Cabinet Secretariat Reference	
Submission No.	BERC166
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Submission to: **Budget and Expenditure Review Committee**

Submission Title: **East West Link Stage One – State contribution**

Portfolio/s: **Treasury**

SUBMISSION PROPOSAL

Recommendation:

That the Budget and Expenditure Review Committee (BERC)

1. Agree to the proposed State contribution structure for the East West Link Stage One (Project) Public Private Partnership (PPP) as outlined in this submission, including:
   a) A total amount of government contributions of $3 billion comprising $2 billion to be made during construction and $1 billion to be made two years after construction completion;
   b) Government contributions to be funded through $1.5 billion from the Commonwealth funding contribution to the Project and $1.5 billion from the State;
   c) For the $2 billion State contribution during construction, annual cumulative caps not to be exceeded as follows:
      - zero for 2014-15;
      - $600 million for 2015-16;
      - $1.7 billion for 2016-17;
      - $2 billion for 2017-18; and
      - $2 billion for 2018-19;
   d) For the $1 billion State contribution after construction completion, a lump sum payment on the second anniversary of final completion;
2. Note that interaction with bidders during the next phase of the Project may require further refinements to the proposed State contribution structure; and
3. Note that the proposed State contributions are within the existing funding allocations currently in the forward estimates, including the Commonwealth funding contribution to the Project.

Objectives:

1. To inform BERC of the proposed tender strategy in relation to the proposed State contributions and financing support for the Project; and
2. To seek BERC approval of the proposed State contribution structure to be incorporated in the Request for Proposal documentation.

Key Issues:

Consideration of modified financing within the reformed PPP policy context

1. The East West Link Stage One (Project) is being procured as an Availability Public Private Partnership (PPP) with the State tolling the road separately. Under this model, typically the private sector designs, builds, fully finances, commissions, operates and maintains the public asset to specified standard over the contract term in exchange for "availability payments" from the Government for services delivered.
2. In May of this year, as Treasurer I announced a suite of policy reforms to the Government's PPP framework which include using modified financing structures to deliver greater value for money in specific circumstances.
3. The policy requires the Department of Treasury and Finance (DTF) to assess project specific factors in determining whether a modified financing structure will improve project outcomes and evaluate modified financing options against prescribed criteria, namely risk allocation, cost and complexity, preservation of the benefits of private finance, competitive tension, alignment of the tenor of finance with the project's risk profile and potential for innovation.
4. In DTF's view, the most efficient and effective form of modified financing for the Project is a State contribution to the total financing requirement. The policy states that a partial capital contribution can be made by Government as milestone payments during construction for mega projects where the full private capital to fully finance construction cannot be raised or as a lump sum payment once construction is complete to achieve greater value. Where a State contribution is made during construction appropriate considerations are given on a project specific basis to ensure the integrity of PPP risk transfer.

<u>State contribution during construction</u>

5. The total financing requirement for the PPP aspects of the Project is likely to be in the region of between $5 billion and $6 billion, comprising of $4 – $5 billion of design and construction (D&C) costs and approximately $1 billion of capitalised interest during construction.
6. A bottom up analysis of the current PPP project finance market capacity, including considering feedback from previous extensive market soundings and the more recent Expressions of Interest responses has been undertaken. Current lending practice (including implications of the Australian regulatory and prudential framework) results in a liquidity threshold for any single PPP project of somewhere between $2 billion and $4 billion. This means that bidders will not be able to fully raise private finance for the Project as there will potentially be a financing gap of $1 - $4 billion.
7. Given the analysis, a State contribution during the D&C phase will be required for the Project.

<u>State contribution post construction completion</u>

8. Consistent with the PPP policy reforms and to achieve better value for money, a State contribution post construction completion is also proposed. In general a State contribution of this type is made at commercial acceptance / commissioning of a project, for example as implemented on the New Bendigo Hospital project and proposed for the Ravenhall Prison project.
9. However, careful consideration needs to be given to some unique characteristics for

this Project. Taking these into account, a further State contribution on the second anniversary of commercial acceptance / final completion will on balance deliver the most optimal outcome for the Project.

10. Further details are discussed in the structuring options below.

Sizing of the State contribution

<u>State contribution during construction</u>

11. In sizing the State contribution, consideration has been given to:
    - the range of possible construction costs and the resulting overall financing requirement;
    - the number of short-listed bidders and their ability to fully raise finance in the context of the current debt market capacity;
    - timing and quantum of any State contribution and potential impacts on:
        - maintaining the integrity of PPP risk allocation (i.e. creating appropriate incentives);
        - State Budget and forward estimates (i.e. potential implications for budget parameters and rating agency considerations);
        - total Project cost and overall value for money proposition; and
        - likely accounting treatment of State contribution and implications for the State's balance sheet and operating result.
12. Attachment A contains a summary and key outputs of DTF analysis of the trade-offs relating to the considerations outlined above. The analysis concludes that a State contribution of $2 billion during the D&C phase of the Project is likely to most optimally meet the desired outcomes of each of the above considerations.
13. In the event that bid construction cost is more competitive and comes in under $4.5 billion, it is proposed that the State contribution will then be sized at the lower of $2 billion or 50 per cent of the construction cost to maintain risk allocation.
14. The main reasons for this conclusion are:
    - the State gets the same level of private sector discipline, rigour and due diligence (underpinned by private financing) whether the private sector debt is $2 billion, $3 billion or $4 billion as these amounts are at a level that will warrant sufficient incentives on risk allocation, hence there is no relative advantage in maximising private sector debt;
    - the higher the private sector debt requirement the harder it is to attract three fully financed bids;
    - private sector debt becomes more expensive after a point, possibly at around $3 – $3.5 billion. This equates to a State contribution of $2 billion; and
    - anecdotal evidence gathered as part of the research undertaken to develop the PPP reforms tends to suggest where a State contribution is made during construction, the size of that contribution could increase up to 50 per cent of the capital cost requirement without any significant shift in risk allocation, providing the State has adequate access to a suitably sized D&C security package. The benefits of private sector incentives under an Availability PPP is believed to be preserved up to that level. Fifty per cent of the total capital cost requirement for the Project is estimated to be in between $2 billion and $2.5 billion.
15. The optimal value for money solution is therefore likely to be achieved where the

State sets the contribution at $2 billion and requires bidders to fill the financing gap with private finance. This level of State contribution is also consistent with current estimates of bank market underwriting capacity for three bids.

<u>State contribution post construction completion</u>

16. In sizing the State contribution post construction completion, consideration has been given to:
    - the Project's ongoing operational performance risk borne by the private sector as well as lifecycle and hand-back condition requirements and the appropriate level of private financing that should remain in the PPP structure to support that level of risk; and
    - the potential interaction between the Project operational performance and toll revenue and the amount of implicit toll revenue risk transferred through the payment mechanism to the private sector.
17. To underpin the risk transfer over the contract term by leaving sufficient private finance in the PPP structure, a further State contribution of $1 billion after construction completion is appropriate. This leaves approximately $2 – $3 billion of private capital at risk in the PPP structure for the rest of the contract term.

Structuring options

<u>State contribution during construction</u>

18. In structuring the State contribution during construction, it is noted that:
    - the timing of private sector debt versus State contribution will impact on yearly profile of Net Debt but should not impact materially on year by year asset capacity because of the way unallocated capital is put aside to build up to the finance lease liability for the PPP anticipated at construction completion; and
    - a back-ended State contribution is preferable to preserve PPP risk allocation and Net Debt implications but results in a higher overall project cost as capitalised interest on private sector finance will be higher.
19. A strategy of asking bidders to maximise private finance and minimise State contribution is not as optimal as specifying a capped amount of State contribution available as although it results in a deferral of recognising Net Debt impact it could distort bidding incentives. This strategy does not result in more private sector discipline or due diligence or improvement in the overall cost of financing. Total Net Debt impact (finance lease liability plus State contribution) at end of construction is also likely to be higher.
20. The optimal value for money solution is therefore likely to be achieved where the State sets the State contribution and requires bidders to fill the funding gap with private finance. That is the cost of any additional private finance that might be obtained if bidders were asked to maximise private finance is expected to outweigh any reduction in risk to the State.
21. A back-ended contribution of $2 billion will preserve incentives and the PPP risk allocation as well as being financially efficient and maintaining a strong competitive landscape.
22. The following structure is proposed:
    - the State contribution be set at $2 billion during construction. It is noted that this could effectively be partially funded by $1.5 billion of Commonwealth Government funding contribution to the Project;

- the State contribution to be substantially backed ended. For the purposes of the Request for Proposal (RFP) release, it is proposed that a structure of pro rata State contribution (to private sector debt) to commence once 80 per cent of private sector debt and an amount equivalent to 100 per cent of private sector equity have been drawn down for the Project. It is noted that this is an aggressive commercial position and will likely require close interaction with bidders during the RFP phase to be further refined; and
- conditions to draw on the State contribution to be equivalent to private sector debt draw down. The State's and financiers' interests are largely aligned in ensuring that proper use of funds occurs during construction.

23. A number of structuring options have been considered including the State contribution to be made pro rata with private sector financing throughout the construction period from the start. While such a structure may provide a better Net Debt impact, it severely undermines the principle of PPP risk transfer and therefore should be discounted.

<u>State contribution post construction completion</u>

24. The key considerations in structuring the State contribution post construction completion are:
    - there is already a material State contribution during construction of the Project. As this State contribution is carefully sized and structured to ensure the PPP risk allocation is not compromised, a further State contribution at construction completion is not expected to derive increasing marginal value;
    - as the Project comprises largely of a twin tunnel and several complex elevated structures in heavily built up areas at either end of the tunnel, it is more beneficial (i.e. less risky) for the State to wait until the road reaches operational steady state and D&C defects or teething operational issues have been properly rectified. The defect liability period is typically two years after final completion;
    - the 2-year period after road opening coincides with the traffic ramp-up period. In theory the State will look to sell or monetise the toll revenue on the road at this point, meaning an additional source of funding may be available to make the State contribution.
25. The following State contribution structure after construction completion is proposed:
    - a further State contribution of $1 billion to be made on the second anniversary of commercial acceptance / final completion for the Project; and
    - the only condition to payment is that at the time of State contribution there is no subsisting default under the PPP contract. If a default exists at that time, the State contribution is delayed until such default is resolved in accordance with the appropriate contractual provisions. The risk of delayed payment lies with the private sector consistent with standard PPP commercial principles.

Tender process strategy

<u>State contribution during construction</u>

26. To ensure that Budget parameters will not be breached, it is proposed that a State contribution cash flow profile be included in the RFP documentation to guide bidders in structuring their bid capital structures for the Project.
27. This cash flow profile will also signal to bidders the State's preference to back end the State contribution.

28. Slide 12 of Attachment A shows funding allocation in the forward estimates available to make the State contribution and the proposed profile to be incorporated in the RFP.
29. It is proposed that RFP documentation specifies that in structuring their capital structure bidders must take into account the State's requirement regarding the State contribution during construction such that it does not exceed an annual cumulative cap as follows:
    - 2014-15: 0;
    - 2015-16: $600 million;
    - 2016-17: $1.7 billion;
    - 2017-18: $2 billion; and
    - 2018-19: $2 billion.

<u>Other financing matters</u>

30. To maximise the potential for private sector innovation and competition, it is proposed that the RFP will maintain standard commercial principles in relation to private financing. This includes requiring bids to be fully financed at RFP submission. This allows the State to stretch test the market and deal with real issues as opposed to perceived issues.
31. However, as noted previously there remains a risk that there may not be sufficient liquidity in the project debt financing market to fund three bids. To mitigate this risk, it is proposed that:
    - the State will require bidders not to engage banks / financiers on an exclusive basis. While this does not oblige banks/financiers to commit to more than one bidder, it allows those banks/financiers who are willing to support multiple bidders to do so, provided appropriate confidentiality arrangements are in place to ensure competition can be maintained;
    - the State will also require each bidder to restrict participation of the four major Australian banks to two per each bidder, allowing the potential to spread the four major Australian banks participation to all three bidders; and
    - the State will require bidders to provide early feedback, approximately six weeks after RFP release on their strategies and approaches to raising finance and meeting the RFP requirements. This will facilitate early identification of potential issues and provide an opportunity for the State to respond appropriately.
32. DTF will continue to work with the Linking Melbourne Authority and its financial adviser on options to respond to bidders feedback. One potential option being investigated is a State finance support mechanism that allows bidders to bridge a financing requirement gap during the RFP phase but falls away after a certain period after financial close.
33. It is anticipated that if further State support measures are required after RFP release due to bidders feedback, BERC approval will be sought.

Budget treatment

34. Slide 12 of Attachment A shows the proposed State contributions to be within the existing funding allocations currently in the forward estimates and as such no adjustment to funding allocations is required.
35. As the tender process progresses and the contract is signed for the Project, appropriate adjustments will be made to the forward estimates to reflect the final State

contribution structure.
<u>Risks</u>: 1. There is a risk that the proposed trigger for the State contribution during construction is excessively aggressive, resulting in one or more of the three short-listed bidders unable to meet this requirement. The tender strategy to engage with all bidders shortly after RFP release to seek live feedback will largely mitigate this risk. 2. There is a risk that State contributions are set higher than required if actual construction cost is significantly below the State's estimates. This is a low risk as the amounts have been set having regard to a number of construction cost outcomes, including taking into account bidders feedback from the Expressions of Interest submissions.
<u>Support/Criticism</u>: 1. The State contribution model is widely used in various forms in the PPP industry. It is commonly supported by governments and the private sector and seen as a tool to achieve PPP risk allocation at better value for the tax payer. 2. There may be concerns raised from the PPP industry regarding the requirement for three bidders to fully finance the Project at RFP submission. However, this is mitigated through the proposed tender strategy where early and proactive engagement with bidders will allow Government to better understand the actual issues faced by bidders and to more appropriately respond to actual problems. 3. The proposed State contributions will likely be welcomed by bidders as these are set at levels that will address current market constraints.

Hon. Michael O'Brien MP
Treasurer

Date:

FUNDING

Financial Implication Tables

[please only include relevant financial information and delete tables where appropriate]

REVENUE IMPACT	Departmental Estimate				
	2013-14 $m	2014-15 $m	2015-16 $m	2016-17 $m	2017-18 $m
Revenue Impact[1]					
- Taxes	0.000	0.000	0.000	0.000	0.000
- Reg. fees/charges	0.000	0.000	0.000	0.000	0.000
- other revenue[2]	0.000	0.000	0.000	0.000	0.000
- other sources[3]	0.000	0.000	0.000	0.000	0.000
Additional Revenue [4]	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**

Note[1]: As per 'Revenue from ordinary activities', statement of financial performance table in Budget paper No 4.
Note[2]: Other revenue includes resources received free of charge, sale of goods and services and other revenue and revenue from other parties.
Note[3]: Other sources include general-purpose Commonwealth grants.
Note[4]: Additional revenue included in this table should be viewed as benefit paid to the Consolidated Fund.

APPROPRIATION IMPACT	Departmental Estimate				
	2013-14 $m	2014-15 $m	2015-16 $m	2016-17 $m	2017-18 $m
Impact on Department's operating cost	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**
Less offsets from:	0.000	0.000	0.000	0.000	0.000
- internal reprioritisation/existing funds					
- revenue retained[5]	0.000	0.000	0.000	0.000	0.000
Net additional appropriation required by the Department.	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**

Note[5]: Benefit retained by Department to offset cost, as per the revenue retention agreement. This may include Commonwealth Specific Purpose Payments.

ASSET INVESTMENT	Departmental Estimate					
	2013-14 $m	2014-15 $m	2015-16 $m	2016-17 $m	2017-18 $m	TEI $m
Total asset cost[6]	0.000	0.000	0.000	0.000	0.000	0.000
Less: funding from other sources[7]	0.000	0.000	0.000	0.000	0.000	0.000
Net funding to Department	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**

Note[6]: This should only include the capital costs. The associated recurrent costs (if any) should be identified in the 'operating impact' table, where typically the recurrent costs would include, depreciation and CAC.
Note[7]: This includes trust funds such as BRV, RIDF, CSF and asset sales.

FUNDING ALREADY IN DEPARTMENT'S BASE						
	Departmental Estimate					
	2013-14 $m	2014-15 $m	2015-16 $m	2016-17 $m	2017-18 $m	TEI $m
Funding already in Department's base[8]	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**

Note[8]: Explanation to be included regarding what figures are being referred to (i.e. the amount appropriated to the output or the amount within an output associated with a specific project or program, existing TEI should be identified for asset proposals).

DTF and the Department have agreed the financial implications and costings in this submission:

☑ **Yes** ☐ **No**

IMPACT ASSESSMENTS
Social Impacts: 1. N/A
Family Impacts: 1. N/A
Regional and Rural Victorian Impacts: 1. N/A
Economic Impacts: 1. N/A Regulatory burden, offsetting reductions and evaluation strategy: Does the submission propose an increase in regulatory burden on the business or not-for-profit sectors that is likely to be 'material' as defined in the Victorian Regulatory Change Measurement (RCM) Manual? ☐ Yes ☑ No If yes, does the submission include: • Realistic potential offsetting reductions? ☐ Yes ☐ No • An evaluation strategy for reviewing the proposal's ongoing effectiveness? ☐ Yes ☐ No
Environmental Impacts: 1. N/A
Charter of Human Rights and Responsibilities Act 2006 Impacts: 1. N/A