue arises with agreement to negotiate clauses which, if not tied to clearly specified areas of risk, may imply that government accepts a proportion of any residual risk.

The principle should remain that the private party bears all risks inherent in the project, except those which government expressly takes back. Material adverse effect regimes and agreement to negotiate clauses which purport to deal with the allocation of unforeseen risks are inconsistent with this principle if they implicate government in an unspecified assumption of residual risk.

Pass-through of costs to end-users

Where a service is paid for directly by members of the public, the private party may be in a position to pass the consequences of a materialised risk in a 'difficult to allocate' category to the service-users in the form of a price increase. In effect, this means that the private party assumes risks which may be wholly or partly outside its control, on the basis that it is able to mitigate the consequences to itself by passing them through, as it would to an insurer. This may have demand risk consequences, but if the private party is in effect a monopoly provider of the services, those consequences may not be appreciable.

Whether or not demand for services will be affected by pass-through, there needs to be some control over the extent of pass-through to maintain the private party’s incentive to manage and mitigate the risk. This may mean restricting the proportion of additional costs that may be passed through. Where tariffs for services are independently regulated, the increase in price may be subject to external scrutiny and approval. The role of the regulator in such matters is complex and beyond the scope of this guide. However, the existence or otherwise of an external regulator is relevant where the ability to pass through increased costs is a factor in the parties' allocation of an otherwise difficult-to-allocate risk. In the absence of external regulation of tariffs, pass-through of costs to end-users may be subject to approval by the relevant Minister or department.

19 Mechanisms for dealing with the benefits of risk

19.1 Introduction

As discussed in Section 4.7, risks inherent in each project may, by definition, materialise to adversely and/or positively impact on either or both parties.

The government-preferred position is that where government agrees to share the downside of a materialised risk, it should be entitled to an equivalent share in any upside. Where government would not otherwise share in the downside of a particular risk, it would not seek to share in any benefit arising from its materialisation.

Notwithstanding the above general position, if the private party's rate of return during the contract term for some reason greatly exceeds expectations, so that the private party receives a windfall gain or super profits, it may be appropriate for government (and the community) to share in that windfall or super profits in accordance with a pre-determined formula. A base case financial model (BCFM) can be used for determining the degree to which government will share in the gain (see Example 2 below). An example of such a windfall gain is discussed in the context of refinancing benefits in Section 10.9.

Generally, the rate of return for all equity providers in *Partnerships Victoria* projects is to be transparent. There may be contractual provisions which prevent equity earning a significantly higher rate of return than that which has been agreed. In appropriate cases where the asset is to be transferred to government, this may result in a shortening of the contract term and the transferring of the asset to government at an earlier than anticipated date.

Government recognises that where it shares in benefits of risk (whether on a symmetrical or wind-fall basis), it must do so in a way which does not unnecessarily discourage or stifle the scope for private sector innovation. There should be a sufficient gap between the expected rate of return and the rate of return required before government can start sharing in super profits.

19.2 Contractual provisions

Allocating a risk to government, does not of itself necessarily allocate any associated potential benefit to government. For example, in a *Partnerships Victoria* project, the private party typically bears the design, construction and commissioning risk. Government may, however, agree to compensate the private party for increased costs incurred in carrying out government-initiated modifications to the works if, having used all reasonable endeavours, the private party is unable to fund the works. In doing so, government would have implicitly taken back the risk of adverse financial consequences arising from government-initiated modifications. Government would not, however, automatically have access to potential benefits (that is, cost savings) arising from such modifications, because the private party continues to bear design, construction and commissioning risk generally. The contract would need to expressly allocate any cost savings to government.

Where the allocation of risk benefits in a *Partnerships Victoria* project does not reflect government's preferred position (i.e. government shares the benefit of any risk where it shares the downside, subject to the super profits exception) or is otherwise unsatisfactory, the contract must reallocate these potential benefits. Alternatively, the contract can be employed to simply formalise the allocation implicit in the structure.

Different contractual mechanisms can address specific benefits, depending on the nature of the contract and of the potential benefit. The contractual mechanisms that can be employed to allocate potential benefits are best illustrated in light of three different possible risk allocation positions. These are:

- allocation of an identified potential benefit arising from a specific risk as the opportunity for the potential benefit becomes evident (see Example 1);
- allocation of potential benefits which may arise from a number of risks (see Example 2); and
- indirect allocation of benefits in the context of a variation to arrangements made under the contract (see Example 3).

Example 1: Express identification and allocation of a benefit

The parties may expressly identify a potential benefit in the contract and provide that, if it arises, it will be allocated to a particular party. For example:

- in an accommodation services project, the contract may provide that, where a government-initiated modification to works decreases the cost of the works, the benefit of the cost saving is to be passed directly to government (provided that any increases in the cost of works arising from government-initiated modifications are also to be borne by government); or
- a *Partnerships Victoria* contract may provide that, prior to financial close, government will 'bear the risk and be entitled to the benefit of the difference in the interest rates'.

Both of these provisions effect a symmetrical risk allocation.

Example 2: Allocation of potential benefits arising from more than one risk

Potential benefit in relation to a wide range of risks may be allocated by way of a profit-sharing arrangement. Profit-sharing focuses on an *overall* benefit to a party arising from the materialisation of several potential risks. As such, a profit-sharing allocation mechanism differs from the benefit-specific mechanisms discussed in Example 1.

Such a mechanism can only be used in a contract under which impacts on the private party's revenues can be validly used as a measure of benefits accrued to it.

For example, an agreed BCFM can be adopted by the parties. The BCFM contains all of the assumptions and information used by the private party in developing its business case, the proposed debt repayment schedule and the projected equity return. A change in circumstances can then be factored into the BCFM and the resulting changes in the project's cash flow and debt service requirements can be determined objectively.

The agreement could, subject to any appropriate exceptions, oblige the private party to pay to government a proportion of the excess amount — triggered perhaps when a pre-defined rate of return is reached — of the aggregate revenue of the private party or its subsidiaries in any relevant period over that projected in the BCFM (i.e. where there is a windfall or super profits). This could be paid as an additional concession fee, for example. There is also scope for the concession term to be shortened if the project is particularly profitable.

Accordingly, if one or more financial benefits accrue to the private party in the form of an increase in revenue, these benefits can in part be allocated to government.

Example 3: Indirect allocation of benefits

Accommodation-based *Partnerships Victoria* projects will typically have a contract term of 20 or 25 years for accommodation services but a shorter term of three to five years for the provision of the ancillary services (such as IT, security etc). This permits government to take the private party's sub-contracts for other ancillary services to competitive tender every three to five years. As part of the competitive bidding process, the service charge (which is partly based on the costs of the sub-contractor in providing the ancillary services) may be varied, based upon pricing submitted by the successful bidders. If costs relating to providing the service are lower at the time of undertaking a competitive bidding process than those payable when the current service charge was struck, those reduced costs could be factored into a reduced service charge. As a result, government would obtain benefits which otherwise would have materialised in favour of the private party.

Banking of benefits

As discussed in Section 4.7, where the downside of a particular risk is allocated to government, it may be possible to provide for any benefit arising from that risk materialising to be notionally banked to government's credit. The total of credits can then be off-set against any later claim by the private party for compensation in respect of adverse impacts of the risk.

In each of the above examples, a clear process which is workable in practice needs to be devised for calculating and apportioning the upside of a risk between the parties.

20 Tenure and access

20.1 Introduction

The obligations of the private party under a *Partnerships Victoria* project for infrastructure services almost always rely on or relate to a facility (new or existing). Those obligations may be to provide accommodation services or to provide other ancillary services from the facility. Tenure refers to the nature of the rights given to or enjoyed by the private party over the site where the facility is located.

Obtaining appropriate tenure is the mechanism by which the private party ensures that it will not be prevented from performing its contractual obligations because it is unable to properly access or use the facility. If, as would be expected, the private party bears the risks inherent in the provision of the contracted services, ensuring appropriate tenure represents one aspect of the private party’s management of this risk.

Tenure also gives the private party a valuable asset for development which allows the project to be financed.

20.2 Forms of tenure

Tenure may be provided to a private party in a number of ways and will vary from project to project. The usual means for providing tenure in a *Partnerships Victoria* project is expected to be by way of lease to the private party, with government as lessor. The lease is granted to the private party for at least the duration of the initial service term but may be for a longer period. Other types of tenure granted may be, for example, a licence to occupy the land or, in some cases, freehold tenure.

Converse to the tenure rights of the private party is government's need to be assured that it and, if appropriate, the public (as the intended beneficiaries of the core and contracted services), have adequate continuing rights to enter and use the facility for the intended purposes. These rights are referred to as access rights. For government, this in part means having the access necessary for it to deliver core services. By ensuring that it and the public have appropriate access rights to the facility, government is in a stronger position to ensure that the contracted and core services are delivered. This may raise interface issues which are dealt with in Chapter 13.

20.3 Contractual provisions

Government's access rights

The following example clauses deal with access for government and the public to the facility during both the construction and operating phases. Access during the construction phase is important to enable government to inspect the works and ensure the private party is complying with its contractual obligations.

During the operating phase, government should have wide access rights to facilities from which it provides core services. To ensure that this access right is not compromised, the government should retain the right of access irrespective of whether or not the government is in breach of the contract. Even in the event of a breach by government, the private party should not be able to deprive the government of access to the asset for the delivery of core services.

Example clause: Access during construction

The [Government Agents][1] and such persons as the [Government Agents] authorise will have access to the Site at all reasonable times to review the progress of the Works, to inspect and test the materials used in the construction of the Works, and to exercise the rights given to the Government under this agreement, provided they observe the reasonable safety and security requirements of the building contractor on the Site and cause as little disruption as possible to the performance of the Works.

1. 'Government Agents' are the parties appointed by government as its agents for the purposes of each project.

Example clause: Access during the operating phase

X.1 General

The Contractor[1] must ensure that the Facility allows the Government, the [Government Agents], such persons as the [Government Agents] authorise and all Service Users[2] to carry out their functions, including without limitation, the Government Functions,[3] and to exercise their access rights.

X.2 Access and Usage Rights

The Contractor must:

(a) ensure that the Facility is open and available for use by [Service Users] including, without limitation, the Government from [time] to [time] on Business Days or such other hours necessary for the purposes specified in clause [x].1;

(b) [ensure that Nominated Users[4] are able to access and use the Facility as and when they wish to do so, whether during or outside the times referred to in paragraph (a);]

(c) allow the Government Agents, such persons as the Government Agents authorise and all Service Users, at any time during the hours referred to in paragraphs (a) and (b), to enter and remain on the Facility for the purpose of (as appropriate):

   (i) carrying out and exercising their respective functions and access rights under this agreement, including without limitation in respect of Government, carrying out the Government Functions;

   (ii) ascertaining compliance by the Contractor with its obligations under this agreement, including without limitation that the Services are being provided in accordance with the [Service Standards][5];

   (iii) inspecting the state of repair of the Facility; and

   (iv) re-inspecting the state of repair of the Facility when notice has been served requiring the Contractor to remedy any lack of repair.

X.3 Notice of Exercise of Access and Usage Rights

The Government may exercise its rights pursuant to clause [X].2 without prior notice to the Contractor but will, as soon as practical, provide notice to the Contractor that it is exercising its rights pursuant to clause [X].2.

1. 'Contractor' in this context (and wherever else it is used in example clauses in Part Three) is a reference to the private party.
2. The definition of 'Service Users' will vary from project to project.
3. 'Government Functions' are defined as those functions (including providing core services) which government will carry out on the facility.

4. 'Nominated Users' are defined as those users who will require after-hours access to the facility. Those users may be generally referred to or identified as a particular class of persons. Depending on the needs of end-users, this clause may not be necessary.
5. The 'Service Standards' are defined to mean the service specifications in accordance with which the contracted services must be delivered.

Indemnity

The private party usually requires an indemnity from government for any loss or damage caused by government employees or agents accessing the site. Accordingly, government should put in place guidelines or procedures relating to access, particularly during construction, to ensure that occupational health and safety issues do not arise.

20.4 Relevant issues

Issues relating to the private party's tenure

The private party normally seeks to obtain a high degree of tenure in relation to the facility in order to protect its own and its financiers' investment in the project.

Government choice of tenure to be offered to the private party is driven by factors other than private party requirements. Of primary importance is whether or not government wants to take control of the facility upon early termination or expiry of the service term. The factors influencing that determination, and the forms of tenure which may be suitable in certain circumstances, have previously been discussed in Part Two in the context of site risk (Chapter 8) and asset ownership risk (Chapter 17). Providing for the private party to have leasehold rather than freehold tenure of the facility, and in particular matching the term of the leasehold to the duration of the contract, better assists government, if it is to take control of the facility on expiry, to ensure continuity of service-provision after the service term ends.

Such an arrangement is also preferable where the facility's location is significant and an integral part of its character, and government wishes to ensure that it will be able to continue providing the services from that location at the end of the service term, or it wishes to retain the ultimate benefit of the land.

Tenure should not, however, be viewed by government as simply an issue involving balancing competing rights of the private party and government in relation to the facility. The type of tenure granted may affect government in a wider sense than simply its access rights. For example, the kind of tenure which the private party obtains impacts on the value of the project asset to the private party (and therefore, to the private party's financiers). The stronger or more certain the tenure rights of the private party, the higher the value placed on the asset. This is likely to result in a lower finance cost, which in turn may flow through to government in the form of a lower service charge. This was a key factor in deciding to grant the 99-year Crown lease of the Victorian County Court site.

Where the government may wish to take control of a facility in the event of a default by the private party, the lease should terminate when the accommodation/services contract is terminated.

Issues relating to government's access rights

In light of the tenure provided or to be provided to the private party, government needs to ensure that there are appropriate in-roads on that tenure. In-roads need to guarantee access to the facility by government and its invitees (including the public) so that the facility can effectively deliver the contracted services (including accommodation services) and the core services, where appropriate. This issue is discussed in more detail under government's access rights, in Section 20.3.

A less important but nonetheless notable reason for government to obtain access rights is so that government may monitor the private party's performance. This is reflected in each of the example access clauses.

21 Changes in service specification

21.1 Introduction

Given the long term of most *Partnerships Victoria* contracts, it is highly probable that service specifications as originally agreed would need to change during the life of the contract.

From government's perspective, it requires a contract which gives it the right to make those changes as the need arises, whether frequently or infrequently.

From the private party's perspective, it may be appropriate that certain obligations it has undertaken be altered to take into account changed circumstances. Also, where it is required to respond to a government-initiated change, it needs some protection from the cost consequences of implementing that change.

Changed circumstances may arise from a number of factors, such as:

- changes in technology or practice in the relevant industry;
- changes in demand for the contracted services; and
- changes in law, including changes in government policy (which include changes in government's service requirements).

21.2 Contractual provisions

In general, where a party seeks a variation of a contractual term, there is no compulsion on the other party to agree unless the contract provides otherwise. Accordingly, a *Partnerships Victoria* contract needs to have clearly built into it government's right to change the service specifications and the circumstances under which this right can be exercised. In particular, the contract must appropriately allocate the risk of costs, delays and other consequences (both positive and negative) arising from the possible changes.

A change to service specifications may be required at various stages of the project. *Partnerships Victoria* contracts ordinarily differentiate between at least two types of changes, and provide different mechanisms for dealing with them:

- modifications to works prior to completion; and
- changes to the service requirements during operation.

Changes requested prior to completion are generally regarded as modifications to works and focus on design modification. Post-completion changes, on the other hand, focus on changes to service specifications and the consequences (whether capital or operational) flowing from those changes.

Modifications prior to completion: works modifications

The private party bears the cost consequences of a change to capital works it initiates pre-completion. Accordingly, a clause dealing with works modifications initiated by the private party is generally either silent as to which party is to bear the consequences (thereby implicitly allocating the risk to the private party) or expressly provides that the private party is to bear the cost and will not be entitled to any compensation or reprieve from its contractual obligations as a result of the modification.

The private party's ability to initiate modifications to works (irrespective of the fact that it will bear the cost of such modifications) should be limited, or at a minimum carefully monitored, particularly where government will be delivering core services from the infrastructure. For example, in an accommodation-based *Partnerships Victoria* services contract, the private party may not make modifications to the facility without government's prior written consent. This is to ensure that such modifications do not detract from the capacity of the facility to meet the service requirements of the contract. Generally, the contract should also provide that the private party must at its own cost (a) obtain government's prior written endorsement of the drawings and specifications for the modifications, and (b) carry out the modifications observing the same construction obligations as applied to other facility works and any other reasonable government requirements.

Notwithstanding the above general position on private party modifications, the private party should be encouraged to initiate innovative modifications which will deliver better value for money to government (for example, in the form of lower service charges). Where such initiatives are considered worthwhile by government, they can be pursued as government-initiated modifications, the cost of which will be borne by — or at a minimum shared with — government.

Subject to certain limited exceptions, government bears the consequences of a government-initiated modification to works pre-completion, whether by way of a lump sum capital payment or in the form of higher service charges to be paid during the operating phase.

When notified of government's required modification, the private party must provide government with its estimate of the cost consequences (if any) that implementing the modification would have on the service charge. If government accepts this estimate, the private party must execute the modification. If government does not accept the estimate, the private party is not obliged to implement the modification.

Where government elects not to fund the modification by way of a capital expenditure payment, the private party must use all reasonable endeavours to fund any government-initiated modification to the facility works (which government will indirectly fund through the service charge). However, where the private party has used all reasonable endeavours but is unable to fund it, the private party is not required to implement the modification.

Where the private party is not required to implement the modification for the reasons set out in the previous two paragraphs, government should still have the right to fund the modification itself.

The discussion of unintentional taking back by government of design risk in Section 9.3 is also relevant to a consideration of risks associated with government-initiated works modifications where they extend or relate to the design of the facility.

An example follows of a suitable provision covering government-initiated modifications to works.

Example clause: Government-initiated works modification

'**Modification**' means, prior to Completion of the Facility, a variation, addition or deletion to the Facility Works and after Completion of the Facility, a variation, addition or deletion to the Facility (excluding any minor changes of a non-structural nature and maintenance and refurbishment works).

[X] Secretary Modifications[1]

(a) The Secretary may at any time prior to the Facility Completion Date request a Modification to the Facility Works.

(b) Where the Secretary requests a Modification, the Contractor must within [*insert relevant approval period*] inform ('Contractor's Notice') the Project Director[2] of:

(i) the cost consequences of the Modification; and

(ii) the time consequences of the Modification; and

(iii) the effects:

(A) on the workmanship or durability of the items of plant or equipment affected by the proposed Modification;

(B) of the proposed Modification on operation or maintenance; and

(C) of the proposed Modification on the Contractor's obligations relating to defects liability, liability for design or other obligations under this Agreement;

(iv) the variation (if any) required to the [*relevant services charge(s)*] as a consequence of the Modification and give evidence supporting that variation.

(c) Within [*a reasonable time period, such as 10 business days*] of receipt of the Contractor's Notice, the Secretary may do one of the following:

(i) accept the Contractor's Notice ('Acceptance Notice');

(ii) dispute the cost consequences in paragraph (b)(i) and/or the variation in fees and charges specified in paragraph (b)(iv); or

(iii) reject the Contractor's Notice.

If the Secretary fails to accept the Contractor's Notice or refers the matter to dispute resolution under clause [y] within *[a reasonable time period such as 10 business days*], the Secretary will be deemed not to have accepted the Contractor's Notice.

If the Secretary issues an Acceptance Notice, the Contractor must execute the Modifications.

(d) Where the Secretary issues an Acceptance Notice the [*relevant service charge(s)]* will from the Facility Completion Date[3] be adjusted in accordance with the Contractor's Notice.

(e) Where the Secretary issues an Acceptance Notice, [the Date for Completion of the Facility], [any Relevant Milestone Date], [the Date for Mechanical Completion] and [the Facility Sunset Date][4] will be extended by the number of days specified in the Contractor's Notice.

(f) (i) The Contractor must use all reasonable endeavours to fund the Modification including:

(A) using any cost savings (excluding amounts paid to the [*Minister*] under paragraph (g) resulting from other Modifications requested and implemented under this clause [x] which have resulted in amounts being available for such purposes;

(B) arranging for additional funding under the [*relevant financing documents*] or from other sources; and

(C) arranging other funding on commercial terms for the Secretary (without any obligation on the Secretary to make any such arrangements).

(ii) Where funding for a Modification is not available and the Contractor has complied with its obligations under paragraph f(i), then the Contractor is not obliged to execute the Modification.

(g) Where the Modification requested by the Secretary under this clause [x] has the consequence of decreasing the cost of the Facility Works, the benefit of such a cost saving will be passed directly to [*insert the relevant Minister entering into the contract on government's behalf*].

1. 'Secretary' in this context means the Secretary of the relevant government department or Chief Executive of the relevant agency that represents government and which has the power (whether directly through legislation or otherwise by delegation) to request, carry out and generally oversee government-initiated modifications.

2. 'Project Director' refers to a person appointed by government as its representative to act for and on its behalf.

3. 'Facility Completion Date' being the date on which government is satisfied that the facility is complete and the provision of the contracted services can commence. Completion usually requires all commissioning and operational commissioning tests to have been satisfied.

4. Each of these dates varies according to the individual circumstances of a project.

Modifications post-completion: variations to service specifications

Unless the circumstances of the particular project require otherwise, only government is to be provided with a right to vary the service specifications during the operating phase. Even though the private party is not to have this right, it should have sufficient flexibility within the terms of the contract to modify the way it delivers the contracted services to allow for innovation and technological advancement. As with pre-completion modifications, the private party can suggest changes if it believes these will be of benefit to both parties.

In accordance with optimal risk allocation principles, government generally bears the risk of government-initiated modifications to service specifications post-completion. In practical terms, this means funding any capital expenditure and/or operating costs arising from a government-initiated change to specifications. Government can provide funding in one of the following two ways:

- in respect of capital works required as a result of the government-initiated change, a lump sum capital expenditure payment required for carrying out those works; or

- increasing the service charges to reflect any capital expenditure, recurrent costs or appropriate funding costs incurred by the private party in carrying out the government-initiated modification.

Where government funds the cost consequences of a government-initiated modification (whether by way of a capital expenditure payment or through the service charges), it does so where the costs are above an agreed minimum monetary amount. Government does not fund expenditure incurred by the private party, by way of capital expenditure or operating costs, where such expenditure is below the agreed amount. The private party bears that cost. Sub-clause X.3(d) of the following example clause deals with this aspect of funding government-initiated modifications. The minimum monetary amount is referred to as a Significant Amount in that example clause.

Where government does not elect to make a capital expenditure payment, the private party is required to use all reasonable endeavours to obtain additional or alternative funding to pay for any necessary capital works. New or additional funding is generally subject to various restrictions considered necessary by government under the circumstances, including:

- where the new/additional funding is debt finance, any increase in the service charge should not be more than the amount required to amortise the loan amount (and interest) over the term of the loan; and

- where the new/additional funding is in the form of equity, the increase in the service charge is not to be greater than amount required to give the equity holders the prevailing market rate of return on the additional funding.

Being required to fund government-initiated modifications with capital cost consequences may be a real issue for the private party, which may not be in a position to readily access additional debt or equity. Requiring the private party to fund the modification and then deferring recoupment to the operating phase may not be practicable. Accordingly, where the private party has used all reasonable endeavours to obtain additional or alternative funding but is unable to fund the cost of the capital works, and government does not elect to make a capital expenditure payment to fund the capital works, the private party will not be required to implement the government-initiated modification.

Where the private party does implement government-initiated modifications, it is generally required to continue providing the contracted services while implementing the modifications unless the private party is prevented from doing so as a result of implementing and adopting them. At a minimum, the private party must take all reasonable action to minimise the disruption to the end-users (whether it be government or the public).

The form that change to service specification clauses can take varies. In certain circumstances, the clause may exclusively address government-initiated changes to the service requirements. In other cases, variations to the service requirement may be dealt with by a change in policy clause, which brings it within the ambit of change in law (legislative and government policy risk) as discussed in Chapter 15.

The contract should, at a minimum, set out procedures for notifying the proposed government-initiated change and for certifying the consequential cost of the change. The process for notifying and assessing the impacts of variations to service requirements may be similar to that applying to pre-completion works modifications, in that the private party is required to provide an estimate of the impact of the variation, which then forms a starting-point for agreement as to compensation and other measures to be provided by government.

The contract should also require the private party to take steps to mitigate the cost consequences of the change. An obvious mitigation step is to attempt to accommodate the change within the private party's existing procedures and cost structure. The private party may be required to provide proof to government of actions taken, before government pays any increase in the service charge or makes a capital expenditure payment.

Where the private party is not required under the following clause to implement the modifications, government may still fund the modification itself.

Following is an example of a clause which adopts a change in policy approach and which would be acceptable for an accommodation-based *Partnerships Victoria* project. Change in policy would be defined to include a significant and sustained increase in the frequency or quantum of the contracted services, or a change in the service standards by government, which affects the facility or the delivery of the contracted services. Unless otherwise indicated, capitalised terms in this clause have the same meaning as in the example clause set out above in 'Modifications prior to completion: works modifications'.

Example clause: Variations to service specifications

X.1 Notification

(a) If there is a Change in Policy, the Secretary must notify the Contractor in writing not less than [*a reasonable time period such as one week*] prior to the effective date of the Change in Policy ('Policy Notice').

(b) Where:

(i) the Contractor considers that a matter which it is lawfully required to comply with is a Change in Policy which affects the Contractor's obligations under the contract [*in an accommodation-based project, this will generally relate to the private party's obligation to provide accommodation services*];

(ii) the Secretary has not issued a Policy Notice under paragraph (a); and

(iii) the Contractor refers the matter to dispute resolution under clause [y] to determine whether or not the matter constitutes a Change in Policy,

then if it is determined by the dispute resolution process in clause [y] that there has been a Change in Policy, the Secretary is deemed to have issued a Policy Notice on the date of the determination.

X.2 Contractor Obligations

As soon as practicable after receipt of the Policy Notice, the Contractor must notify the Secretary ('Contractor's Notice'):

(a) of the structural improvements that the Contractor proposes to make to the Facility to comply with the new policy, if any;

(b) of the capital expenditure involved in making those improvements, if any;

(c) of the change in procedures or systems that the Contractor proposes to adopt to comply with the new policy, if any;

(d) of the increase (if any) in the [*relevant service charge*] proposed by the Contractor to reflect any capital expenditure payment made or to be made by the Contractor and any recurrent or funding costs incurred or to be incurred by the Contractor in complying with the Change in Policy (which may include any capitalised interest the Contractor will incur as a result of the proposed method of funding a capital expenditure payment, but not including a profit component to the Contractor);

(e) of whether or not any required capital expenditure can be accommodated within the next planned refurbishment or renovation of the Facility;

(f) of the estimated financial cost to the Contractor of the Change in Policy, in the form of a financial statement certified by an accountant independent of the Contractor who is a member of the Australian Society of Certified Practising Accountants or of the Institute of Chartered Accountants or a successor body carrying out the same or similar functions;

(g) of the time within, and the manner in which, the Contractor proposes to construct and complete any such structural improvements; and

(h) of the proposed method of funding the capital expenditure.

For the purposes of sub-paragraph (d), the [*service charge*] can only be increased if the Change in Policy adversely affects the delivery or the cost of delivering the Services.

Where the Change in Policy requires structural improvements to be made to the Facility, the provisions of Part [#][1] of this Agreement will apply to the execution of such works.

As soon as practicable after receipt of the Policy Notice, the Contractor must provide the Secretary with a certificate under the *Evidence Act 1958* from a director of the Contractor declaring:

(i) the Change in Policy cannot be accommodated within the current Operating Manual[2] and the existing costs; and

(ii) the accuracy of the estimated financial information provided to the Secretary.

X.3 Acceptance by Secretary

(a) **Accommodation Services**

The Secretary may, subject to clause X.3(c):

(i) accept the Contractor's Notice issued under clause X.2;

(ii) elect to make the capital expenditure payment referred to in clause X.2(b) provided the Minister confirms this election; or

(iii) withdraw the Policy Notice. If the Secretary withdraws the Policy Notice, the Contractor is not required to comply with nor implement the new policy the subject of the Policy Notice.

(b) **Implementation**

If the Secretary accepts the Contractor's Notice or the dispute is resolved under clause [y] (Dispute Resolution) and the Secretary does not, within [*a reasonable time period such as 5 business days*] of resolution of the dispute, withdraw the Policy Notice, then:

(i) the Contractor must, subject to paragraph (c) below, implement and adopt the Change in Policy in compliance with the proposals in the Contractor's Notice as modified by the resolution of any dispute under clause [y] (Dispute Resolution); and

(ii) where the new policy relates to [*Accommodation Services or any other relevant services*][3] and a Significant Amount[4] has been incurred or will be incurred, then:

(A) where the Contractor has proposed an increase in the [*relevant service charge*] under the Contractor’s Notice, the [*relevant service charge*] will be adjusted in accordance with the Contractor’s Notice with effect from completion of the works required to comply with the Change in Policy; or

(B) where the Secretary has elected to make a capital expenditure payment under clause X.3(a)(ii), Government will make such payment upon certification by the Secretary's consultants that the works required to comply with the Change in Policy have been completed.

(c) **Provision of Services**

In adopting and implementing the Change in Policy, the Contractor must continue to provide the Services except to the extent that such Services cannot be provided in the ordinary course as a necessary and intended consequence of adopting and implementing the Change in Policy. In any event, the Contractor must minimise any disruption to [*the End-Users, whether it be government or the public*] as a result of the adoption and implementation of the Change in Policy.

(d) **Significant Amount**

Notwithstanding any other provision contained in this clause X, if a Significant Amount is not incurred by the Contractor then Government will not be obliged to pay any increase in the [*relevant service charge*] or make a capital expenditure payment.

X.4 Alternative Funding

Unless Government elects to make the capital expenditure payment described in X.3(a)(ii), the Contractor must use all reasonable endeavours to obtain additional or alternative funding for the purpose of the capital expenditure referred to in paragraph X.2(b). The parties agree that the proposed method of funding the expenditure must reflect the following principles:

(a) it must allow for lower construction costs (if any) due to the existing infrastructure on the project land;

(b) it must reflect the cost to the Contractor of securing the additional or new funding:

(i) such that, if the additional or new funding is debt finance provided by a third-party financier, any increase to the [*relevant service charge*] is equal to the amount required to amortise the increased or new loan facility and interest by the expiration of the loan term; or

(ii) such that, if the additional or new funding is provided by way of subscription of shares in the Contractor or the making of loans to the Contractor by its shareholders, the increase to the [*relevant service charge*] is equal to the amount required to give the new or additional equity an internal rate of return that is not greater than the prevailing market rate of return.

X.5 No Obligation to Fund

Where the Contractor has complied with its obligations under clause X.4 and, notwithstanding that compliance, is unable to fund the cost of the capital expenditure and Government does not elect to make the capital expenditure payment under clause X.3(a)(ii), the Contractor is not obliged to implement the Change in Policy.

X.6 Contractor Costs

Where the Contractor uses all reasonable endeavours to obtain additional or alternative funding, but, in accordance with X.5, is not obliged to implement the Change in Policy and:

(a) it was reasonably necessary that the Contractor incur expenses in attempting to obtain the additional or alternative funding; and

(b) the Contractor can demonstrate to the Secretary's satisfaction, that, having acted reasonably to minimise any such expenses, there are nonetheless reasonable and justifiable expenses (excluding any consequential losses) which it has incurred,

the Minister and the Contractor will negotiate in good faith to agree on a sum, not exceeding $[*amount*], which the Minister will pay to the Contractor to compensate the Contractor for those expenses. The cap of $[*amount*] is not an acknowledgment by the Minister that there will be expenses which satisfy the requirements of this sub-clause X.6, nor is it to be taken as an estimate of the quantum of such expenses.

1. Part [#] is a reference to that part of a *Partnerships Victoria* contract which deals with design and construction issues.
2. This is a reference to the manual or other mechanism prepared by the Contractor which contains the Contractor's operating philosophy and specifies how the Contractor will deliver the contracted services to the specified standards.
3. 'Accommodation Services' refers to the building-related services, including maintenance and refurbishment and the provision of the accommodation in the form, for example, of prison cells, courtrooms and hospital beds.
4. 'Significant Amount' is the monetary amount agreed to by the parties, below which government will not be required to make a capital expenditure payment or fund the cost of compliance through the service charges. The 'Significant Amount' is to be a reference to the aggregate of all modifications requested by government in a given year or over the contract term.

21.3 Relevant issues

Risk of unintentional take-back by government

Given that *Partnerships Victoria* projects are output-based, government intervention during the construction phase (by capital works modifications) or during the operating phase (by modifications to the service specifications) could potentially prejudice government's risk position. More specifically, by intervening in any of these ways, government could risk taking back design and construction and operating risks (or aspects of them) which it thought it had successfully allocated to the private party. Accordingly, care must be taken in this respect. Government-initiated works modifications during the construction phase should not be necessary if the appropriate work on the service specifications was undertaken by government before it went to the market. These issues are more fully discussed in Section 4.5 and in Chapters 9 and 11.

Assessing cost implications

In accepting risks associated with a government-initiated modification (whether to capital works during construction or to service specifications), government needs to be assured that a suitable mechanism is in place by which the cost impact of the modification can be appropriately measured and funded. This is reflected in both example clauses above, which provide in part:

- that upon being notified of the government-initiated modification, the private party must provide government with an estimate of the technical, financial, contractual and timing implications of adopting and implementing the modification; and
- for government to:
  - accept the private party's estimate, in which case the modification is carried out on the basis of the private party's suggested variations (in which case the service charge is adjusted accordingly and/or the relevant capital expenditure payment made);
  - reject the contractor's estimate, in which case government may withdraw its request for modification or (where it has the right to do so) take the issue to dispute resolution if it wishes to continue with its proposed modification; or
  - fund any capital works by way of a lump sum capital expenditure payment, where the private party, having used all reasonable endeavours to so, has been unable to fund a government-initiated modification.

The contract should also provide government with a means of testing the private party's estimate, whether by specifying valuation principles to be applied in assessing the impact of the variation; by requiring the private party to provide supporting evidence of its estimate; or by giving government a right to have the estimate independently reviewed.

22 Availability

22.1 Introduction

Given that the substance of a *Partnerships Victoria* project is the procurement of a service, the availability of the service is a key issue for government. Failure by the private party to make services available strikes at the very heart of the project, especially where payment is based (wholly or partly) on availability rather than usage. *Partnerships Victoria* projects that involve accommodation-based services (such as the provision of hospital, prison, educational or office accommodation services) are of particular relevance as they are more likely to give rise to availability-type issues than other *Partnerships Victoria* projects.

The contract must define what is meant by the service being 'available'. Typically, a service is available when it is provided in accordance with ‘Availability Standards’, being the set of performance indicators against which the standard of service delivery is measured. The Availability Standards vary from contract to contract depending on the nature of the project. Generally however, they are associated with the quantity and quality of the service and the frequency with which it is to be provided. If the service is not provided in accordance with the Availability Standards or is not provided at all, the service is 'unavailable'.

22.2 Availability and the payment structure

The risk of unavailability is to be borne by the private party. Accordingly, payment under the contract must depend on the services being available. The private party is not to be paid — or is to be paid a reduced service charge — if the service is unavailable. As payment depends directly on availability, the definition of availability must be clear and objective, and the specifications reasonable and easily measurable (so that the parties can objectively establish whether or not the specifications have been met, and the payments affected in any way).

The alignment of availability of a service and payment for it may be achieved:

- by basing the service charge (or at least part of it) on a measure of available service (for example, in a contract for court accommodation services, payment might be based on the number of courtrooms that are available and meeting the service specifications during a particular period); or

- by abating a pre-agreed payment in accordance with a calculation based on services which are unavailable (again, using the court accommodation services contract as an example, payment might be abated in line with the number of courtrooms which are unavailable during a particular period); or

- by using a combination of both.

It is not uncommon for government also to seek compensation for accumulated unavailability, calculated in various ways including a points system.

Other mechanisms (such as step-in and termination) may also be used to redress the situation of unavailability of a contracted service, but they are generally options of last resort.

An abatement regime can be used wherever government is required to make payment, whether or not government is receiving the service itself.

In addition to its rights to abate the service charge in line with unavailability, government should also have the right to issue a notice to the private party requiring it to effect, at its cost, a rectification program to remedy an existing or likely failure to make the services available.

22.3 Contractual provisions: relevant issues

Application of the concept of availability

Payments based on availability and capacity are most familiar in the context of *Partnerships Victoria* projects for accommodation services, where what is to be made available is serviced space.

Despite that, there is no reason in theory why the concept of availability should not extend beyond the physical aspect of the service (such as hospital accommodation in the form of beds or court accommodation in the form of courtrooms) to related ancillary services which it is necessary to provide to meet the performance standards of the accommodation services and to make them useable. In practice, this would result in government effectively paying for properly maintained, cleaned, air-conditioned and well secured court, hospital or office space with fully functioning IT infrastructure, not just for the basic accommodation service.

Depending on the project, different weightings may be ascribed to different service requirements, so that some failures to provide a service exactly in accordance with the terms of the contract do not lead to an abatement of the service charge. For example, some contracts may distinguish between unavailability which is material and unavailability which is not, and only that which is material will give rise to an abatement of the service charge. This is facilitated if the service charge is a unitised charge. However, continued failure to make non-material services available must lead to some sanctions, such as abatement.

In the context of accommodation services, the service charge will typically comprise:

- a payment for common areas which are in general use whenever the facility is in operation; and

- a payment in respect of allocable units of functional space such as beds or wards in a hospital or courtrooms in a court complex.

Separate abatement regimes for unavailability may apply to each of these components.

The following example clause sets out the kind of formulae which may be applied in the case of a unit payment, where the units of space can be reserved or booked in advance. The formulae are generic and will need to be customised to suit the payment mechanism and service requirements of the particular project.

Example clause: Abatement for allocable units of functional space

[X] Abatement

X.1 Unit payment

If a unit is not Available[1], the Minister may abate the [*relevant unit-charge*] in any [*relevant payment period*] by the amount of the Usage Fee Reduction ('**UFR**') which is determined in accordance with the following formula:

$$UFR = (F_1 \times D_1) + (F_2 \times D_2)$$

where:

F_1	=	The agreed fee for the reserved unit space.
F_2	=	The agreed fee for late booked unit space.
D_1	=	The number of Days/Hours for which a unit of space was reserved for the relevant period and was not Available.
D_2	=	The number of Days/Hours for which a unit of space which was booked late for the relevant period, was not Available.

1. The definition of Availability will vary depending on the service requirements of the particular project.

To facilitate abatement for non-availability of accommodation services, the relevant facility can also be divided into zones to allow abatement for non-availability of common areas to be calculated on the basis of pre-agreed percentages of floor-space.

Example clause: Abatement for common areas

X.2 Common Area Payment

If the Common Areas[1] or any part of them are not Available, the Minister may abate the [*Common Area service charge*] in any [*relevant payment period*] by the amount of the Common Area Payment Reduction ('**CAPR**') which is determined in accordance with the following formula:

$$CAPR = \frac{CAP}{N} \times AA \text{ X } PFA$$

where:

CAP	=	the [Common Area service charge] otherwise payable during the period in which the relevant Common Area is not Available
N	=	the number of days in the relevant period.
AA	=	is the Area Allocation applicable to the relevant Common Area affected by the Unavailability, expressed as a percentage of the total area of the Common Areas and as specified in the following table

1. The definition of Common Areas will vary from project to project depending on the accommodation services being provided.

Common Area	m^2	Area Allocation
Specialised area [e.g. judicial chambers or operating theatres and associated corridor areas]		a%
Other specialised area [e.g. jury areas or consulting rooms and associated corridor areas]		b%
General non-public areas, training room, staff canteen etc.		c%
Car park and surrounds		d%
Public and general spaces		e%
Administration		f%

PFA = the percentage of the relevant Common Area which is not Available (for example, if the whole of the relevant Common Area is affected, the PFA is 100%, if half the Relevant Area is affected, the PFA is 50%).

Exceptions from liability

There may be certain circumstances where unavailability of the service will not result in a reduced payment for the private party. Again, while exceptions vary between contracts, some examples are:

- where the unavailability is a direct result of scheduled or preventive maintenance being carried out;
- where the unavailability is caused by government interference and the private party has taken all proper and reasonable steps to minimise the effect of the government intervention. This exception may, in another light, be viewed as the private party managing its risks of interface with government; and
- where the private party puts in place 'temporary measures' and diligently attempts to cure or address the circumstances of the unavailability.

Temporary measures are those which the private party puts in place (generally on a temporary basis) as an alternative means of providing the contracted service. These may be of a lesser standard than otherwise required by the service specifications but are nevertheless of a standard reasonably acceptable to government.

Example clause: Temporary Measures

[X] Temporary Measures

(a) Without limiting any other rights of the Minister under this clause, immediately upon the Secretary issuing a certificate that a Common Area is not Available, the Contractor must implement reasonable Temporary Measures to address the lack of Availability described in the relevant certificate.

(b) Where the Contractor implements Temporary Measures during any period of Unavailability of a Common Area, the [*relevant service charge*] will not be reduced in accordance with clause [y] [Abatement] for the period during which the Temporary Measures are effected and to the extent that such Temporary Measures result in the Minister being able to use the relevant Common Area.

(c) The Contractor is only entitled to the benefit of paragraph (b) where the Contractor is also diligently pursuing a cure for or otherwise addressing the Unavailability described in the Secretary's certificate.

Grace period for abatement

Depending on the circumstances, the private party may be allowed a grace period during which it can rectify the unavailability, without triggering an abatement of the service charge. Government's preferred position is not to allow the use of grace periods without abatement, so that the private party is not paid for a service it has not made available. In the exceptional circumstances where such grace periods are allowed, however, the contract must clearly and precisely identify when a service will be deemed to have become unavailable, to enable both parties to accurately measure the period allowed for rectifying the unavailability. In those circumstances, unavailability is to be deemed to commence upon notification by government to the private party of the unavailability.

How long the grace period should be depends on the nature of the project and more specifically, how critical the unavailable service is. Where the unavailability affects more than an agreed percentage of the services, or the sub-standard performance accrues to below an agreed level, it is increasingly inappropriate for government to make payment for services it is not receiving. In these circumstances particularly, the private party should not have any right to a grace period without abatement.

Relationship between abatement and default

It is important to recognise the distinction between failure to earn a payment and default. If the contract merely states that failure to make a service available will lead to payment abatement, no default arises from such failure. Such unavailability complies with the contract terms and is not in breach of them. The redress for government is non-payment (unless the private party can earn a payment by implementing temporary measures).

However, continued non-compliance will generally lead to default. Subject to appropriate cure periods, this may give rise to the exercise of step-in rights and, in the event of serious default, may result in termination.

If government uses 'unavailable' services

In some circumstances, government may continue to use a service notwithstanding that it is technically unavailable or not fully available. For example, part of the accommodation service may be unavailable because the air-conditioning is not working, but government may nevertheless continue to use that part of the facility. In that situation, the question arises as to whether the service charge should still be abated.

The matter may be dealt with in a variety of ways, including the following:

- the service may be deemed to be available if government does not stop using it within a specified time period and government will continue paying the service charge for availability;
- the service charge may not be abated or any abatement may be reduced, to the extent that government uses the service; and
- the service charge may still be fully abated in line with the service being unavailable. This measure might only be acceptable in circumstance where, although the service is still used, either the unavailable service element is important or it is well below the required standard and there is no alternative service.

Even though government may continue using services that are unavailable, the private party has an obligation to provide temporary measures and take all other reasonable action to rectify the service deficiency.

Example clause: Government uses 'unavailable' services

[X] Minister's discretion on Unavailability

(a) Where:

(i) a [*relevant unit of space*] is not Available; or

(ii) the Common Area or any part of it is not Available,

or becomes Unavailable during the course of a day on which the Government is entitled to use the Affected Area[1] in accordance with this Agreement and a certificate is issued by the Secretary in respect of that Unavailability, the Contract Administrator[2] may, after arranging for an inspection of the Affected Area to be conducted, at his or her discretion, notify the Contractor that the Government will use the relevant Affected Area notwithstanding its Unavailability.

(b) If the Contract Administrator gives notice in accordance with paragraph (a), the [*relevant service charge*] will not, subject to paragraph (d), be reduced in accordance with clause [y] [Abatement] for the period during which the Government uses the Affected Area.

(c) Despite the Government electing to use the Affected Area in accordance with paragraph (a), the Contractor must, immediately upon the Secretary issuing a certificate that the Affected Area is not Available, provide an [Acceptable Alternate *unit of space*][3] or, in relation to the relevant Common Areas, implement Temporary Measures and diligently pursue a cure under and in accordance with clause [u] [Temporary Measures].

(d) The Government may at any time while the Affected Area remains Unavailable elect, at the Government's discretion, to cease using the Affected Area and exercise its rights in accordance with clause [y] [Abatement].

1. 'Affected Area' will be defined to mean that part of the facility which is not Available.
2. The Contract Administrator will be appointed by government to act on behalf of the relevant Minister.
3. How this term is defined in each project will depend on the accommodation services being provided and the standards to which those services must be delivered.

Compensation and abatement where government has to use alternative services

Where government has to find alternative services because the contracted services are unavailable, the private party generally needs to compensate government for any consequential losses, unless such loss is otherwise dealt with through the abatement regime. Such compensation is generally capped in some way, so that the private party is not exposed to unlimited liability for uncapped consequential losses. The default and termination provisions of the contract are also relevant here, in that they are likely in practice to limit the duration of alternative service provision by bringing other mechanisms and sanctions into play.

23 Force majeure

23.1 Introduction

As discussed in detail in Chapter 16, events of force majeure are generally major specified events which are beyond the control of either party and which, when they occur and as a consequence of their occurrence, prevent the private party from fulfilling its contractual obligations. Force majeure events traditionally fall into two categories, acts of God and political events.

The definition of a force majeure event will vary significantly between contracts. Contracts must expressly define events that will constitute force majeure events to limit any catch-all effect, even where the starting point is apparently very broad. The following is an example of a suitable force majeure event definition which reflects the discussion and government's preferred position as outlined in Chapter 16.

Example of a force majeure event definition

Force Majeure Event means

(a) acts of God, specifically storms, lightning, cyclones, earthquakes, natural disasters, actions of the elements, tidal waves, floods, droughts, landslides, mudslides and nuclear, chemical and biological contamination; and

(b) civil riots, rebellions, revolutions, terrorism, civil commotion, insurrections and military and usurped power, malicious damage, acts of a public enemy and war (declared and undeclared)

as a result of which a party is prevented from or delayed in performing any of its non-financial obligations.

23.2 Contractual provisions

Once a force majeure event has been defined, the contract must allocate the risk of it occurring. A sample force majeure clause is set out below. It has been drafted to reflect a sharing of force majeure risk by government to the extent that the materialised risk prevents it from receiving the contracted services. This risk allocation is discussed in more detail in Section 16.5.

Example clause: Force majeure

X.1 Notification

(a) If the Contractor becomes aware of any matter likely to constitute a Force Majeure Event, the Contractor must immediately give notice of that matter and all relevant particulars to the Government.

(b) Within [*specified period*] of the occurrence of a Force Majeure Event, the Contractor must give to the Government notice containing full particulars of the Force Majeure Event including its nature and likely duration, the obligations affected by it and the nature, extent and likely duration of its effect on the Contractor’s ability to perform those obligations ('Suspension Notice').

(c) The Contractor must keep the Government informed at reasonable intervals, and upon the request of the Government, of:

(i) an estimate of the likely duration of the Force Majeure Event and of its effect on the Contractor's ability to perform its non-financial obligations;

(ii) the actions taken or the actions proposed to be taken by the Contractor to mitigate or minimise the effects of that Force Majeure Event including any Temporary Measures; and

(iii) any other matter relevant to the Force Majeure Event or the Contractor's obligations affected by the Force Majeure Event.

X.2 Suspension of Obligations

To the extent they are affected by a Force Majeure Event, the Contractor's non-financial obligations under this agreement will, subject to clause X.3, be suspended from the date the Contractor gives a Suspension Notice in respect of that Force Majeure Event until the Contractor ceases to be prevented from or delayed in performing any of its non-financial obligations under this agreement as a result of the relevant Force Majeure Event ('Cessation Date'), provided however that:

(a) irrespective of any suspension of obligation under this clause X.2, the maximum period of suspension of obligations under this clause will be [*specified period*] per event from the date of occurrence of the relevant Force Majeure Event; and

(b) the [*term of the contract/relevant milestone dates*] will be extended by the period during which the Contractor's obligations are suspended pursuant to this clause, so long as the aggregate of all extensions of the [*term of the contract/relevant milestone dates*] pursuant to this clause does not exceed [*specified period*].

X.3 Temporary Measures and Alternative Arrangements

During the suspension of any obligation under clause X.2:

(a) the Contractor must use its best endeavours (including, without limitation, incurring any reasonable expenditure of funds, rescheduling of manpower and resources and the implementation of Temporary Measures) to remove the effect of each Force Majeure Event on the Contractor's performance of its non-financial obligations under this agreement; and

(b) the Government may make alternative arrangements for the performance of any suspended obligation, whether by another person or otherwise, without incurring any liability to the Contractor.

X.4 Notice of Cessation of Force Majeure

The Contractor must give immediate notice to the Government of the Cessation Date and must immediately after the Cessation Date resume performance of any obligation suspended as a result of the particular Event of Default.

X.5 Adjustment of [Service Charge]

(a) Subject to sub-clause (b) below, during the period that the Contractor's relevant obligations are suspended under clause X.2, the [*relevant service charge*] will be reduced by an amount reasonably determined by the [Government/Independent Assessor], which amount must be proportionate to the obligations not performed.

(b) Where the Contractor implements Temporary Measures to mitigate or minimise the effects of the relevant Force Majeure Event and is otherwise in compliance with clause X.3(a), the [*relevant service charge*] will not be reduced, to the extent that, and for the period during which, the Temporary Measures are being provided.

> '**Temporary Measures**' are the plans, measures or programs adopted by the Contractor and approved by the Government (which approval will not be unreasonably withheld or delayed) as an alternative means of providing the Services to [*Service Users*] as a result of an [*insert relevant operating defaults*] or a Force Majeure Event, as the case may be and which measures:
>
> (a) may be of a standard less than the [Service Standards] but are of a standard which is reasonably acceptable to the Government; and
>
> (b) may be approved by the Government either before or after their implementation and, where they are approved by the Government after their implementation, will be deemed to have been effected from the date those approved measures were implemented by the Contractor.

23.3 Relevant issues

Contractual effect

Where the private party fails to perform its obligations due to a force majeure event, thereby risking government action for breach of contract, the force majeure mechanism ameliorates this risk by suspending the private party's contractual obligations for a specified period of time, after which the contract terminates. The effect is to suspend the ability of government to take action in respect of the private party's breach during the specified period.

Unless the private party is able to make alternative arrangements to continue service provision, fully or partly, government is also relieved from its obligation to pay the private party for the affected service. Government's obligation to pay is suspended or abated as long as the private party's obligation to perform is suspended. However, even though government is relieved of its payment obligation, it is very much exposed during this period, especially if there are no alternative services it can use or it relies on the facility to provide the core services. The efficacy of government's contingency planning for alternative means of delivering core services and procuring the contracted services will be put to the test.

Although the private party is relieved of the risk of the contract being terminated, it still bears the financial risk of the force majeure event. The private party continues to be liable to meet its costs — other than those which it ceases to incur because it is not obliged to perform the affected obligation(s) — and loses the ability to earn some or all of the contracted revenue.

If a force majeure event leads to the project contract being terminated and government chooses to exercise a right to acquire the (impaired) asset, the private party may be compensated for the fair market value of the asset taking into account any amount required to restore it to the condition required under the contract. Government would be entitled to any insurance proceeds received for reinstatement of the asset.

Allocation and management of risk

The extent of allocation of risk depends upon the scope of the definition of the force majeure event. Generally private parties will endeavour to frame very wide descriptions of what constitutes a force majeure event, but the approach by government is generally to define such events narrowly.

Under a typical force majeure provision, relief is not usually available to the private party unless it takes steps to mitigate the effect of the force majeure event and, in particular, attempts to make available temporary or alternative arrangements to replace the affected service. The private party's financial risk is reduced if it takes these measures, as government is usually obliged to make full or partial payment for the services provided through temporary measures. As a result, the private party should be prompted to minimise and try to manage the impact of the risk. Government should also require this insertion in the contract to help it meet its service delivery obligations.

It is likely, unless it would otherwise prejudice government's position and provided the private party has taken appropriate mitigation steps, that government will agree to extend the contract term by the period of the force majeure. This is intended to help reinstate the private party to its financial position before the force majeure event occurred. In deciding whether or not to extend the contract term and for how long, account should be taken of any insurance proceeds received by the private party.

Extent of relief

Force majeure relief may be provided for some or all of the private party's obligations under the contract. An important and usual exception from the relief is the private party’s financial obligations (that is, its obligations to pay money and to indemnify).

Depending on the nature of the particular project and the objectives which government is seeking to achieve, other specific obligations or classes of obligations may be excluded from coverage under a force majeure provision.

The following chapter on insurance should also be consulted. It deals with the issues of applying insurance funds and reinstating the asset when a force majeure event has occurred.

24 Insurance

24.1 Introduction

Insurance is a primary method of risk mitigation. A party bearing a risk may, through insurance, pass the financial consequences of the risk to a commercial insurer, effectively managing the risk for the price of the insurance policy. In a competitive insurance market, it is likely that the premium charged will reflect a true valuation of the risk.

Under a *Partnerships Victoria* contract, all design, construction and operational risks are borne by the private party except those which government agrees to take back. The majority of insurances connected with the project are therefore typically maintained not by government but by the private party and relevant sub-contractors, in their efforts to mitigate the risks they each carry. However, it is usual for all parties with an interest in the facility, both during and after its construction (builder, contractor, government, financiers), to be covered by material damage insurances, usually as co-insured, irrespective of which party actually takes out and maintains the insurance.

Government is interested, particularly where the private party's assets are limited to those of the project, to ensure that certain liability insurances are maintained by the private party so that if a risk materialises, funds will be available to appropriately deal with the consequences.

Insurance is also a relevant consideration for government in assessing the possible financial consequences of any risks it agrees to accept. Government usually relies on its interest in the asset being covered under project insurances. For other risks, it may insure through the Victorian Managed Insurance Authority. Insurance of government-accepted risks is rarely dealt with directly in the contract.

24.2 Insurance: some commercial considerations

As is reflected in Section 16.5, the availability or otherwise of insurance may to some extent influence which party bears a risk (particularly of adverse financial consequences). Insurance for a force majeure risk in relation to the facility, for example, may be unavailable because insurance in respect of that risk is not available, or because it is not available on commercially realistic terms. Some texts, in fact, refer to allocation of force majeure risk on the basis of availability or unavailability of insurance (where the private party bears the risk of insurable force majeure events occurring) as an accepted principle.[23] This principle is based on the notion that, if the private party is able to obtain the relevant insurance, it is in a better position to mitigate the effects of the force majeure event if it occurs. The financial impacts on the private party in that instance will be capped.

Government's main concern, in ensuring that the private party has adequate insurance cover, is that service delivery should be maintained as closely as possible to the terms of the services contract. This concern applies to a variety of insurance types including professional indemnity cover for architects, engineers and other consultants who have responsibility for ensuring that

[23] See, for example, Jason Fox and Nicholas Tott, *The PFI Handbook*, Jordans, Bristol, 1999, para 10.3.5.

the facility is fit to deliver the service (including appropriate run-off cover), the material damage cover for the facility during and after construction, and the private party's cover for public liability to protect its solvency.

Clearly many loss events or liability claims result in or are associated with service interruption, even if funds are available to reinstate or correct design defects. In that case, business interruption insurance may be available to cover the increased costs of government obtaining the service from an alternative venue or by other means, particularly if a core service is at stake. Such insurance is generally written in conjunction with material damage and industrial special risk policies. The private party is likely to take out such insurance to cover its fixed costs during reinstatement, and also its liability to government if an indemnity is given to government for its increased cost of service delivery. Alternatively, both parties may take out the insurance as co-insured, covering government directly for its additional costs. The policy is however likely to provide only a limited indemnity (as to duration), to encourage timely reinstatement. For example, the period during which losses are indemnified under the policy may be capped at 150 per cent of the original build-time, to allow for demolition, clearance and total rebuilding in a worst-case scenario.

If business interruption insurance is to be taken out by the private party and core services depend on the contracted services, government should ensure that the policy cover extends to the increased costs of procuring the contracted services and, where appropriate, providing the core services from alternative premises. Government should be named as an insured party (rather than simply having its interests noted) to ensure that it benefits from the policy in its own right and does not risk losing its cover through any action of the private party.

Advance business interruption insurance covers losses due to delay in start-up, including holding finance, loss of revenue and extra construction expenses. This insurance is also available to the private party in conjunction with material damage policies covering the development phase.

24.3 Contractual provisions

It is important to note that not all insurances put in place by the private party are relevant to its contractual obligations. Those insurances which it is obliged to maintain under the contract reflect government's minimum insurance requirements. The private party or its sub-contractors will, in most cases, have insurance beyond those contractual requirements.

The private party and its sub-contractors each assesses the nature of the risks it carries in connection with the project and puts in place insurance policies to mitigate those risks if they are available at competitive rates.

The type of insurance which government requires the private party to take depends on the nature of the project and the extent of obligations and risk assumed by the private party. They include:

- during the construction phase, insurance of the works and items brought onto the site, public and products liability insurance, professional indemnity insurance and workers' compensation and other statutory insurances; and

- during the operational phase, replacement insurance for the facility, public and products liability insurance, business interruption insurance, and workers' compensation and other statutory insurances.

The contract obliges the private party to name government and (usually) relevant sub-contractors and financiers as co-insureds where they have an insurable interest in the subject of the insurance policy.

Example clause: Insurance requirements

X.1 Insurance

The Contractor must effect and maintain or cause to be effected and maintained, at its cost, at all times during the [*Construction Term/Operating Term/or relevant part of the Construction or Operating Term*] with insurers approved by [*insert the Government representative*] and with the interests of the Contractor, Government, [*financiers*] and [*relevant sub-contractors*] noted, such insurances with respect to the [*Works/operation of the Facility*] as a prudent owner or operator of the Facility would consider normal and usual if it were subject to the Contractor's obligations under this agreement, including (without limitation) the following insurances on the following terms.

(a) A professional indemnity policy in the name of the Contractor for an amount of not less than [$10,000,000][1] for any one claim and [$20,000,000] in aggregate in any year covering, amongst other things, claims by the Government against the Contractor or by any other person or corporation arising out of or incidental to any negligent act, error or omission by the Contractor in connection with the professional activities and duties of the Contractor as a designer of the Works and as the party responsible for the construction of the Works.

The Contractor will maintain (or cause to be maintained) such professional indemnity insurance for those amounts, or such greater amounts of cover from time to time, which a prudent owner or operator of the Facility would consider normal and adequate cover, until the expiration of five years after the date on which the Operating Term commences.

(b) All risks insurance in respect of the Works (re-instatement basis) and the third-party legal liability insurance to an amount of not less than [$50,000,000] to include cover for all consultants' fees and removal of debris from the Site.

(c) Public and product liability insurance cover for an amount of not less than [$10,000,000] for any one claim and [$20,000,000] in aggregate in any year, whereby the Contractor and the Government are indemnified against all liability at law for any damage or loss occurring to any property and for injury (including death) to any person arising out of anything done or omitted to be done in the execution or purported execution by the parties of their rights or obligations under this agreement and against all actions, suits, claims, demands, proceedings, losses, damages, compensation, costs, charges and expenses in connection therewith.

X.2 Additional Requirements

The Contractor will comply (as appropriate), and will ensure that the Builder complies, with its obligations to take out and maintain registration and to pay all levies required to be paid, under the *Accident Compensation Act 1985* (Victoria) and the *Accident Compensation (WorkCover Insurance) Act 1993* (Victoria) and to take out and maintain the insurances required under the *Building Act 1993* (Victoria).

1. This and other monetary amounts in this example clause may differ depending on the nature of the project.

Reviewing and varying insurance cover

The extent of insurance required is usually specified in the contract by reference to specified amounts and types of insurance. Given the lengthy term of most infrastructure projects, these specifications may not remain appropriate, for example through inflation. The contract should therefore generally provide for specifications to be reviewed. Reviews may be provided for on a regular basis (for example, annually), may happen automatically (for example, coverage amounts being CPI-adjusted) or may be carried out from time to time as government considers appropriate.

Once the project contract has been signed, government is generally only able to demand additional insurance cover if it is willing to increase the service charge to cover the increased premiums.

> **Example clause: Variation of insurance cover**
>
> The nature and extent of the insurances in relation to the Facility will at all times be such as the Government reasonably requires. If the Government at any time reasonably requires the Contractor to:
>
> (a) insure against a risk not specifically provided for or contemplated under clause [y] [Insurance]; or
>
> (b) increase the extent of or change the terms of an existing cover in relation to a risk,
>
> it may notify the Contractor in writing and request that the Contractor give effect to the Government's requirements as set out in the written notice.
>
> The Contractor must promptly inform the Government of the amount of any additional premium payable to effect a request by the Government under this clause. Within [14] days of receipt of notification of the premium, the Government will inform the Contractor whether it requires the Contractor to purchase the relevant insurance cover. If it requires the Contractor to purchase the relevant insurance cover, the Government must reimburse the amount of the premium to the Contractor within 28 days.

24.4 Standard *Partnerships Victoria* insurance covenants

Given the importance to government of ensuring that necessary insurances remain in place throughout the project, the contract imposes a range of obligations on the private party aimed at ensuring that insurance proceeds are available when required, including:

- an obligation to insure with reputable insurers or insurers approved by government;
- an obligation to ensure that the policies' terms are satisfactory to government and do not contain any unusual exclusions, endorsements or alterations unless approved by government;
- a requirement that policies contain:
  - an obligation on the part of the insurer to notify government if the policy is cancelled;
  - a 'cross-liability clause' in appropriate types of insurance (where government is a co-insured), in which the insurer agrees to waive all rights of subrogation or action against each of the persons insured under the policy, and also agrees that the policy applies to each co-insured as if there were a separate insurance policy covering each party;
  - an agreement from the insurer under a material damage policy that government's approval is required for any settlement or compromise of a claim where it may result in a payment less than that provided for under the policy; and

  - a provision under which the insurer agrees that the failure of one insured to observe and fulfil the terms of the policy does not prejudice the policy with respect to the interests of the others;

- an obligation to provide copies of policies and certificates of currency to government; and

- an obligation to pay all premiums on time and not to do anything to void any insurance contract.

As a co-insured, government also has the benefit of a number of relevant protections granted under the Commonwealth *Insurance Contracts Act 1984.*

24.5 Unavailability of insurance

Not all project risks are commercially insurable. The unavailability of insurance for particular risks which the private party is asked to assume will be factored into its bid price. By paying the private party a premium to assume the risk, government is in effect insuring itself from liability through the private party. The private party takes the risk if the premium is acceptable given the likelihood and consequences of the risk materialising, and if the diversity of its investment portfolios enables it to do so. Government, on the other hand, should not pay the premium (either to the private party itself or for commercial cover) if that does not produce the best value for money solution.

Sometimes, over the life of a project, a particular risk which the private party is obliged to commercially insure may become uninsurable. This may happen because insurance is no longer available for the particular risk or because insurance against the risk, although available, is no longer available on commercially acceptable terms.

If insurances previously taken out by the private party become unavailable, the risk profile of the project may alter. The contract can deal with this issue by allowing the private party to be relieved of its obligation to maintain insurance where that insurance becomes unavailable. The private party must, however, be required to take out and maintain suitable substitute insurance if it is available, or to put other mechanisms in place to mitigate the relevant risk, as agreed with government. If this is not possible, the parties will be required to renegotiate an appropriate allocation of the uninsurable risk.

It should also be noted that professional indemnity policies are claims-based, not occurrence-based. This means that coverage is annually renewed and it can be difficult to arrange the necessary coverage which is for up to seven years after completion. It is sometimes possible to negotiate coverage 'up front' for an appropriate run-off period and this is government's preferred position, depending on cost and availability.

24.6 Application of insurance proceeds

The government-preferred position

As noted in Chapter 23, government's major concern in requiring the private party to maintain insurances is to ensure the continuity of the contracted services. Therefore, in the case of damage or destruction of the facility, the private party must apply any insurance proceeds paid to it to reinstate the facility. While not obliged to do so, government may reconsider this position if the contract is near term and another option is attractive, taking into account changed circumstances.

A question arises as to what arrangements apply if the insurance proceeds are insufficient to meet the cost of reinstating the facility or if payment of the insurance proceeds is delayed. Government expects private parties, their financiers and their sub-contractors to take all necessary steps to ensure that insurance shortfalls do not occur, by (for example) arranging additional sponsor support or by other appropriate means.

If the private party has chosen, at its cost, to insure against loss of revenue via business interruption cover or advance consequential loss cover, government accepts that the private party is entitled to the proceeds. However, the private party's right to those proceeds may be subject to government's claim for indemnity for the additional cost of alternative service provision.

Objectives of project financiers

It is not unusual for project financiers to seek the right to elect that, in certain circumstances, insurance proceeds from a claim on a material damage policy are used not to reinstate the facility but to pay out the project debt. Such a result is contrary to government's objectives and should be resisted.

The question to be asked in these circumstances is who is beneficially entitled to the insurance proceeds and therefore has the right to determine how they are to be applied. While the private party may have been allocated the risk on the basis that it had insurance available, and may have paid the insurance premium, government has financed the insurance premium indirectly through higher service charges. Government has the right under the services contract to continuity of services during the contract term and, in some cases, has an additional interest in reinstatement of the asset in that it will take control of the asset when the term expires. The private party (and its financiers) have contracted on the basis that their return will be achieved via a stream of service payments. Application of insurance proceeds is usually dealt with in a tripartite agreement between government, the private party and its financiers, in which government expects to reflect its preferred position.

Example clause: Application of insurance proceeds

[X] **Obligation to Reinstate and Application of Insurance Proceeds**

X.1 If the Facility is destroyed or damaged (whether wholly or in part) such as to render it incapable of or unsuitable for the delivery of Services at the Services Standards, the Contractor must fully reinstate the Facility and resume delivery of the Services at the Services Standards as soon as possible after the damage is caused.

X.2 The Contractor must apply any insurance proceeds it receives in relation to the damage to reinstate the Facility and for no other purpose.

25 Government step-in

25.1 Introduction

Step-in refers to the situation where government elects to assume all or some of the service delivery obligations of the private party for a period of time. Government may exercise its contractual rights to step in when it needs to:

- prevent or mitigate a serious risk:
  - to the environment; or
  - to public health; or
  - to the safety of people or property; or
- guarantee continuity of an essential service; or
- discharge a statutory duty; or
- otherwise deal with a default by the private party under the contract.

Ordinarily, government has step-in rights as part of a package of remedies for private party default. However, step-in does not necessarily require a private party default and may need to be exercised simply because the private party is unable to deal with a particular situation appropriately, for example, in an emergency. If a risk materialises, its consequences may be beyond the capacity of the private party to resolve, necessitating urgent government intervention. 'Essentially, the focus of the right is a serious short-term problem that can or must be solved quickly, where [government] is in a better position to do this than the private party'.[24]

It is also particularly important that government has a right of step-in in a contract concerning public infrastructure or the provision of services to the public. In certain cases, government has a duty to ensure the optimal performance and continuity of the contracted services to the public and needs to retain the ability to temporarily assume control of them if the public interest is jeopardised. This will include stepping in on contracted services on which the quality of its own delivery of core services vitally depends, if core services are being adversely affected by the private party's failure to perform its service obligations.

An issue for the private party, if government exercises its step-in right in a non-default situation, is to preserve the agreed payment stream, particularly to meet debt service obligations. If this is done — subject to government recovering its costs — non-default step-in should not be contentious. A step-in clause usually requires government step-out when the relevant situation has been resolved.

[24] Treasury Taskforce, Private Finance, *Standardisation of PFI Contracts*, Issue 1, Information Technology, Butterworths, London, 2000, p. 221.

For the sake of completeness, it should be noted that step-in rights may be given to government by statute or regulation. For example, civil defence legislation may permit emergency control of premises and facilities.

25.2 Relevant issues

Circumstances of step-in

Determining the circumstances in which government may exercise step-in rights is always a balancing act between the private party's desire to limit step-in instances to very serious urgent situations, and government's need to ensure that it has appropriate rights to protect the provision of the contracted services and, where relevant, the core services. Where that balance is struck will depend on the nature of the project and the sensitivity of the public service involved.

Process of step-in

The process of government step-in normally involves government giving notice to the private party. There are various options as how and when notice is to be given. For example, different alternatives that the parties may agree to include are:

- notice must be given, but not necessarily prior to government step-in;
- prior notice must be given, except in the case of emergency;
- prior written notice must be given but, in the case of an emergency, prior verbal notice may be given; and
- prior notice must be given and a cure period allowed to the private party (see below for a discussion of the interaction of step-in and default).

Rights of government on step-in

Government generally requires sufficient rights on step-in to enable it to take over the facility or provide the contracted services to the extent necessary. Government is usually given rights of possession and use in relation to the facility and associated equipment. While the contract may not always contain an attorney clause by which the private party grants government and its nominees irrevocable power of attorney over its affairs, such a provision is a useful tool for government in exercising its rights once it has stepped in. Government typically reserves the right to undertake capital works.

Assistance and cooperation

To ensure that government has sufficient means at its disposal to assume the duties of the private party, the private party should be under a broad obligation to provide assistance to government where necessary. Practically, this assistance is likely to involve providing government with information, documents, support and other assistance necessary for government to step in and continue providing the contracted services. This may include access to intellectual property, operating manuals and key contractor staff.

Conversely, if step-in rights are assumed when a material default occurs and the private party is diligently pursuing a remedy, it is usual for government to undertake to use its reasonable endeavours to assist the private party to remedy the default (at the private party's cost and with no assumption of liability for a continuing default).

Effect on private party

In exercising its step-in rights, government assumes all or a part of the contractual rights and obligations of the private party. Accordingly, it is necessary for the relevant rights and obligations of the private party to be suspended during the period of step-in.

Costs of step-in

Government would usually expect to recover net costs incurred through proper exercise of step-in rights, including capital expenditure, from the private party.

If there is no default and the private party is otherwise entitled to payment because it would have been able to continue providing the services, the private party should generally continue to be paid the service charge except for the costs which the private party no longer has to bear because government has stepped in and subject to any reduction for government’s own net step-in costs as discussed above.

Where government costs involve capital expenditure, these should be treated in accordance with the principles relating to capital costs set out below.

Liability on step-in

The effect of the step-in clause should be to permit government to step in, resolve the relevant situation and step out. In exercising these rights, government looks to avoid incurring any liability to the private party to remedy the relevant default or emergency and the contract generally expressly excludes government from such liability.

In addition, government's right to step in should be in addition to its other contractual rights and the contract should expressly provide for this.

Step-out

Again, the private party is concerned to tightly limit government's step-in rights and looks to define the period during which government may step in. Accordingly, government is usually required to step out once the issue requiring the step-in has been resolved. Government should not be obliged to continue to step in and may generally step out at any time.

Step-in and default

In general, government may exercise a right of step-in where there is no default. This may be related to the public policy issues stemming from external public circumstances or the need to continue services where the private party, for reasons for which it has no responsibility or is beyond its control (such as certain force majeure circumstances) is unable to continue providing the service but government is able to do so.

However, there are circumstances where there may have been a default and the step-in rights are exercised. In that case, a question of the interaction between the default regime and the step-in regime arises.

In general, the two circumstances — of default on the one hand and step-in circumstances on the other — should be seen as quite separate, stemming from different considerations. If there is a default and the private party is doing all that might be expected to achieve a cure, then the private party should generally be left to effect a cure unless government is demonstrably able to rectify issues more quickly.

Step-in and financing

Financiers are often very concerned about government step-in rights, which they see as being inconsistent with their enforcement rights and in particular their right to effect a cure of any default.

In general, the financiers' position should not be advantaged above the private party. However, where appropriate, separate notice and perhaps extra time may be given to financiers to effect a cure before step-in rights are exercised because of a default event. These issues are generally dealt with in a direct agreement between government and the financiers.

In order to protect the status of contractual step-in rights, security is usually granted over the assets used to provide the contracted services. In some cases, the structure of the project itself may assist as well. For example, where the assets are on leased property, government as lessor may be able to exercise paramount rights over the private party and any other secured financier who has taken security over the lease.

Step-in and capital costs

On step-in, government may need to expend capital costs to rectify the event causing step-in. In general, these costs and other step-in costs should have a priority over any payment to the private party. Not all capital costs incurred by government on step-in may be able to be recovered at once and it would be usual for a mechanism to be established to allocate the payments among:

- amortisation of capital expended by government: there would typically be a regime to establish the reasonableness of these costs; as the amortisation would be over time, there should be an interest factor payable to government as well;

- capacity and availability (capital) charges of the private party (in particular, payment to financiers);

- private party equity providers; and

- ongoing payments (without deduction) may also be required to meet operational or service costs of providing the services.

Any mechanism would generally be developed on a case by case basis.

Example clause: Government step-in (addressing both the default and non-default situation)

[X] Government Step-In

X.1 If:

(a) a Material Default[1] has occurred and the Applicable Cure Period[2] has expired without that Material Default (if curable) having been cured or cured to the reasonable satisfaction of the Government or (if incurable) the Contractor has failed to take actions it is required to take under this agreement in relation to such Default; or

(b) the Government forms the reasonable opinion that there is or is likely to be a material risk to the environment, to the health or safety of Service Users [3] or other members of the public, or of material damage to the Facility,

the Government will be entitled and the Contractor will assist the Government wherever and however possible to ensure that the Government is able to take the steps permitted under this clause [X], including by grant of a licence for access to the Facility and use of the plant and equipment and furnishings and fittings in the Facility.

X.2 The exercise by the Government of its rights under this clause [X] will in no way affect any other rights of the Government under this agreement.

X.3 The steps which the Government will be entitled to take pursuant to this clause [X] (but in the case of clause X.1(a), only if, and to the extent necessary, to remedy the relevant Material Default) are:

(a) temporarily assuming total or partial possession, management and operation of the Facility and the provision of the Services to Service Users;

(b) such other steps as are, in the reasonable opinion of the Government, necessary to safeguard the provision of the Services from the Facility as required by this agreement or to minimise the relevant risk to the environment, Service Users, other members of the public or the Facility in respect of which the Government is exercising its rights under this clause [X]; and

(c) electing to cease exercising any of its rights referred to above.

X.4 When exercising its rights under this clause [X], the Government will use all reasonable endeavours to operate the Facility in a manner which is consistent with the management and operation of the Facility and with the provision of the Services, as required by this agreement.

X.5 The Government may exercise its rights pursuant to this clause [X] without prior notice to the Contractor but will, as soon as practical, provide notice to the Contractor that it is exercising its rights pursuant to this clause [X].

X.6 If the Government exercises its rights under this clause [X], the Government will be entitled to retain from the Service Charge an amount equal to its reasonable operating costs and any necessary capital expenditure in exercising those rights and, where appropriate, providing the relevant Services. The Service Charge payable by Government during the period in which the Government exercises its rights under this clause [X], will otherwise be the amount payable under this agreement, after taking into account any rights the Government may have to abate the Service Charge pursuant to clause [y] [Abatement][4].

X.7 Upon the Government exercising any of its rights under this clause [X], the Contractor's obligations under this agreement to provide the Services being provided by the Government or in respect of which the Government is exercising its rights under this clause, are suspended to the extent and for such period as is necessary to permit Government to exercise those rights.

X.8 The Contractor:

(a) irrevocably appoints the Government, and such persons as are from time to time nominated by the Government, jointly and severally as its attorney to exercise the rights of the Government under this clause [X]; and

(b) agrees to ratify and confirm whatever action an attorney appointed under paragraph (a) takes in accordance with paragraph (a).

X.9 If the Government exercises its rights pursuant to clause X.1(a) and the Contractor is diligently pursuing a remedy for the relevant Material Default, the Government will, at the cost of the Contractor and with no liability to itself, use reasonable endeavours to assist the Contractor to rectify the Material Default.

X.10 The Government will cease to exercise its rights under this clause [X] as soon as:

(a) where Government exercised its rights pursuant to clause X.1(a), the relevant Material Default is cured or remedied or Government ceases to pursue a cure or remedy of the relevant Material Default; or

(b) where Government exercised its rights pursuant to clause X.1(b), the relevant material risk is averted or overcome or, where it materialises, its consequences have been mitigated or otherwise dealt with to the Government's reasonable satisfaction.

X.11 The Contractor acknowledges that the Government:

(a) will not be liable to the Contractor in the exercise of its rights under this clause [X] unless it acts with wilful negligence or in bad faith;[5] and

(b) is not obliged to remedy any Material Default or to overcome or mitigate any risk or risk consequences in respect of which the Government exercises its rights under this clause [X].

1. See Section 26 — 'Default and Remedies' for a discussion on Material and Non-Material Defaults.
2. See Section 26 — 'Default and Remedies' for a discussion on Applicable Cure Periods.
3. Defined as persons other than Government using the Services provided under the contract.
4. This is a reference to the clause within the payment mechanism which deals with abatement of the service charge.
5. The government may, in certain circumstances, consider deleting the reference to "wilful negligence or in bad faith" and replacing it with a reference to "negligence" in a non-default situation.

26 Default and remedies

26.1 Introduction

The default and remedy provisions of the contract make the risk allocation enforceable. A breach of the contract (known as a default) occurs when a party fails to behave as the contract requires, such as when a party fails to meet its obligations in relation to a materialised risk. The contract acknowledges the differing scale and consequences of contractual breaches by recognising some defaults (described as material defaults) as giving rise to a right of termination, and others (described as non-material defaults) as attracting an obligation to rectify but not on their own allowing the other party to terminate the contract. However, a non-material default may become a material default if it is not rectified within the period allowed and if progress with rectification is unsatisfactory, or if the default occurs several times or in combination with other defaults.

In this chapter (except in the example clauses), a reference to a default means a material default, unless specified as a non-material default.

Balance of default provisions

Partnerships Victoria projects generally give both parties the ability to invoke a default provision in appropriate circumstances. Government generally has the right to invoke a default provision if the private party fails to meet its contractual obligations in a material way. In addition to a failure to deliver the contracted services, this would include failing to meet the financial consequences of a materialised risk if the private party has been allocated that risk and government is materially affected by the private party failing to pay. The private party's right to invoke a default provision, however, is much more limited. It will usually only apply:

- if government fails to pay where it is contractually obliged to do so; or
- if government makes its relationship with the private party untenable or completely frustrates the private party's ability to provide the contracted services.[25]

In light of this difference, contracts generally distinguish between the default procedures available to each party and provide for them separately. Given the more extensive treatment of government's default rights in contracts, in this chapter the discussion focuses on default procedures available to government rather than to the private party.

26.2 Contractual provisions

The contract sets out what constitutes a default (whether material or non-material) for the purposes of the default procedure. A default may relate to a failure by the private party to comply with its contractual obligations but may also relate to other events which may indirectly affect its ability to comply with its obligations (such as insolvency, or a change in the control of the private

[25] Treasury Taskforce, Private Finance, *Standardisation of PFI Contracts*, Issue 1, Information Technology, Butterworths, London, 2000, p. 139.

party). Given the potential gravity of the consequences of a default for the private party (in fact, it can mean the end of the project, making financiers particularly nervous), the private party and its financiers will be keen to ensure that the specified defaults (particularly those which may lead to termination) are reasonable and clearly defined.

Types of default

Different defaults may be relevant at different stages of the project and the contract often distinguishes between these and provides a separate regime for each. In particular, the contract usually sets out separate provisions for defaults which occur during construction and those which occur during the operating stage. A further distinction may be made between different services provided during the operation stage, effectively quarantining a default in one service area and ensuring that payment of the service charge for unaffected services continues (for example, in an accommodation-based services contract, different default regimes for accommodation services and for ancillary services such as IT).

As noted above, a *Partnerships Victoria* contract also distinguishes between material and non-material defaults, to which different cure rights attach. A non-material default must be rectified and may give rise to abated payments or liabilities to pay compensation, but does not in itself lead to termination.

Cure period

The private party is usually allowed an opportunity to cure the relevant default before government has the right to use any remedies specified in the contract. The private party (and its financiers) will seek as long a period as possible to cure defaults, so as to limit government's potential to exercise its default remedies. This requirement competes with government's desire to limit the duration of cure periods to prevent a prolonged default impacting on the provision and quality of the contracted services.

Of course, a cure period is only relevant where the default is capable of cure (for example, where the private party has not complied with obligations to maintain the facility properly and maintenance is required in order to remedy the breach). Where an incurable default has occurred (such as the insolvency of the private party), the private party is unable to cure the default and a cure period is fruitless. The remedy for the latter is generally to find a suitably qualified, credit-worthy party, acceptable to government as service provider. This may be an appointee of the financiers for a period, such as an administrator or receiver.

The contract may also allow the private party to ask government to agree to extend the cure period. Approval of an extension is normally conditional upon the private party providing satisfactory evidence that it has taken appropriate steps to remedy the default and that the default can be remedied in a particular manner within that extended period.

Example clause: Cure periods

[X] Cure Periods

(a) Upon receipt of a notice under clause [y] [Notice of Default], where the Default is capable of being remedied or cured, the Contractor must remedy or cure the Default within the Applicable Cure Period[1].

(b) If the Contractor determines that it requires an extension to the Applicable Cure Period it must, as soon as possible (but no later than the expiration of the current Applicable Cure Period) submit to the Government:

(i) a Cure Plan[2]; and

(ii) evidence that it has diligently pursued and is continuing to diligently pursue a cure, but that the Default, cannot, with reasonable diligence, be cured within the current Applicable Cure Period.

(c) The Government will not unreasonably refuse to grant an extension of the Applicable Cure Period where the Contractor has satisfied the requirements of this clause.

(d) The Contractor can only apply once for an extension of the Applicable Cure Period in respect of a particular Default, unless the Government otherwise agrees in the Government's sole discretion. Where the Government grants an extension of the Applicable Cure Period the Contractor must comply with the Cure Plan.

1. The 'Applicable Cure Period' will be defined as a particular number of days within which the Contractor may cure the relevant default before the Government can exercise its default remedies. Different 'Applicable Cure Periods' will apply to different defaults. For example, depending on the default, the cure period could be in hours, days or even months.

2. A Cure Plan is defined as a detailed plan proposed by the Contractor to remedy the relevant Default if an extension of the Applicable Cure Period is granted.

Action for incurable defaults

While an incurable default is not the subject of a cure period, the private party is nevertheless obliged to take action in relation to it, such as paying compensation to government for its proper redress.

In extreme circumstances, where an incurable default so seriously affects the quality of service delivery to the extent that compensation is an inadequate remedy, that incurable default may give rise to a right to terminate.

Access to remedies

If, after a cure period, the default continues unremedied, government is entitled to exercise remedies available under the contract. This is the point at which, as noted above, a distinction is made between a default which is material (allowing government to exercise its full range of remedies) and a non-material default (which does not, in isolation, permit government to exercise all its remedies such as termination and step-in, unless certain circumstances are present).

Remedies

Remedies available to government for a private party default generally include some or all of the following:

- the ability to demand payment from the private party for compensation for the default. Compensation payable may be specified in the contract as 'liquidated damages', being an amount which the parties estimate and agree will be government's loss arising from the particular breach. The estimate must be a reasonable approximation of the likely losses resulting from the default, to avoid the risk of unenforceability. A popular use of the liquidated damages remedy is where the private party fails to meet a completion or commissioning deadline;

- since the private party prices its liability to pay liquidated damages into the project costs, care should be taken to ensure value for money is maintained where liquidated damages are required;
- if liquidated damages are not specified, compensation is calculated at the time of the breach and in accordance with the contractual principles, based on government's reasonable loss arising from the default;
- the ability to exercise all available legal and equitable remedies against the private party, including suing for specific performance, injunctive relief or other orders;
- the right to appoint, or require the private party to appoint, a replacement operator to provide some or all of the services to which the default relates, at the private party's cost. Certain contracts may provide for government to become the replacement operator. The private party is usually obliged to implement appropriate temporary measures until the replacement operator is appointed;
- the right to step in (see Chapter 25);
- the right to exercise its rights under any security it may have; and
- the right to terminate the agreement partly or completely.

Terminating the contract is generally viewed as a measure of last resort and government is often obliged (and willing) to use or reasonably consider other remedies in preference.

Example clause: Default and remedies

[X] Default and Termination

X.1 Notification

If a Default[1] occurs, the Government may give the Contractor a notice in writing specifying that the Default has occurred and the nature of the Default.

X.2 Remedying within the Applicable Cure Period

Upon receipt of a notice under clause X.1, where the Default is capable of being remedied or cured, the Contractor must remedy or cure that Default within the Applicable Cure Period.

X.3 Default not capable of cure

(a) Subject to paragraph X.3(b), if the Default is not capable of remedy or cure the Contractor must:

   (i) promptly comply with the reasonable requirements of the Government in relation to the Default; and

   (ii) pay compensation to the Government for the damages suffered by the Government because of that Default within 5 Business Days of the compensation being determined.

   Where the Contractor complies with the requirements of this paragraph X.3(a), the Default will be deemed to have been cured.

(b) If a Default occurs which is incapable of remedy or cure and its consequences are so serious that paragraph x.3(a) cannot provide the Government with reasonable redress, the Government may exercise its rights and remedies pursuant to clauses X.4 and X.5.

X.4 Remedies

If a Default has occurred and a notice has been given under clause X.1 in relation to that Default and:

(a) where the Default is capable of remedy or cure, the Default is not remedied or cured to the reasonable satisfaction of the Government within the Applicable Cure Period; or

(b) where the Default is not capable of being remedied or cured, the Contractor fails to comply with paragraph X.3(a) or the Default is one to which paragraph X.3(b) applies,

the Government may (without prejudice to any other rights provided for and conferred on the Government pursuant to this agreement with respect to the Default), where that Default is a Relevant Default,[2] exercise all or any of the following remedies:

(c) require the Contractor to replace the relevant [*sub-contractor*] currently providing the [*relevant services*] to which the Default relates with a competent and experienced [*insert relevant type of sub-contractor*] reasonably acceptable to the Minister within an appropriate time frame notified to the Contractor by the Minister (such period not to be less than [*insert appropriate number of days/months*] or more than [*insert relevant number of days/months*], depending on the [*insert relevant services*] affected) in which case;

  (i) during the period in which the Contractor is seeking to replace the [*relevant sub-contractor*] the Contractor must implement reasonable Temporary Measures relating to the relevant Default; and

  (ii) the replacement of the [*relevant sub-contractor*] will be at the Contractor's cost, and the Government is not obliged to make any increase to the [*relevant service charge*].

(d) sue the Contractor for Compensation for that Default, and exercise all available legal and equitable remedies including without limitation suing for specific performance, injunctive relief or some other orders as the Government considers appropriate; or

(e) exercise its rights pursuant to [*any security the Government holds*] and any rights of step-in the Government may have under this Agreement;

(f) in respect of:

  (i) a Default which may be cured or remedied by the appointment of a replacement sub-contractor under paragraph (i), only after the Government has exercised its remedy in that paragraph and the Contractor fails to replace the [*relevant sub-contractor*] in accordance with that paragraph, terminate this Agreement; or

  (ii) any other Default, terminate this Agreement.

X.5 Non-Material Defaults

Where the Contractor has failed to cure a Default which is a Non-Material Default[3] and which is capable of being remedied or cured within the Applicable Cure Period it must:

(a) at the expiration of the Applicable Cure Period provide evidence to the Government of the action that it has diligently pursued or taken or which it will diligently pursue or take, which will result in the Default being remedied or cured to the Government's satisfaction within a reasonable period of time after the expiration of the Applicable Cure Period; and

(b) where requested by the Government, take such action as the Government considers is reasonable in the circumstances to remedy or cure the Default.

X.6 Compensation for alternative arrangements

Without limiting the amount and type of compensation for which the Government may make demand under this agreement, and without limiting clause [y] [Abatement], if at any time as a result of a Default the Services are wholly or partly Unavailable, and the Government uses other resources to procure those Services or to provide them to the Service Users then, notwithstanding that the Contractor may be operating within an Applicable Cure Period, the Contractor must compensate the Government for the cost of such alternative arrangements.

The compensation amount payable under this sub-clause X.6 will be an amount equal to the reasonable cost to the Government of the alternative arrangements for the provision of the affected Services to the extent that this cost exceeds the amount which would have been payable by the Government to the Contractor if the Contractor had complied with its obligations in relation to the Services which are the subject of the alternative arrangements[4].

1. As mentioned below, the definition of 'Default' will vary depending on the nature of the project, but will include Material and Non-Material Defaults.

2. A'Relevant Default' should be defined as:

(a) a Material Default; or
(b) a in respect of which the Contractor has failed to satisfy sub-clause X.5; or
(c) a Non-Material Default of which there have been persistent or repeated occurences — thereby constituting a 'Material Default'.

3. A 'Non-Material Default' will be defined as a Default which is not a Material Default.

4. This rights of compensation of the government interrelates with the right of the government to abate the service charge: see section [w] - 'Availability'.

26.3 Issues relating to termination

From government's point of view, default provisions provide a means by which it can address the impact of a materialised risk, make alternative arrangements for service provision and be compensated for the additional cost of those arrangements. Before looking to terminate the contract in the event of a default, government generally seeks other avenues of redress (e.g. abatement of service charge and step-in rights). As stated above, termination is viewed as an option of last resort, and can have very real ramifications and costs for government (if, for example, it is unable to find alternative services or is unable to deliver its own services). A key objective of good contract management is to keep the contract in operation for the benefit of both parties, not to seek occasions for it to end. For this very reason, *Partnerships Victoria* contracts clearly provide for adequate cure periods and distinguish between — and provide different regimes for — material and non-material defaults.

If the contract is terminated in part (for example, only in relation to some services), the contract usually obliges the existing private party to provide the new contractor with appropriate access to enable it to meet its obligations. During a transition period, the private party is also required to provide 'disengagement assistance' to government and the new contractor. This is particularly vital in the IT area.

In the County Court contract, for example, the private party is obliged to provide disengagement assistance for three months before, and one month after, the replacement of the IT operator. The meaning of disengagement assistance is set out in detail in the contract and the private party must train the replacement staff in use of the system and user requirements, transfer and review documents, provide all reasonable migration assistance, answer questions and provide any other information and assistance as the Minister reasonably requires. The clause also requires the private party to assign any licences relating to third-party software and make available any third-party software support and hardware maintenance services, on reasonable terms and conditions. The private party acknowledges that 'it is critical for the Minister to have continuity of the IT services and, for that reason, the Minister relies significantly on the Contractor fulfilling its obligations under this clause'.

Compensation upon termination arising from default

Another issue to be addressed in connection with terminating the contract because of a default, is that of compensation payable to the non-defaulting party. If the private party terminates the contract as a result of a material default by government, the private party should be properly compensated. The contract will usually provide for an appropriate compensation formula.

Similarly, where the contract is terminated as a result of a private party default, government should be compensated for any loss and damage sustained as a result of the default and termination of the contract. However, it may be appropriate in some instances of termination resulting from private party default, for compensation also to be paid to the private party (or to be set off against any compensation payable to government) if failure to do so would unfairly benefit government. This would be the case where, for example, the private party developed the facility (completely or partly, depending on when the default occurred) at its cost and it was obliged to transfer the facility to government on early termination.

Any entitlement of the private party to compensation for termination arising from a private party default should be considered on a project by project basis. A significant issue will be whether the project asset is to be transferred to government at the end of the contract term. If the project asset is to remain with the private party at the end of the contract term, government may walk away without the private party having any entitlement to compensation.

Where the asset is transferred to government and it is considered appropriate to compensate the private party, government's preferred formula for compensation — where termination occurs before completion — is to repay the private party the amounts it has invested on completed works, adjusted for any increase in the costs to government to complete the facility, government's break costs and any liquidated damages payable to government.

Where termination occurs during the operational phase and the asset is transferred to government, government's preferred position is that the fair market value of the asset is paid to the private party, less government's break costs and any compensation or other amounts payable or owing to government (which may include additional service costs, rectification and re-tendering costs, and any balance in a maintenance sinking fund). This is considered an appropriate basis for calculating the compensation payable.

Continuity of termination rights

The various parties' rights are usually set out in more than one document. Therefore, government's termination rights in the project contract need to be linked with termination rights under other associated documents so that, where the need arises, a complete termination of contractual arrangements can be made. For example, if the private party is to be provided with tenure to the facility through a lease, provision may need to be made for government to terminate or purchase the lease in certain circumstances.

Financier issues

The structure and detail of the default provisions (especially the part relating to government's termination rights) is of great interest to a project financier. The financier usually seeks contractual assurances from government as to how government will exercise its rights under the default clause. This is particularly so given that the financiers usually want the opportunity to try to rectify a default before government exercises its rights (such as step-in and termination).

27 Dispute resolution

27.1 Introduction

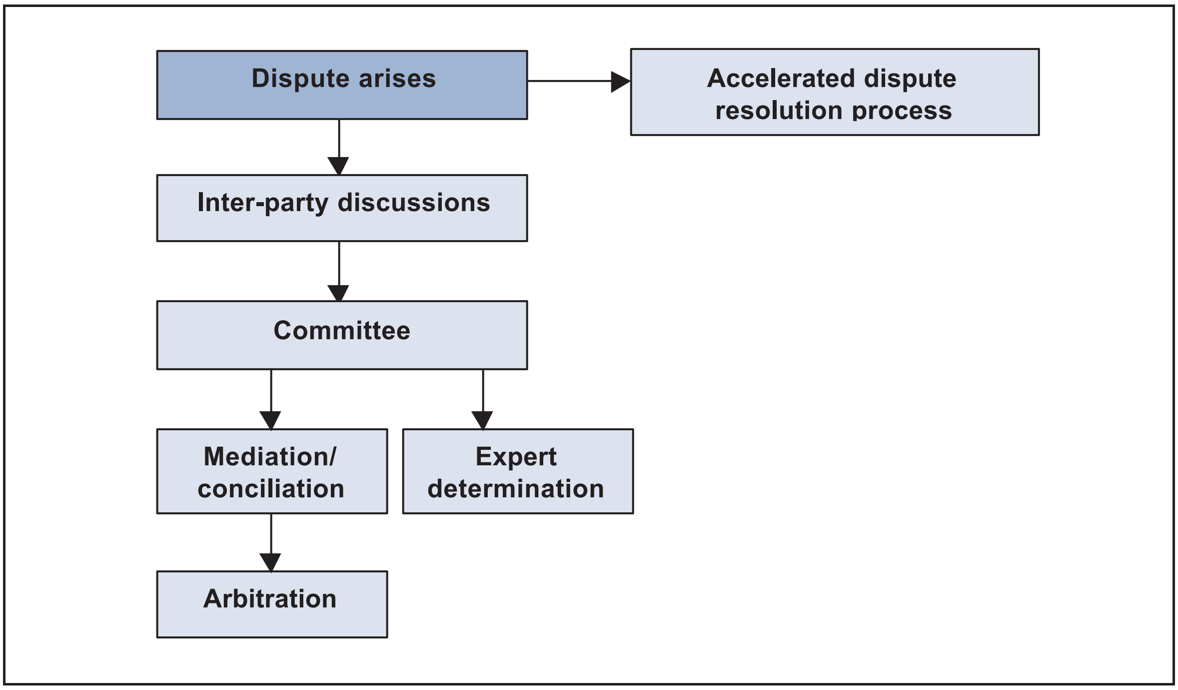
Where a dispute arises over the parties' contractual obligations which impacts on the underlying risk allocation position, an appropriate dispute resolution procedure may speedily resolve the dispute and avoid the need for each party to exercise its rights under the default regime. The main benefits of a pre-determined dispute resolution process (rather than dealing with disputes through the courts) are cost savings, avoidance of delay and lack of publicity. In addition, an informal dispute resolution procedure offers the chance to resolve a dispute in its early stages. For *Partnerships Victoria* contracts, this decreases the chances of service interruption and assists in ensuring that public benefit and value for money are maintained.

27.2 Contract drafting

The dispute resolution procedure adopted by the parties is likely to vary between projects in line with the parties' preferences, usually based on previous experience. Accordingly, rather than examine a particular dispute resolution clause, it is more useful here to touch on the various methods of dispute resolution available. Consideration will then be given to issues which arise in the dispute resolution context and how these may be dealt with under the contract.

A dispute resolution procedure may involve any one or more of several possible methods, each of which can be made available to the parties in turn. If a particular method fails to resolve the dispute within a certain time, either party — or sometimes the relevant resolution body — may (or must) refer the dispute to the next stage of the process. The different methods and the order in which they are generally undertaken are shown in the flow-chart below (Figure 27.1).

Figure 27.1 Hierarchy of dispute resolution procedures



Accelerated dispute resolution

Provision may be made in the contract for certain identified types of dispute to be referred to an accelerated method of dispute resolution. The exact process of accelerated dispute resolution varies but generally involves the dispute being considered by a neutral third person or persons and a determination — binding on the parties — being made in a relatively short time.

Inter-party discussions

Representatives of each party meet and attempt to resolve the dispute, in good faith.

Committee

The dispute is referred to a committee comprising one or more representatives of each party. The committee, in accordance with the procedures set out in the contract or decided by the committee itself, attempts to resolve the dispute. Any decision of the committee is usually binding on the parties.

Mediation or conciliation

Representatives of the parties attend before a mediator or a conciliator and attempt to resolve the dispute. The mediator or conciliator is agreed by the parties or selected by an independent third party agreed to by the parties and specified in the contract. Procedures to be followed during mediation or conciliation may be set out in the contract, agreed by the parties at the time of the dispute or selected by an independent third party (which may be the mediator or conciliator or another person specified in the contract).

Mediation is a consensual process in which the parties are helped by the mediator (a neutral third party) to reach an agreed resolution. The role of the mediator is to facilitate negotiations of the parties by assisting them in their discussions and in identifying their respective issues and differences. The mediator's role is to facilitate only and the mediator makes no binding determination.

Conciliation is similar to mediation in that the neutral third party makes no binding determination. However, the conciliator plays a slightly more involved role in the resolution process than the mediator, making positive suggestions and recommendations, although it is still for the parties to decide whether these recommendations will be adopted.[26]

Expert determination

The dispute is referred to an independent expert who makes a determination based on information from each party. This method is usually employed in respect of disputes with a technical or specialist element requiring expertise in the relevant area to resolve them. The expert may be agreed by the parties, selected by a third party specified in the contract or selected from a list of independent experts which the parties maintain. The determination of the expert may or may not be binding on the parties.

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[26] P. W. Young (ed.), *The Australian Encyclopaedia of Forms and Precedents*, 3rd edition, Vol. 1, Butterworths, Melbourne, 1988.

Arbitration

The dispute is referred to and determined by an arbitrator to whom the parties make submissions. The arbitrator's determination is binding. The process of arbitration is supported by and will be carried out in accordance with the *Commercial Arbitration Act 1984* (Victoria), although the parties may agree that certain provisions of the Act do not apply.

The parties may choose to incorporate any or all of these options in their agreed dispute resolution process.

27.3 Relevant issues

In addition to providing for the various methods of dispute resolution to be undertaken by the parties, the dispute resolution provisions of the contract may need to deal with a number of ancillary issues.

Limitation on which disputes can be dealt with by which process

The contract may specify that certain kinds of dispute are to be referred to certain dispute resolution procedures rather than others. For example, certain issues of a technical nature (such as the amount of compensation to be paid in connection with a delay in commissioning the facility) may be required to be referred to expert determination.

Obligations of parties continue

The contract should also provide that the obligations of the parties (including those which are the subject of the dispute) are to continue while the dispute resolution procedure is being pursued. This is to ensure continuity of service as far as possible while the dispute is being progressed through the dispute resolution process.

Resort to the courts

As the intent of a dispute resolution procedure is to avoid the usual consequences of litigation such as delay, cost and publicity, the contract usually prohibits the parties from beginning court action in relation to a dispute until some or all of the alternative dispute resolution procedure have been followed.

Costs

As the dispute resolution procedure will involve third parties, the contract must make provision as to which party is to pay the costs incurred in resolving the dispute. The contract may oblige a certain party to pay costs at a particular stage, or may provide that the relevant independent party determining the dispute is to decide which party is to pay the costs.

Appendix A: Risk matrix

Risk category	Description	Consequence	Mitigation	Preferred allocation
Site risks				
Existing structure (refurbishment/ extensions)	risk that existing structures are inadequate to support new improvements	additional construction time and cost	private party will pass to builder which relies on expert engineering reports	private party
Site conditions	risk that unanticipated adverse ground conditions are discovered which cause construction costs to increase and/or cause construction delays	additional construction time and cost	private party will pass to builder which relies on expert testing and due diligence	private party
Approvals	risk that necessary approvals may not be obtained or may be obtained only subject to unanticipated conditions which have adverse cost consequences or cause prolonged delay	delay in works commencement or completion and cost increases	prior to beginning the tender process government may seek a planning scheme amendment or environmental impact assessment taking risk of a route diversion or special measures to protect environmental values; for example in the case of linear infrastructure (road, rail, pipeline); during the tender process by means of a Project Development Agreement both government and the private party may achieve a measure of pre-contractual certainty allowing an early start to the approval process and a sharing of costs	private party possibly up to a specific cost amount unless government assumes because of complexity or sensitivity

Risk category	Description	Consequence	Mitigation	Preferred allocation
Environmental (1)	risk that the project site is contaminated requiring significant expense to remediate	clean-up costs and delay	reliance on expert reports and insurance	private party will generally assume the risk although because of the time and cost implications of full due diligence for each bidder, some risk sharing may be a cost effective solution particularly using a regime for allocation of cost consequences such as a Material Adverse Effect regime
Environmental (2)	risk that prior to financial close offsite pollution has been caused from a government preferred site (any site) to adjacent land	clean-up liability	government to commission reports; government should also have greatest knowledge of past uses of its site	government may assume responsibility by way of indemnity or obligation to compensate for unidentified off site pollution pre financial close where the site is a preferred government site
Environmental (3)	risk that prior to financial close (in case of a non-government site) or after financial close (any site) offsite pollution is caused to adjacent land	clean up liability	private party can manage site activity	the private party will be in control of activities on the site post financial close and will be required to assume risk of offsite pollution caused by those activities; also it will take risk of offsite pollution from any site which is not a government preferred site (even if it occurs pre-completion)

Risk category	Description	Consequence	Mitigation	Preferred allocation
Clean-up and rehabilitation	risk that the use of the project site over the contract term has resulted in a significant clean up or rehabilitation obligation to make the site fit for future anticipated use	financial liability on residual owner	private party able to manage the use of the asset and attend to its maintenance and refurbishment; government may require sinking funds if it is to resume the site and its use is liable to result in significant clean up/rehabilitation cost	private party to take risk (whether government is to resume or not) and must demonstrate financial capacity or support to deliver the site in the state required by government
Native title	risk of costs and delays in negotiating indigenous land use agreements where project site may be subject to native title or risk injunction and/or invalidity of approvals	delay and cost	search of registers and enquiry if appropriate and take expert advice	government will usually take risk on government preferred sites as it generally has a better understanding of procedures, has special powers of acquisition and use of native title land for infrastructure and is usually in best position to manage this risk; government is also in better position to negotiate where policy discourages use of compulsory acquisition power
Cultural heritage	the risk of costs and delays associated with archaeological and cultural heritage discoveries	delay and cost	search of registers and enquiry if appropriate and take expert advice	government will generally take risk on government preferred site as it generally has a better understanding of procedures, and is usually in best position to manage this risk otherwise private party takes responsibility

Risk category	Description	Consequence	Mitigation	Preferred allocation
Availability of site	risk that tenure/access to a selected site which is not presently owned by government or private party cannot be negotiated	delay and cost	bidders obligation to secure access prior to contract signing	private party, as it makes the decision to bid on a non preferred site
Design, construction and commissioning risk				
Design	the risk that the design of the facility is incapable of delivering the services at anticipated cost	long term increase in recurrent costs - possible long term inadequacy of service	private party may pass risk to builder/architects and other subcontractors while maintaining primary liability; government has the right to abate service charge payments where the risk eventuates and results in a lack of service - it may ultimately result in termination where the problem cannot be suitably remedied	private party will be responsible except where an express government mandated change has caused the design defect
Construction	the risk that events occur during construction which prevent the facility being delivered on time and on cost	delay and cost	private party generally will enter into a fixed term, fixed price building contract to pass the risk to a builder with the experience and resources to construct so as to satisfy the private party's obligations under the contract	private party will be liable unless the event is one for which relief as to time or cost or both is specifically granted under the contract, such as force majeure or government intervention
Commissioning	the risk that either the physical or the operational commissioning tests which are required to be completed for the provision of services to commence, cannot be successfully completed	for the private party and its financiers - delayed/lost revenue for government - delayed service commencement	no payment by government until all physical and operational commissioning tests have been successfully completed	private party, although government will assume an obligation to cooperate and facilitate prompt public sector attendance on commissioning tests

Risk category	Description	Consequence	Mitigation	Preferred allocation
Sponsor and financial				
Interest rates pre-completion	the risk that prior to completion interest rates may move adversely thereby undermining bid pricing	increased project cost	interest rate hedging may occur including under Project Development Agreement	government may assume or share
Sponsor risk	the risk that the private party is unable to provide the required services or becomes insolvent or is later found to be an improper person for involvement in the provision of these services or financial demands on the private party or its sponsors exceed its or their financial capacity causing corporate failure	cessation of service to government and possible loss of investment for equity providers	ensure project is financially remote from external financial liabilities, ensure adequacy of finances under loan facilities or sponsor commitments supported by performance guarantees; also through the use of non financial evaluation criteria and due diligence on private parties (and their sponsors)	government
Financing unavailable	the risk that when debt and/or equity is required by the private party for the project it is not available then and in the amounts and on the conditions anticipated	no funding to progress or complete construction	government requires all bids to have fully documented financial commitments with minimal and easily achievable conditionality	private party

Risk category	Description	Consequence	Mitigation	Preferred allocation
Further finance	the risk that by reason of a change in law, policy or other event additional funding is needed to rebuild, alter, re-equip etc the facility which cannot be obtained by the private party	no funding available to complete further works required by government	private party must assume best endeavours obligation to fund at agreed rate of return with option on government to pay by way of uplift in the services charge over the balance of the term or by a separate capital expenditure payment; government to satisfy itself as to likelihood of this need arising, its likely criticality if it does arise, and as to financial capacity of private party to provide required funds and (if appropriate) budget allocation if government itself is required to fund it	government takes the risk that private finance is unavailable
Change in ownership	the risk that a change in ownership or control of the private party results in a weakening in its financial standing or support or other detriment to the project	government assurance of the financial robustness of the private party may be diminished and, depending on the type of project, probity and other non financial risks may arise from a change in ownership or control which may be unacceptable to government	government requirement for its consent prior to any change in control. N.B. private party will seek to limit this control to circumstances where substantive issues are of concern such as financial capacity and probity	government risk as to the adverse consequence of a change if it occurs; private party risk that its commercial objectives may be inhibited by a restrictive requirement for government consent to a change
Refinancing benefit	the risk (upside) that at completion or other stage in project development the project finances can be restructured to materially reduce the project's finance costs	a beneficial change in the financing cost structure of the project	government will assure itself that likely benefit has been factored into competitive bids to avoid the risk that the private party will be allowed to earn super profits from the project	private party to benefit; government will share in limited circumstances (essentially, in symmetrical risk allocation and super profits)

Risk category	Description	Consequence	Mitigation	Preferred allocation
Tax changes	the risk that before or after completion the tax impost on the private party, its assets or on the project, will change	a negative effect on the private party's financial returns and in extreme cases, it may undermine the financial structure of the project so that it cannot proceed in that form	the financial returns of the private party should be sufficient to withstand such change; with respect to specific infrastructure taxation particularly that relating to transactions with government, the private party should obtain a private tax ruling	private party
Operating				
Inputs	the risk that required inputs cost more than anticipated, are of inadequate quality or are unavailable in required quantities	cost increases and in some cases adverse effect on quality of service output	private party may manage through long term supply contracts where quality/quantity can be assured; private party can address to some extent in its facility design	private party unless government controls inputs eg water catchment
Maintenance and Refurbishment	the risk that design and/or construction quality is inadequate resulting in higher than anticipated maintenance and refurbishment costs	cost increases where private party has assured whole of life obligation and adverse effect on delivery of contracted services and, in core services model, a corresponding adverse effect on government ability to deliver core services	private party to manage through long term subcontracts with suitably qualified and resourced sub-contractors and through formal or informal consultation processes with government	private party

Risk category	Description	Consequence	Mitigation	Preferred allocation
Changes in output specification outside agreed specification range	risk that government's output requirements are changed after contract signing whether pre or post commissioning	a change in output requirements prior to commissioning may necessitate a design change with capital cost consequences depending on the significance of the change and its proximity to completion; a change after completion may have a capital cost consequence or a change in recurrent costs only; for example where an increase in output requirements can be accommodated within existing facility capacity	government can mitigate this risk to an extent by minimising the chance of its specifications changing and, to the extent they must change, ensuring the design is likely to accommodate it at least expense; this will involve considerable time and effort in specifying the outputs up front and planning likely output requirements over the term	government
Operator failure	risk that a subcontract operator may fail financially or may fail to provide contracted services to specification	the failure may result in service unavailability, an inability for government to deliver core services and, in each case, a need to make alternate arrangements for service delivery with corresponding cost consequences	government will carry out due diligence on principal subcontractors for probity and financial capacity and commission a legal review of the major subcontracts including the guarantees or other assurances taken by the private party; if failure does occur the private party may replace the operator or government may require operator replacement	private party is fully and primarily liable for all obligations to government irrespective of whether it has passed the risk to a subcontractor
Technical obsolescence or innovation	risk of the contracted service and its method of delivery not keeping pace, from a technological perspective, with competition and/or public requirements	private party's revenue may fall below projections either via loss of demand (user pays model) payment abatement (availability model) and/or operating costs increasing; for government - consequence will be failure to receive contracted service at appropriate quantity/quality including adverse effect on core service delivery in core service model	private party may arrange contingency/reserve fund to meet upgrade costs subject to government agreement as to funding the reserve and control of reserve funds upon default; also monitoring obligations in the contract and work on detailed, well-researched output specifications (government) and design solution (private party)	private party except where contingency is anticipated and government agrees to share risk possibly by funding a reserve

Risk category	Description	Consequence	Mitigation	Preferred allocation
Market				
General economic downturn	in a user pays model, the risk of a reduction in economic activity affecting demand for the contracted service	revenue below projections	where government is the primary off-taker the private party will seek an availability payment element; otherwise the private party will ensure robust financial structure and sponsor/financier support	private party except to the extent that government has committed to an availability payment element or agreed to provide redress for impact of government subsidised competition
Competition	in a user pays model the risk of alternate suppliers of the contracted service competing for customers	revenue below projections arising from a need to reduce the price and/or from a reduction in overall demand, because of increased competition	private party to review likely competition for service and barriers to entry	private party except to the extent that government has committed to an availability payment element or agreed to provide redress for impact of government subsidised competition
Demographic change	the risk of a demographic/socio-economic change affecting demand for contracted service	revenue below projections	private party to review likely competition for service, barriers to entry	private party except to the extent that government has committed to an availability payment element
Inflation	risk that value of payments received during the term is eroded by inflation	diminution in real returns of the private party	private party seeks an appropriate mechanism to maintain real value eg via linkage to CPI; government concern to ensure its payments do not overcompensate for inflation and to avoid any double payment for after costs adjustments eg on changes in policy/law	private party takes risk on the methodology adopted to maintain value; government shares to the extent of agreed indexation

Risk category	Description	Consequence	Mitigation	Preferred allocation
Network and interface				
Withdrawal of support network	the risk that, where the facility relies on a complementary government network, that support is withdrawn or varied adversely affecting the project	negative patronage and revenue consequences	private party will seek financial redress against change which unfairly discriminates against the project particularly on a user pays project where revenue is directly affected; under an availability model private party will seek to avoid abatement if government 'prevention' is cause of unavailability	government where the change discriminates against the project
Changes in competitive network	the risk that an existing network is extended/changed/re-priced so as to increase competition for the facility	negative patronage and revenue consequences	private party will seek financial redress against change which unfairly discriminates against the project by government subsidising competition (existing or new)	private party except to the extent that government provides redress for appropriate, discriminatory changes
Interface (1)	the risk that the delivery of core services in a way which is not specified/anticipated in the contract adversely affects the delivery of contracted services	adverse effect on delivery of contracted service, potential for default by private party and possible need for government to make other arrangements for service provision	government manages core service activities allowing it to influence the materialisation of interface risk and its consequences; other mitigants include an upfront assessment (by both government and the private party) of the likely interface issues, continual review and monitoring and development of a communications strategy in respect of delivery of the two related services; government will also specify in the contract the extent of core services and the way in which they will be delivered so that only manifest and adverse changes and deficiencies can trigger this risk	private party except to the extent that government provides redress for appropriate, discriminatory changes

Risk category	Description	Consequence	Mitigation	Preferred allocation
Interface (2)	the risk that the delivery of contracted services adversely affects the delivery of core services in a manner not specified/anticipated in the contract	adverse effect on delivery of core services, default by private party and possible need for government to make other arrangements for core service provision	private party manages contracted service activities	private party
Industrial relations				
Industrial relations and civil commotion	risk of strikes, industrial action or civil commotion causing delay and cost to the project	cost and time delay	private party or its sub-contractors manage project delivery and operations	private party
Legislative and government policy				
Approvals	the risk that additional approvals required during the course of the project cannot be obtained	further project development or change in business operation may be prevented	private party to anticipate requirements	private party unless government has initiated the change requiring approval

Risk category	Description	Consequence	Mitigation	Preferred allocation
Changes in law/policy (1)	the risk of a change in law/policy of the State Government only, which could not be anticipated at contract signing and which is directed specifically and exclusively at the project or the services and which has adverse capital expenditure or operating cost consequences for the private party	a material increase in the private party's operating costs and/or a requirement to carry out capital works to comply with the change	government may mitigate its liability for such change by monitoring and limiting (where appropriate) changes which may have these effects or consequence on the project and via mechanisms in the contract allowing compensation only above a pre-agreed 'Significant Amount'; also requiring the private party to effect the change in such a manner that the financial effect on government is minimised and, if payment is required, that payment is made in a way and a time best suited to government (eg, pay on a progressive scale); also (in a user pays model) having in place a regulatory regime which allows pass through to end users	government: although the parties may share the financial consequences of capital cost increases in an agreed way, for example by the private party meeting a percentage of the cost up to a specific limit and government meeting any excess
Changes in law/policy (2)	in some cases, the risk of a change in law/policy (at whatever level of government it occurs) which could not be anticipated at contract signing which is general (ie not project specific) in its application and which causes a marked increase in capital costs and/or has substantial operating cost consequences for the private party	requirement on the private party to fund and carry out capital works or meet a marked increase in operating costs to comply with the change	government mitigates by excluding changes such as tax changes or changes for which the private party is compensated under a CPI adjustment or similar and only allowing compensation above a pre-agreed Significant Amount; also, again mechanisms could be used to minimise and manage financial impact on government and (where appropriate) a regulatory regime to allow pass-through to end users	government: although the parties may share the financial consequences of capital cost increases in an agreed way for example by the private party meeting a percentage of the cost up to a specific limit and government meeting any excess
Regulation	where there is a statutory regulator involved there are pricing or other changes imposed on the private party which do not reflect its investment expectations	cost or revenue effects	private party to assess regulatory system and may make appropriate representations	private party

Risk category	Description	Consequence	Mitigation	Preferred allocation
Force majeure				
Force majeure	the risk that inability to meet contracted service delivery (pre or post completion) is caused by reason of force majeure events	loss or damage to the asset, service discontinuity for government (may include inability to deliver core service) and loss of revenue or delay in revenue commencement for private party	private party given relief from consequences of service discontinuity; if uninsurable, private party may establish reserve funding; government to establish contingency for alternate service delivery; if insurable, private party must ensure availability of insurance proceeds towards repair of asset and service resumption and government is to be given the benefit of insurance for service disruption costs	private party takes the risk of loss or damage to the asset and loss of revenue, government takes some risk of service discontinuity both as to contracted service and core service subject to insurance availability and will need to arrange alternative service provision the cost of which will be met from redirected service payments and (if insurable) any shortfall made up from insurance proceeds
Asset ownership				
Technical obsolescence	the risk that design life of the facility proves to be shorter than anticipated accelerating refurbishment expense	cost of upgrade	private party may have recourse to designer, builder or their insurers	private party, but in certain high technology projects costs may be anticipated and shared

Risk category	Description	Consequence	Mitigation	Preferred allocation
Default and termination	risk of 'loss' of the facility or other assets upon the premature termination of lease or other project contracts upon breach by the private party and without adequate payment	loss of investment of private party; possible service disruption for government	private party (and its debt financiers) will be given cure rights (time and opportunity) to remedy defaults by the private party which may lead to termination including under tripartite deed with financiers; also only serious breaches by the private party to lead to termination; if termination occurs pre completion government may (but need not) make payment for value in the project on a cost to complete basis; if it occurs post completion the private party may receive fair market value less all amounts due to government; government will require step in rights to ensure access and service continuity until ownership/control issues are resolved	private party will take the risk of loss of value on termination
Residual value on transfer to government	the risk that on expiry or earlier termination of the services contract the asset does not have the value originally estimated by government at which the private party agreed to transfer it to government	capital costs incurred to upgrade the asset to the agreed value and useful life or asset demolished or removed	government will impose on the private party maintenance and refurbishment obligations, ensure an acceptable maintenance contractor is responsible for the work, commission regular surveys and inspections; it may also direct funds from the project into dedicated controlled sinking fund accounts to accumulate funds sufficient to bring the asset to agreed condition and/or (if required) obtain performance bonds to ensure the liability is satisfied	government

Appendix B: Glossary

The following are explanations of terms used in the *Partnerships Victoria Risk Allocation and Contractual Issues* guidance material.[27]

Asset The service potential of future economic benefits as a result of past transactions or other past events. Assets may be physical (eg plant, equipment or buildings) or non-physical (e.g. financial investments). Assets may also be current (having a store of service potential which is consumed in one year or less) or non-current (having a store of service potential that is consumed over a period of more than one year).

Asset ownership risk Refer to the definition of Asset ownership risk in Section 17.2.

Bidder A respondent to a request for Expressions of Interest or an invitation to submit a bid in response to a Project Brief. Typically, a bidder will be a consortium of parties, each responsible for a specific element, such as constructing the infrastructure, supplying the equipment, or operating the business. Government normally contracts with only one lead party (bidder) who is responsible for the provision of all contracted services on behalf of the consortium.

Business case The business case sets out the overview of the rationale supporting a *Partnerships Victoria* approach and a preliminary view on how the project will be delivered. It also provides an analysis of the various impacts of the project and an indication of the likely level of market interest. The business case provides information allowing government to decide whether to support a proposed project, before significant resources are spent on its development.

Commissioning Commissioning refers to the proving processes involving the start-up of operations, to deliver the contracted services as specified.

County Court The Victorian County Court, Melbourne, Victoria, is referred to as the County Court in this publication.

Cure period A specified period of time for a party to rectify/cure a default (that can be rectified or cured) before the government has the right to enforce any remedies for default specified in the contract.

Default The failure of a party to perform a contractual requirement or obligation, including failures to meet deadlines, to perform to a specified standard, to meet a loan repayment or to meet its obligations in relation to a materialised risk.

[27] These explanations are not necessarily the same as definitions adopted in authoritative documents, such as accounting standards. However, at the time of publication, they are not inconsistent with such definitions.

Design, construction and commissioning risk	Refer to the definition of Design, construction and commissioning risk in Section 9.2.
Expressions of interest (EoI)	A call by a government department or agency for expressions of interest from the private sector in a project. Responses to Expressions of Interest are used to evaluate the capability of bidders to deliver a project and may be used to gather some information from bidders on particular approaches that may be accommodated in the project brief. Based on the information presented in responses to an Expression of Interest, bidders are shortlisted to provide a final submission.
Financial risk	Refer to the definition of Financial risk in Section 10.4.
Force majeure	Acts of God and other specified risks (e.g. terrorism) which are beyond the control of the parties to the contract and as a result of which a party is prevented from or delayed in performing any of its non-financial obligations under the contract.
Force majeure risk	Refer to the definition of Force majeure risk in Section 16.2.
Government business enterprise	A commercially focused government-owned trading body constituted under State legislation and/or Corporations Law as a separate legal entity.
Government department or agency	An agent of the Victorian Government, including departments, statutory authorities, statutory corporations and government business enterprises.
Industrial relations risk	Refer to the definition of Industrial relations risk in Section 14.2.
Infrastructure	Fixed capital assets, such as schools and hospitals, which support the provision of services. Infrastructure can also refer to a network of reticulated services such as roads, energy services, rail, airports, etc.
Intellectual property	Legally protected intellectual property (copyright, patents, registered designs etc) and ideas and information which are protected as confidential information at common law or under contract.
Interface risk	Refer to the definition of Interface risk in Section 13.2.
Legislative and government policy risk	Refer to the definition of Legislative and government policy risk in Section 15.2.
Market risk	Refer to the definition of Market risk in Section 12.2.

Material adverse effect regime	The designation of particular categories of risks which, if they materialise, will have a material adverse effect on the project and are to undergo a special process of assessment and allocation between the parties.
Network risk	Refer to the definition of Network risk in Section 13.2.
Operating risk	Refer to the definition of Operating risk in Section 11.2.
Operator	The party responsible for operating the business (for example, a public building) once the infrastructure has been established.
Output specification	The output specification sets out the range of services that government is seeking to procure and the performance levels required for each of those services.
Preferred bidder	The preferred bidder is a bidder selected to develop its proposal during the negotiation period, in sufficient detail to enable the execution of the final contract.
Private party	The private sector entity with which government directly contracts. Traditionally the private party has been a special purpose vehicle created specifically for the purposes of the project. The private party is not limited to this form and can be set up under a number of structures, including a joint venture and a trust structure. Behind the contracting party, however, there may be a number of private sector interests at play, seeking to be represented through the contracting party. (*see also* Special purpose vehicle)
Probity	Uprightness, honesty, proper and ethical conduct and propriety in dealings. Used by government to mean 'good process'.
Project Brief	The Project Brief details government's objectives, service delivery requirements, policy and commercial matters, material background information and the processes for lodging and evaluating submissions. It also sets out government's role and intentions for the infrastructure to be built, and explains how checks and balances are observed in the process to ensure impartiality.
Public interest test	An assessment of the impact of the project on the following eight elements of public interest: effectiveness, accountability and transparency; affected individuals and communities; equity; consumer rights; public access; security; and privacy.
Public Sector Comparator (PSC)	The Public Sector Comparator (PSC) represents the most efficient public procurement cost (including all capital and operating costs and share of overheads) after adjustments for Competitive Neutrality, Retained Risk and Transferable Risk (for definitions of these terms please refer to the *Public Sector Comparator* technical note) to achieve the required service delivery outcomes. This is used as the benchmark for assessing the potential value for money of private party bids in *Partnerships Victoria* projects.

Risk	The chance of an event occurring which would cause actual project circumstances to differ from those assumed when forecasting project benefit and costs.
Risk allocation	The allocation of responsibility for dealing with the consequences of each risk to one of the parties to the contract, or agreeing to deal with the risk through a specified mechanism which may involve sharing the risk.
Risk assessment	The determination of the likelihood of identified risks materialising and the magnitude of their consequences if they do materialise.
Risk category	Risk can be allocated into broad categories such as site risk, network risk, operating risk, market/demand risk, sponsor risk and industrial relations risk.
Risk identification	The process of identifying all the risks relevant to the project.
Risk management	The identification, assessment, allocation, mitigation and monitoring of risks associated with a project. The aim is to reduce their variability and impact.
Risk matrix	A method of presenting all possible significant risks likely to be encountered in a project, the magnitude and likelihood of the risks occurring, their areas of impact, the allocation of risks between parties and the risk mitigation techniques to be employed.
Risk mitigation	The attempt to reduce the likelihood of the risk occurring and the degree of its consequences for the risk-taker.
Risk premium	The amount required to compensate an investor for assuming a particular risk attached to an investment proposal.
Site risk	Refer to the definition of Site risk in Section 8.2.
Sovereign risk	The risk that there is no remedy available at law to prevent government from legislating to affect the rights of the private party. Sovereign risk is a category of legislative and government policy risk.
Special purpose vehicle (SPV)	In establishing a project consortium, the sponsor or sponsors typically establish the private party in the form of a special purpose vehicle (SPV) which contracts with government. The SPV is simply an entity created to act as the legal manifestation of a project consortium. The SPV itself has no historical financial or operating record which government can assess.
Sponsor risk	Refer to the definition of Sponsor risk in Section 10.2.
Statutory authority/ corporation	An organisation owned by the State, established by legislation under a charter to produce goods, or deliver services to the public.

Step-in	Government's election to assume all or some of the service delivery obligations of the private party under the contract for a period of time. The circumstances where government may have the right under the contract to exercise rights to step in may include a need to: prevent or mitigate a serious risk (to the environment; public health; the safety of persons or property); guarantee continuity of an essential service; discharge a statutory duty; or deal with a default by the private party under the contract.