New Zealand Transport Agency

Transmission Gully PPP - Lessons Learnt Review

FINAL REPORT

December 2014
This report contains 39 pages
Transmission Gully Lessons Learnt Review

Important notice

Inherent Limitations

This report has been prepared in accordance with our Engagement Letter dated 1 October 2014. The services provided under our engagement letter ('Services') have not been undertaken in accordance with any auditing, review or assurance standards. The term "Audit/Review" used in this report does not relate to an Audit/Review as defined under professional assurance standards.

The information presented in this report is based on information provided by the New Zealand Transport Agency (NZTA) and interviewees. We have indicated within this report the sources of the information provided. Unless otherwise stated in this report, we have relied upon the truth, accuracy and completeness of any information provided or made available to us in connection with the Services without independently verifying it.

No warranty of completeness, accuracy or reliability is given in relation to the statements and representations made by, and the information and documentation provided by NZTA personnel and wider stakeholders consulted as part of the process.

Third Party Reliance

Other than our responsibility to NZTA, neither KPMG nor any member or employee of KPMG undertakes responsibility arising in any way from reliance placed by a third party on this report. Any reliance placed is that party's sole responsibility.

Our report was prepared solely in accordance with the specific terms of reference set out in the engagement letter agreed dated 1 October 2014 between ourselves and NZTA and for no other purpose.

KPMG expressly disclaims any and all liability for any loss or damage of whatever kind to any person acting on information contained in this report, other than NZTA. Additionally, we reserve the right but not the obligation to update our report or to revise the information contained therein because of events and transactions occurring subsequent to the date of this report.

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1 Introduction

1.1 Scope

KPMG has been asked by the New Zealand Transport Agency (NZTA) to provide input into a review of the procurement of Transmission Gully (the Project). Transmission Gully is New Zealand's first Public Private Partnership (PPP) road and NZTA is keen to ensure lessons are captured for future roads projects.

KPMG's work is one component of the review of Transmission Gully. A Lessons Learnt Review was conducted by 41 South in September 2014 which involved interviews with a broad range of parties involved in the project, including the Project Director and Project Manager. NZTA has also been more generally considering what worked and what could be improved as it prepares for potential future PPP projects. The intention is that KPMG's input does not replicate previous work but instead focuses on specific areas that require a strong understanding of PPP procurement.

NZTA provided KPMG with the list of topics to focus on and a list of people from whom to seek feedback. The content of this report is a summary of the feedback received from interviewees and theory from KPMG's knowledge of PPP projects in New Zealand and other jurisdictions.

1.2 Methodology

KPMG developed a list of interview questions based on the areas of focus provided by NZTA. A slightly different set of questions was developed for public and private sector interviewees to ensure relevance to the interviewee. The questions were sent to interviewees ahead of interviews. See Appendix One for the list of questions and list of interviewees.

The majority of interviews were conducted face to face, although it was necessary to perform a small number over the phone. KPMG ran the interviews without NZTA present and feedback was anonymised.

The key findings emerging from interviews were presented to the NZTA review team. NZTA provided feedback on the findings of most interest and KPMG then researched these areas further to develop an assessment of common practice in other jurisdictions.

This report is structured around NZTA's original areas of focus. It presents the feedback from interviews and, where relevant, the assessment from research conducted by KPMG. Where KPMG assessment is provided, this is presented in *italics*.

Consistent with KPMG's role as auditor of NZTA, this report does not contain explicit recommendations on future courses of action. For the avoidance of doubt, all decisions on subsequent courses of action arising from this report remain the responsibility of NZTA.

2 Executive Summary

KPMG was asked by the NZTA to provide input into a review of the procurement of Transmission Gully (the Project). NZTA provided KPMG with the list of topics and people from whom to seek feedback. The content of this report is a summary of the feedback received from interviewees and theory from KPMG's knowledge of PPP projects in New Zealand and other jurisdictions. This Executive Summary presents KPMG's view of the most material comments in each section.

2.1 Project Governance and Reporting

- The governance structure and senior project team were largely outside core NZTA. The public sector respondents felt this helped the Project team focus on delivery but meant that governance were not as engaged in the Project as they could have been. It also contributed to concerns about loss of Intellectual Property (IP) following Financial Close. Public sector respondents would have liked NZTA employees and management to have a deeper understanding of the Project as it moves into delivery and operational phases.
- Many public sector interviewees felt that delegations could have been clearer and more formalised internally. In addition the governance structure was complicated with multiple groups established; the respective roles of each were not always clear. The governance structure should be simplified on future transactions.
- There was a common view that the Project Director had a significant level of autonomy in decision making. This may have contributed to the perception that the governance group was less involved than would have been ideal.
- PPPs tend to be large and high profile and to the extent that the NZTA expects to pursue further PPP projects in the future, longer term planning should be undertaken to ensure the right team and internal resources are available. This would also aide the retention of IP.

2.2 Efficiency of the process

- The majority of interviewees considered the overall procurement process to be well run. The Preferred Bidder (PB) phase was protracted and there was surprise on both sides at the extent to which points had to be (re)negotiated post award. This resulted in material additional pre-Financial Close costs being incurred on both sides.
- Common reasons given for long PB phase include (i) the extent to which the Project documentation was developed at bid stage (ii) the ground breaking nature of the transaction and (iii) consenting.
- In KPMG's view there are a number of options that might help encourage greater bid development and minimise the extent of open issues at RFP submission, such as increasing the evaluation weighting related to "certainty", being more specific on the level to which bid elements are expected to have been developed, and scoring commercial derogations in future projects.
- There were clear views expressed that the tight Affordability Threshold (AT) had a direct impact on both commercial and technical aspects of bids.

- The stipend was considered critical amongst private sector participants in receiving approval to bid and was seen to improve the quality of the proposals that were submitted. If it is to be retained, NZTA could review the level of the stipend in advance of each PPP, recognising the important role in plays in driving competition, but setting it at a level that retains a clear incentive to win the project - it is appropriate that there is some pain in losing.

2.3 Risk Allocation

- Respondents on both the public and private sector sides felt the process to negotiate risk allocation was involved and intensive, but overall the outcome was reasonably fair and effective.
- Bidders said they undertook more risk analysis than they would on other New Zealand roads projects, including researching natural event risk, sourcing academic research and doing extensive data analysis of traffic flow and accidents on New Zealand roads.

2.4 Optimising NZTA funding

- It is considered that there may be benefits to the NZTA if there was the option to structure or 'sculpt' the payment stream under the contract, including use of capital contributions, to better match the NZTA's own obligations and headroom in the fund. The use of capital contributions will need to be discussed with the Treasury as it is currently outside their PPP policy.
- There are some implications on private sector appetite, risk transfer and the outcomes focused approach in the use of capital contributions but these are unlikely to be prohibiting factors.

2.5 Public Sector Comparator, AT and Discount Rate

- There was a strong message from private sector interviewees that the AT is vital when developing a bid. It is deconstructed, allocated out to intra-consortium workstreams and then referred to every day. It is a target all parties focus on and it drives key design and commercial trade-offs.
- Public sector parties commented that a dynamic AT could weaken the incentive on bidders to develop innovative designs that come in under the AT.
- Parties agreed that they were more open to an AT changing for observable external changes, for example base interest rate changes. It was felt, however, that this was best done through the discount rate.

2.6 Funding Markets and Competition

- A common view that liquidity in the debt and equity markets continues to recover strongly since the GFC. Debt market capacity is unlikely to be a material factor in driving financing terms.
- The majority of PPP projects elsewhere have been run with three bidders. Generally this is considered a suitable compromise between efficiency of process and the cost of procurement against competitive tension. On future deals, NZTA could consider using the term "up to

three" bidders. This is consistent with the approach used on other New Zealand PPP projects and provides for flexibility depending on the quality of responses received at the Expression of Interest stage.

3 Project Governance & Resourcing

3.1 Focus of review

- Was the governance structure fit for purpose?
- Was an efficient/effective balance struck between informing NZTA management, suitable project oversight and delegating decision making?
- Did the team and governance structure facilitate the retention of Intellectual Property (IP)?
- How could the governance and project resourcing structure be improved?

3.2 Key observations

- All parties generally felt that NZTA and its advisors had the right capabilities and resources to deliver Transmission Gully.
- People felt that it was right that contractors with PPP experience were brought in, but noted that this meant there was limited retention of IP within NZTA. To the extent PPP projects will continued to be pursued the NZTA should consider its longer term approach and how best to ensure staff with the right skills and expertise are available to the organisation.
- The governance structure was complicated and senior project team were largely outside core NZTA. The public sector respondents felt this helped the Project team focus on delivery but meant that governance were not as engaged in the Project as they could have been. Public sector respondents would have liked NZTA employees and management to have a deeper understanding of the Project as it moves into delivery and operation phases.
- Many public sector interviewees felt that delegations could have been clearer and more formalised internally. There was a common view that the Project Director had a significant level of autonomy in decision making. This may have contributed to the perception that the governance group was less involved.
- The private sector felt the right people were in the room on the public sector side and the management and governance structures allowed the project to operate efficiently. Delegation and capability of the Project team allowed relatively prompt feedback and decisions.
- It was generally agreed that transparency and communication are key to the successful delivery of a complex project such as this.

3.3 Governance structure and delegations

As expected, the public and private sector respondents had different viewpoints on the governance structure for the project.

The private sector valued prompt and clear decisions and they felt that the Project governance delivered this. Their impression was that the Project Director could provide feedback in meetings (or shortly after) and either had sufficient delegation or was able to put the point through the governance structure efficiently. Some said that there were some occasions when the necessary

people did not attend meetings and this meant it took longer to get feedback, but that this was not a significant issue.

The public sector respondents felt that the governance was appropriate for the size and complexity of the Project, however still felt improvements could be made. The governance structure was complicated with three groups established (a governance group, decision making team and steering group) some of which had common member and the distinction between them was not always clear. In addition, many saw the Project team as a separate unit and not well connected into core NZTA. This may have contributed to by the level of autonomous decision making by the Project Director.

This had the advantage of allowing the team to be nimble and focused on delivery, but the downside was that wider NZTA and governance did not gain a deep understanding of the Project. It also contributed to the loss of intellectual property which is explored below.

On future projects NZTA may want to consider:

- *Having a more detailed delegations matrix agreed within Detailed Business Case approvals so that it is clear which decisions are made at each level of governance, especially which decisions the Project Director can make without governance approval.*
- *Providing for a less complicated governance structure perhaps by combining multiple governance groups into a single steering committee.*
- *Having a representative from the NZTA's Planning & Investment Group on the governance group.*

3.4 Retention of intellectual property

Public sector respondents commented that the use of contractors and the relative isolation of the Project team meant that few people in NZTA have a deep understanding of the Project, particularly in terms of the detailed commercial arrangements. This was exacerbated by the loss of senior staff during the Project and the fact that the Project Director and Project Manager were both on contract roles which ended shortly after Financial Close. It was acknowledged that as the Project was the first roads PPP in New Zealand it was important to contract in the right expertise.

Respondents felt future projects could build and retain roads PPP knowledge within NZTA by:

- Having junior NZTA staff in Project administration roles
- More senior NZTA staff working alongside contractors and advisors
- Greater involvement of governance in key decisions

In addition, PPPs tend to be large and high profile and to the extent that the NZTA expects to pursue further PPP projects in the future, longer term planning should be undertaken to ensure the right team and internal resources are available.

As a PPP it is important to contract in the right expertise where there are gaps. However, NZTA may want to consider making contractors and/or advisors roles continue for a period post Financial Close to ensure IP is better passed on and that there is continuity of expertise. In addition, to the extent PPP projects will continued to be pursued the NZTA should consider its longer term approach and how best to ensure staff with the right skills and expertise are available to the organisation.

3.5 Project resourcing

All respondents felt that the Project team was sufficiently resourced. The extent to which advisors were used was largely left to the workstream leads. In general the view was that NZTA used its advisors well, although some were less visible to bidders than on other PPP projects. Some respondents commented on the shallow market for technical advisors in New Zealand with PPP experience and some felt that NZTA's insurance advisors could have been brought in earlier and included in more meetings.

The private sector felt NZTA had deep technical knowledge of the Project and were able to provide valuable information and feedback during Request for Proposal (RFP) and Preferred Bidder (PB) phases. They thought that this was partly due to the history of the Project and future projects may not have the same level of information available.

NZTA was viewed by the private sector as a competent agency that has strong procurement skills and very good technical knowledge.

4 Efficiency of the Process

4.1 Focus of the Review

- Was competitive tension optimised against the project timetable and procurement costs?
- What are the advantages and risks of requiring further bid development before appointing a preferred bidder and what options are there for enforcing bid positions post-PB?
- What are the advantages and risks of providing a bid cost stipend to the losing bidder, what is a reasonable level of the stipend, and should cash-flow coverage be provided to the preferred bidder during the negotiation phase?
- Were submitted bids clear and understood?

4.2 Key Observations

- Generally the process was considered to be well run and promoted a competitive process.
- The Expression of Interest (EOI) phase was considered to have been efficient although the Project might have benefitted if it had been better signaled to the market pre EOI release.
- The RFP phase and interactive tendering process were considered to be very well run.
- The PB phase was protracted and there was surprise on both sides at the extent to which points had to be (re)negotiated post award. This resulted in material additional pre-Financial Close costs being incurred on both sides.
- Common reasons given for long PB phase include (i) the limited extent to which the Project documentation was developed at bid stage (ii) the ground breaking nature of the transaction and (iii) consenting.
- There were mixed views on whether bid requirements and evaluation methodology were clear. There were key differences between the bids received, which indicates that bidders may have struggled to assess the optimal trade-off between achieving the affordability threshold as against delivering a proposal which met all of NZTA's qualitative criteria.
- There were clear views that the tight Affordability Threshold had a direct impact on both commercial and technical aspects of bids.
- The stipend was considered critical amongst private sector participants in receiving approval to bid and was seen to improve the quality of the proposals that were submitted.
- There were no material concerns or issues raised around probity.

4.3 Was competitive tension optimised against the project timetable and procurement costs?

In general feedback on the process was positive and, through until PB appointment, there was praise for the way the NZTA adhered to the original timetable. In KPMG's experience the

Project timetable up to PB appointment was in-line if not at the faster end of comparable procurements in other jurisdictions, particularly given this is the NZTA's first PPP project.

4.3.1 Expressions of Interest

There were no material concerns around the EOI process and timetable other than it was noted that the EOI release appeared to catch some market participants unaware. This may have contributed to the fact that some EOI responses were less well developed and therefore did not score as well as they might have done.

In our experience there are benefits from early and clear signals to the market prior to EOI release to provide potential bidders with time to form consortia, appoint advisors and to prepare a strong EOI response. The market would typically be comfortable if the earlier signals remained subject to Board and/or Cabinet approvals.

4.3.2 Request for Proposal

The RFP process was considered to be very well run and compared well against similar PPP procurement processes in other New Zealand PPP projects and in other jurisdictions. All parties felt both private and public sides were highly engaged in the process and used the ITP meetings to good effect. It was felt the NZTA had the right people attend those meetings, suitable information was provided and the NZTA were able address issues or questions efficiently. Interviewees were clear that this made a material contribution to quality of the bids that were received.

Bidders were provided with up to 15 ITP meetings (10 technical, 5 commercial). Some parties indicated that this was possibly more than was needed although they felt an obligation to take them up. It was also expressed that perhaps more flexibility with regards to the split between technical and commercial could be provided, particularly given the natural overlap between these workstreams on this transaction.

4.3.3 Preferred Bidder to Financial Close

The process from Preferred Bidder appointment to Financial Close took 8 months. This is long in the context of previous NZ PPP projects (Hobsonville Schools 5 months and Wiri Prison 6 months). Internationally, the length of a typical Preferred Bidder phase varies by jurisdiction and is largely a function of the extent to which bids are required to be developed at RFP submission stage. In this Project, a number of interviewees indicated that the extent to which the bid and project documentation was developed (or not) was a contributing factor in the length of the Preferred Bidder stage. The pros and cons of developing bids further is explored further below.

It was acknowledged by a number of interviewees that the fact that the Project was the first New Zealand transport PPP project and as such significant parts of the contract were established from scratch was also a factor in the post award timetable.

Almost all interviewees that were involved at this stage of the process expressed surprise at the degree to which points were renegotiated post Preferred Bidder. The extent to which the Project was developed at contract award, meant that it was necessary to negotiate issues to finalise the contract. However, it also indicates that there was a lack of clarity on the basis on which the bid

had been awarded and the extent to which terms were considered as "agreed" prior to bid submission.

4.3.3.1 Consenting

Interviewees from a number of parties indicated that the consenting process between PB and Financial Close was particularly challenging. This was explained by;

1. The large number of changes within the winning bid from the original consented NZTA design and limited extent of design development at PB stage;
2. The number of councils that were required to be engaged; and
3. A perception that there was insufficient engagement with those councils prior to bid stage by both sides. This may have been in part due to concerns about loss of IP to the other bidder.

Given one of the potential advantages of the PPP model is the opportunity that it provides bidders to innovate, a rigid consented design could limit this outcome. On the other hand there are challenges from moving to a more flexible consented approach including the accurate assessment of the Affordability Threshold. On balance, we consider that the benefits of a more flexible consent outweigh the downsides.

In addition the NZTA should engage early with the relevant council's to explain the PPP process and manage expectations around the level of detail that will be provided at the various stages. It should be made clear to bidders that there is an expectation to have a clear plan and advance the consenting process prior to submission.

4.4 What are the advantages and risks of requiring further bid development before appointing a preferred bidder and what options are there for enforcing bid positions post-PB?

A number of interviewees expressed that they felt that there are clear benefits from further development of bids and project documentation at bid stage which would help minimise the time and cost of the post award period. The major downside was the impact on pre-bid costs (although it was acknowledged that a stipend helps in this regard). Further, it was also acknowledged that there was a trade-off to be made between meeting the Affordability Threshold and the qualitative aspects of the bid.

It was also acknowledged that the options available to the NZTA for enforcing bid positions post award are limited, to the extent they have any real teeth commercially, other than the right to walk away from the Project.

The extent to which PPP bids are developed at bid submission varies significantly between jurisdictions. For example, in a typical UK PPP project bids are submitted at an earlier stage of development, with just preliminary due diligence undertaken and in principal agreement (but not binding commitments) from funders. As a result "at risk" bid costs are lower (and stipends are not typically paid), however the Preferred Bidder period is often long and involves an extended period of negotiation. At the other extreme, in the US and Australian PPP markets, documents are typically largely negotiated prior to submission stage and bids include binding

commitments from lenders. As a result bids are likely to be more expensive to prepare but the Preferred Bidder phase is shorter.

The New Zealand model which is based on an outcomes focused approach as opposed to a price based competition as in some other jurisdictions, is a hybrid. There is a period of negotiation post bid, although detailed due diligence has often been completed and funders have received credit committee approval. Under this model and to promote innovation, it is appropriate to provide for a period of negotiation post bid to accommodate project specific elements. However, the major downside is that elements of the project documentation will be negotiated on a bilateral basis and under reduced competitive tension compared to the bid phase and therefore we think there is scope for bids to be further developed. For example we note that some material elements of the Project were significantly renegotiated post preferred bidder, including the Works Requirements, Completion Tests, Performance Regime, Insurance, Natural Events and Crown support.

The NZTA need to be careful in requiring further development of bids that the potential for innovation is not stifled. Nevertheless the following options might help encourage greater bid development and minimise the extent of open issues post bid;

1. *Increase the evaluation weighting attributed to "certainty" (e.g. design and contractual documents and the certainty of reaching financial close);*
2. *Score the extent of commercial derogations from the baseline project documents on future projects;*
3. *Make it more clear the extent to which the NZTA expects bids to have been developed at submission stage; and*
4. *Make maximum use of the bid clarification process and agreement of the Preferred Bidder letter to ensure the bidder's positions are clearly understood.*

In terms of enforcing positions at Preferred Bidder stage, we note in some PPP jurisdictions in which bids are more fully negotiated such as the US, some projects have required a bid bond to be posted which is technically available to be drawn if the Project has not reached close within a particular timeframe. However in the context of an outcomes focused approach and with consenting process to complete prior to Financial Close, the reasons for a delay are harder to determine and would be challenging to enforce. A bid bond also imposes an additional cost on bidders which is ultimately borne by the procuring authority.

4.5 What are the advantages and risks of providing a bid cost stipend to the losing bidder, what is a reasonable level of the stipend, and should cash-flow coverage be provided to the preferred bidder during the negotiation phase?

4.5.1 Stipend

The payment and the amount of the stipend (~1% of capital costs) to the losing bidder was considered by bidders to be a critical element in a) receiving approval to bid and b) contributing to the quality of the submission. Interviewees noted that in their assessment of whether to bid the Project, a stipend helps move the project higher up the list of potential opportunities to pursue. Bidders stated that they expended more than the amount of the stipend in developing the

bid and felt that it was at broadly the right level. A number of players expressed surprise at the cost of submitting a PPP bid compared to traditional procurement. It was also acknowledged that access to the losing bidder's IP can be a useful feature of the stipend, and that one element of the Project was changed as a result, albeit resulting in only minor savings to the NZTA.

In KPMG's experience, on a per bidder basis the size of the stipend that was offered on Transmission Gully is higher than in a number of other jurisdictions. For example, it is not common in the UK to pay stipends at all, although as per our comments above, bids are often less developed at submission stage and there is a high level of standardisation in the market which has helped to drive down costs. In the US market, stipends are more common. For example, in two large transportation deals to close, Ohio River Bridges PPP (US$1.3b, 2013) and I-4 Interstate Florida (US$2.2bn, 2014), losing bidders were each paid US$2.5m and US$2.0m[1] respectively, although we note that there were four shortlisted bidders on each.

On the other hand it is clear that the payment of a stipend has the potential to improve competition by 1) encouraging new entrants into the relatively isolated New Zealand market and 2) facilitating the involvement of domestic contractors who might otherwise have limited financial capacity to bid expensive projects such as PPPs. This is particularly true in the context of the NZTA's approach to pay a stipend on other large scale projects and hence if not paid on PPPs could cause the market to select traditional procurement over PPPs.

It should also be recognised that the New Zealand PPP market is arguably potentially less competitive than other jurisdictions where there are a more established contractors with the financial capacity to bid PPP projects. In addition anecdotal evidence in other jurisdictions suggests that bidders may seek to over-recover bid costs from projects that are won to compensate for previous sunk costs, and to the extent that is true and the NZTA intend to procure a number of PPP projects, it is possible that the NZTA would ultimately pay for the difference anyway.

The NZTA should review the level of the stipend in advance of each PPP project (which we would expect would include the discussion on the preferred number of bidders) recognising the important role it plays in driving competition, but setting it at a level that creates an incentive to win the project - it is appropriate that there is some pain in losing. We also note that, to the extent the NZTA is encouraging bidders to further develop bids, reducing or removing the stipend is potentially inconsistent with this objective.

In addition the stipend should be conditional on the submission of a fully compliant proposal.

4.5.2 Cashflow Coverage during PB stage

Interviewees on both sides made the point that the extended PB period created material cashflow issues, particularly for the preferred bidder in terms of the cost of advancing the design. As a result, for a period of time design work effectively ceased although there are differing views as to whether this had any impact on the ultimate timetable - on one hand there

[1] www.in.gov/ifa/files/ORB_East_End_Crossing_RFQ.pdf
I-4: www.dot.state.fl.us/contractsadministrationdistrict5/PublicPrivatePartnership/PublicPrivatePartnership.shtm

is a view it contributed to the consenting related delays, on the other there is a view that there was minimal impact given the nature of the work seasons in this Project.

It was made clear by bidders that, to the extent the NZTA are able to provide coverage during this period, either as a partial cash payment or by way of an agreement to ultimately fund if close is not reached within a defined period, this would enable works to continue during this phase. Public sector interviewees typically expressed a contrary view.

While we have seen early works agreements entered in other PPP projects, we would not consider it to be typical for the procuring authority to provide a payment for interim costs during the PB phase. It is clear that the Preferred Bidder period was too long and we would expect that the preferred outcome for all parties would instead be to minimise the length of time between PB and financial close including encouraging further bid and project development at submission stage as outlined above.

4.6 Were submitted bids clear and understood?

There were mixed views on whether bid requirements and evaluation methodology were clear. In general, interviewees understood the bid and project documentation. Bidders were generally comfortable that they understood the NZTA's objectives and are becoming increasingly familiar with the outcomes focused approach to PPP in New Zealand.

4.6.1 Impact of the Affordability Threshold

Interviewees on both sides acknowledged that the Affordability Threshold proved to be a challenging target on this Project and this is explored further in section 7. It was generally acknowledged that the tight Affordability Threshold had a flow on impact of this on the nature of the bids that were submitted and there is a direct trade-off between achieving the Affordability Threshold as against delivering a proposal which met all of NZTA's qualitative criteria. Interviewees also pointed to the key differences between the bids that were received which may have indicated that bidders were not clear in assessing the optimal trade-off.

It is clear that the impact of the tight Affordability Threshold 1) drove bidders to find alternative options to deliver and document the project (presenting as derogations to the Project requirements and documentation) and 2) potentially reduced competition.

5 Risk Allocation

5.1 Focus of review

- Was the risk transfer to SPV effective and did it represent value for money, with specific reference to insurance, the performance regime and general change in law?
- What process does the private sector generally assess (and quantify where appropriate), each of the above risks in a PPP project?
- Does this differ between investor groups (i.e. offshore versus local investors) and between consortium members (eg, sub-contractors vs equity providers)?

5.2 Key observations

- The general view was that bidders understood what NZTA was trying to achieve with risk allocation in the Project and have bought into the New Zealand approach to PPPs.
- Respondents on both the public and private sector sides felt the process to negotiate risk allocation was involved and intensive, but overall the outcome was reasonably fair and effective.
- When assessing the risks of the Project, bidders spent most time and resources on the Performance regime, natural events and insurance
- Bidders said they undertook more risk analysis than they would on other New Zealand roads projects, including sourcing academic research and doing extensive data analysis of traffic flow and accidents on New Zealand roads. When assessing a risk that has been allocated to them, bidders generally try to understand risk, manage the risk contractually or through design and as a last resort will assess likely monetary impact and price it in.
- There were mixed views on the degree that the Performance Regime drove innovation.

5.3 Effectiveness and value for money of risk transfer

There were four general comments on risk transfer:

- The view was that all parties had compromised on the degree and price of risk transfer, and that this was an indication that the final outcome was probably a good balance. Most respondents felt that NZTA had secured value for money.
- Late changes to the policy environment or NZTA's commercial positions meant that NZTA had to negotiate changes to risk positions during RFP or PB phases. These were the areas where NZTA was most at risk of not achieving value for money.
- According to bidders, more sophisticated risk analysis was performed than on non-PPP New Zealand road projects. This meant local contractors learnt from larger contractors and have information and practices that will potentially benefit future New Zealand road projects regardless of the procurement method used.

- The risks that bidders applied most resources and time to were natural events, insurance, Crown guarantee and the travel time and accident components of the performance regime.

The nature of PPP projects means that it is usually not possible to assess the cost to the procuring agency of each risk separately that was transferred to the SPV. Instead, NZTA must consider which bundle of risks it believes the SPV is better placed to mitigate or manage efficiently, and then ask the SPV to price the project on that basis. The private sector then assesses the probability of risks occurring, ways to mitigate those risks and the likely scale of costs which are then factored into the bid price (see section 5.4 for further detail).

5.3.1 Insurance

A self-insurance regime was brought into the Project after the release of the RFP and developed in detail at PB stage. The intention was that self-insurance should represent better value for money for NZTA because it is consistent with their approach on other New Zealand roads and avoids the material diseconomies of scale with insuring a small part of the network. Parties felt that developing an insurance regime in procurement drew in considerable resources and required bidders to develop considerable analysis to prove the price of insuring a road which in the end was not used.

Both the public and private sector felt that the value for money of insurance in road PPPs should have been identified earlier in the process (e.g. in the business case phase) and a self-insurance regime developed before the project went to market.

Some commented that the NZTA should have had its insurance advisors involved earlier and should have used them more and had them at more meetings to allow insurance points to be debated and resolved.

Some expressed concern about the operation of the insurance regime over the contract life, for example how NZTA will assess insurable events and the interface between performance and insurable events.

Overall parties felt that self-insurance was the right outcome, but the process to get there was not optimal.

Insurance is dealt with differently in PPP projects across jurisdictions. The starting point is often that the SPV is responsible for purchasing the insurance it believes is efficient to allow it to manage the risks it holds. Some jurisdictions have looked into requiring SPVs to purchase insurance, but using panel contracts across government projects to draw on the economies of scale and reduce the price. Others allow SPVs to benefit from a government agency's own insurance arrangements. In any event, there are clear benefits of developing the regime as far as possible prior to Preferred Bidder appointment.

5.3.2 Performance regime

Bidders generally felt that the performance regime represented an appropriate level of challenge and value for money. They felt that there were risks that they had not seen before and needed to perform new analysis on, however they had come to expect this from New Zealand PPPs.

Most said the regime drove changes in their behavior during the procurement, for example the analysis that was performed on traffic flow and accident rates, and focused their design on the areas that mattered to NZTA. For example, it was felt there was lower focus on user experience than other factors and therefore materials were used that would be good for maintenance but may be noisy or less comfortable to drive on.

Most respondents said the regime drove innovation in design and operations, particularly on travel time and to an extent on safety. The responses were caveated with the view that the regulations limit the need for innovation in safety. It was felt that the New Zealand standards require a good level of road safety and are quite prescriptive so there was not much need for safety innovation. Accident innovation included considering the feedback mechanisms during the operational period to ensure high accident spots are identified and modified. Travel time innovation included consideration of design changes and technology in operations to identify blockages promptly so the road be cleared and normal traffic flows resume again.

In responding to the performance regime the bidders used academic research, New Zealand state highway data, New Zealand motorway data and Australian road data. It was felt that a higher level of analysis was performed than would have been the case in other New Zealand road projects or if the performance regime was not focused on these key outcomes.

5.3.3 Natural events

Private sector respondents commented that this Project in particular, required greater consideration of natural event risk than other Projects in other jurisdictions. Significant bidder time and cost was spent on the analysis. They also noted that road projects are different to social infrastructure due to the extensive land that is covered and therefore there are a greater variety of seismic risks.

Public sector respondents acknowledged that significant time and effort went into developing and negotiating the natural event regime but felt that this was a critical element of the Project given the high seismicity in the area and the key role in providing network resilience.

Both the public and private sector were content with the final position that was reached.

5.3.4 General change in law

Some public sector respondents were concerned that the final position on general change in law was not aligned with other roads projects and may not be value for money. Some respondents commented that in the case of Transmission Gully much of what could have been considered general change in law, was defined as specific change in law and they were surprised that bidders were not comfortable holding the risk.

In PPP projects globally, it is common for general change in law to be allocated to the private sector and specific change in law to be allocated to the procuring agency. The reason being that the private sector manages general change in law in its day to day operations (e.g. changes in health and safety law, changes in employment law) and should be equally well placed to manage these risks within a PPP project. Specific change in law on the other hand protects the private sector from a future government legislating with the intention of impacting the project and changing the fundamental commercial positions of the project. The government is best placed to manage this risk and the SPV would generally be compensated for the impact of specific legislation.

As it is difficult to assess the probability and scale of risk associated with a general change in law, bidders in other jurisdictions occasionally establish a fund or facility within their project that they can draw down on if there is a general change in law that creates a cost for the project. The fund or facility comes at a cost and this is priced into the bid.

5.4 Process private sector uses to assess risk, including differences between groups

Private sector respondents all said that the methodology by which they assessed risk in Transmission Gully was aligned to their approach in any other PPP project. While the outcomes focused approach in New Zealand PPP may introduce some unique risks, bidders indicated that the approach they used to assess those risks was not necessarily different to the approach in other projects, other than the extent of analysis that was required in some areas (such as natural events for example).

When assessing a risk bidders will generally allocate each risk out to the relevant parties within the consortium to assess it. The degree of risk assessment depends on the scale and complexity of the risk and also whether the risk is something the party has seen before or if it is unique. When assessing a risk bidders draw on specialist advice, academic research and search out data sets that can be analysed to assess the probability of the risk.

Each party will decide whether a risk is significant and requires mitigation. The preference is to mitigate the risk contractually, by either renegotiating it or placing suitably boundaries, caps or floors around it. If the risk cannot be mitigated efficiently, then a price will be put against the risk and included in the bid price Bidders commented that they will exhaust all mitigation options before resorting to pricing a risk.

Parties within a bidding consortium will challenge each other's analysis to ensure there is a good balance between a robust project and having a competitive bid price.

New Zealand parties commented that the degree of risk analysis in a PPP is greater than they had experienced in non-PPP road projects.

The feedback from interviewees is consistent with KPMG's experience in bidding PPP projects with the private sector. Typically the pressure on price is such that bidder's will work to understand and analyse risk and then contractually mitigate rather than include a large risk premium in the bid. In addition availability PPP funding structures typically have thin equity buffers (~10%) compared to debt. Therefore, if material risks eventuate the impact can be catastrophic for equity (i.e. total loss of investment). Debt financing terms also tends to be very tightly structured and PPP funders will seek to have most material risks passed down to subcontractors rather than price them. For this reason, Availability PPP transactions are seen as relatively low risk investments but similarly, the potential for significant outperformance or "super profit" tends to be low.

6 Optimising NZTA funding

6.1 Focus of the Review

- What factors might determine the optimal project funding structure e.g. operating vs capital?
- What are the advantages and risks of sculpted payments, and how does the private sector view this approach?
- What are the advantages and risks of capital contributions, and how does the private sector view this approach?
- Are there implications of a changed capital structure or payment profile for the outcomes focused approach, particularly if either of these is a bid parameter?

6.2 Key Observations

- It is considered that there may be benefits to the NZTA if there was the option to structure or 'sculpt' the payment stream under the contract to better match the NZTA's own obligations and headroom in the fund.
- However, imposing a payment structure on bidders could cost in net present value (NPV) terms, depending on the extent to which there is a mismatch with the project cost base. Similarly, there is potential value for money benefits from providing bidders with the flexibility to sculpt payments.
- Private sector in general do not like the concept of capital contributions. Contractors are neutral, except to the extent there would be an impact on liquidated damages amounts. Equity investors are likely to find the project less attractive if there is a large capital contribution as the investment size of the project is effectively reduced.
- There are some implications on risk transfer and the outcomes focused approach but which are unlikely to be a prohibiting factor in the use of capital contributions

6.3 What factors might determine the optimal project funding structure e.g. operating vs capital?

Interviewees on both sides identified different factors that drive the optimal project funding structure. From the NZTA's perspective, the most obvious is the extent of available headroom in the fund. Providing the NZTA with flexibility to select between operating and capital payments would help cash management and long term planning.

On the private sector side, capital contributions in particular are not viewed favorably, principally because they reduce the net size of the deal and which is explored further below. However, while

it was acknowledged that bidders might dislike capital contributions, to the extent this provides the NZTA with the flexibility to procure more projects as PPPs, there might be some longer term benefits for the PPP market.

6.4 What are the advantages and risks of sculpted payments, and how does the private sector view this approach?

The advantages and risks of sculpted payments are summarised in the following table;

Potential advantages	**Potential Risks**
• Provides some value for money benefits by better matching against project company's cost base	• Could result in lumpy or materially back or front ended payment profile – budgeting challenges for NZTA • Potential implications on risk transfer (at an extreme) • Potential to game to NPV calculation in assessment against the Affordability Threshold

The private sector are broadly neutral about the benefits and risks of sculpted payments. The current payment mechanism does provide for some flexibility to sculpt payments. The private sector use this flexibility to better match payment to the project company's cost base, principally to lifecycle costs, which can generate value for money savings.

We note that bidders also have the flexibility to select the proportion of the unitary payment that is indexed which in turn drives the profile of the payment stream through time (the higher the % indexed, the "steeper" the payment profile through time and vice versa). Providing bidders with the ability to sculpt payments beyond this might be used by bidders to make financing payments (both debt and/or equity) earlier or later in the concession term. This might create additional value for money benefits but, at an extreme could create some unusual outcomes in terms of the shape of the payment curve by materially front or back ending the payment profile. There might also be some implications for risk transfer (for example, if the payment curve is materially front-ended there is a risk that equity has less financial incentive linked to asset performance in later years). There is also the potential for "gaming" the methodology used to calculate the NPV against the affordability target (see the later discussion on the AT and discount rate).

In our experience, some specialist infrastructure investors prefer a relatively steady cashflow yield with larger distributions being earned post repayment of debt in the later years of the concession. Debt providers also prefer a structure that has relatively smooth debt coverage profile. This might mean there is some "self-policing" on the extent to which bidders would be willing to sculpt payments in any event.

6.5 What are the advantages and risks of capital contributions, and how does the private sector view this approach?

The advantages and risks of capital contributions are summarised in the following table;

Potential advantages	**Potential Risks**
• Provides the NZTA with flexibility to choose the optimal combination of capital and operating costs • Uses public sector funds to repay private sector financing – potential differential cost saving (on a non-risk weighted basis) • Potentially increases the relatively scale of operating cost to financing cost post completion (operational gearing) - arguably increases the incentive to perform during the operating period • Better matches debt repayment profile to current tenor of debt available in the market – reduced refinancing risk • Reduces the size of the swap counterparty hedge that would need to be entered • Reduces the potential compensation on termination liability post payment of the capital contribution	• Potentially makes projects less attractive to infrastructure investors – at an extreme could impact competition • Partial reduction in risk transfer – the NZTA are effectively part funding the asset. • Potentially increases operational gearing and thus perceived risk of operations / maintenance phase – could result in additional risk premium / contingencies / reserves built into the price • Potentially complicates project company's funding structure by creating additional tranche of debt

A number of interviewees expressed a clear opinion on the use of capital contributions. Some advantages were articulated on the public side – the ability to select between the optimal mix of capital and operating payments and a better alignment between the capital base and operating costs post completion being common themes. It was pointed out that the nature of Transmission Gully and indeed most roads, means that operating costs tended to be relatively low compared to upfront capital investment.

On the private sector side, the view of capital contributions differs by the type of entity. A number of parties pointed out that the use of capital contributions may reduce the effective size of the deal for an investor (see note below) and which, depending on the size of the capital contribution, could have a material impact on the attractiveness of the project as an investment opportunity. Construction contractors on the other hand, were less concerned given the size of the capital cost would not be impacted. Although it was noted that there would have to be consideration of any indirect impacts such as on the Contractor's security package and liquidated damages calculations for example.

Other second order concerns were raised including the potential increase to the operational gearing and hence risk that funders will require additional risk premium or contingencies to be built into the deal compared to a transaction without a capital contribution.

In addition to the factors above, to the extent the NZTA is considering a capital contribution model, a key consideration is the point at which a contribution is made to the Project Company. A capital contribution will be used by the private sector to repay short term debt and possibly equity, reducing the ongoing Unitary Payment and thereby taking advantage of the cost of capital

differential between public and private financing. To get the most "bang for your buck" a capital contribution should be made as early as possible, however there are potential implications in risk transfer as the public sector is effectively part financing the asset. Capital contributions have been widely used in other jurisdictions, in the US, Australia and especially in the Canadian PPP market. The majority of these transactions link the payment of the capital contribution to the successful completion of the asset, thereby maximizing transfer of risk during the most risky period of the deal. There are some precedent transactions which have made capital contributions during construction (such as Denver RTD Fastracks PPP) or based on partial construction milestones but they are exceptions to the rule.

If the capital contribution is made after completion, typically, the bidder will still need to raise short term financing to bridge construction costs until the payment is received. This can give rise to complications in the financing structure as it potentially introduces a separate tranche of debt and associated inter-creditor considerations. There are other issues including the extent to which the maturity of the tranche can be extended for delays in construction, implications on the construction liquidated damages calculation and hedging to consider, however we note that all of these are regularly managed in other deals.

If the capital contribution is made during construction, this effectively reduces the size of the financing and therefore the attractiveness of the deal to investors. If it is paid post construction, bidders may take different approaches to using the funds to repay a combination of debt and/or equity depending on what is optimal in terms of the financing structure (bearing in mind they are bound by debt funder's constraints on gearing and coverage). It is possible that the optimal structure is one whereby both debt as well as some equity is repaid – again this might be less attractive to specialist infrastructure investors who typically have a longer term investment horizon.

6.6 Are there implications of a changed capital structure or payment profile for the outcomes focused approach, particularly if either of these is a bid parameter?

As outlined above there might be some implications for risk transfer if the payment curve is left as a bid variable and, as a result, payments are materially front-loaded. Capital contributions are common in other PPP jurisdictions and any impact on risk transfer is minimised if it is paid post completion. A key issue is the size in comparison to the projected capital costs, if it is a large percentage then the transaction effectively becomes a construction financing and competition will be impacted. Too small and there seems little point given the additional complications in terms of documenting the transaction.

7 PSC, AT and discount rate

7.1 Focus of review

- What is the NZ PPP methodology for calculating value for money and what does this mean for the quality of information NZTA needs to hold?
- How does the private sector use the public sector comparator (PSC) and the Affordability Threshold (AT)?
- What incentives on bidding behavior did the discount rate generate for the private sector?
- How would the private sector view a dynamic AT?
- Are there implications of an uncertain PSC or dynamic AT for the outcomes focused approach?

7.2 Key observations

- There were mixed levels of understanding of how a PSC is calculated and used and how an AT is derived. Generally the private sector had a low level of knowledge of the details but did not feel that they needed greater knowledge.
- There was a strong message that the AT is vital when developing a bid. It is deconstructed, allocated out to intra-consortium workstreams and then referred to every day. It is a target all parties focus on and it drives key design and commercial trade-offs.
- There were some concerns over a dynamic AT.
- If the AT / discount rate was updated later to reflect observable changes in the debt market, i.e. base interest rates, this did not cause concern.

7.3 Methodology for calculating value for money

The private sector respondents had limited understanding of the methodology for calculating the PSC and AT. They felt they had the right level of knowledge. Some said they would appreciate having more visibility of the cost breakdown within the AT but others said they were happy with a single figure to aim for because it was consistent with the principles of PPP.

Some respondents from the public sector expressed a view that the value for money methodology is heavily reliant on quality technical advice and a reasonably high level of road design at business case stage. They felt that roads were different to social infrastructure in that generally the design and price are developed over a period of time and need to respond to issues that arise e.g. geotechnical information and consenting requirements, over the course of the detailed design. This makes it difficult to set an AT that is challenging for bidders but still realistic.

Some public sector respondents also commented that the nature of roads being high capital and relatively low operating and maintenance expense means the importance of getting the build costs correct is heightened.

The NZTA should consider (and discuss with New Zealand Government if appropriate) whether road PPPs are better suited to an element of price competition rather than a quality competition

because the scope for innovation is smaller than in social infrastructure and the price is more difficult to estimate.

7.4 The importance of the Affordability Threshold

All parties in the private sector commented on the importance of the AT. The figure is back solved to provide a budget for design and construction, and operations. Each workstream then has a target they refer to daily to manage scope of the solution back under.

The design and construction workstream develops a number of high level options that trade-off different upfront construction and maintenance profiles. They then consider the top two or three in more detail. For Transmission Gully it was considered better value for money to have a lower build cost and higher maintenance expenditure.

Bidders knew early in the RFP process that the AT for Transmission Gully was tight. NZTA provided detailed requirements through the consented design and the road standards. Bidders decided early on that they would not be able to deliver to the consented design within the AT and would need to sacrifice parts of the requirements to be affordable. Bidders felt this was a difficult decision because NZTA staff were firm in ITPs that bids must comply with the specifications.

7.5 A dynamic Affordability Threshold

The general feedback was that the difficulty of setting an AT for a road was understood, but a dynamic and uncertain AT would create risk in the project and procurement process.

Bidders commented that due to the importance of the AT in their bid development, they need to have certainty on the level so they can progress the development of their solutions. They were open to the AT being increased if necessary, as happened in Transmission Gully, but would not want NZTA going into an RFP phase with the intention to move the AT. Some commented that NZTA could do more geotechnical assessment before a project goes to market to reduce the need for a dynamic AT.

Public sector parties commented that a dynamic AT could weaken the incentive on bidders to develop innovative designs that come in under the AT. An expectation of a dynamic AT may encourage bidders to develop a solution that is above the AT and then try to get the AT raised.

Parties agreed that they were more open to an AT changing for observable external changes, for example base interest rate changes. It was felt, however, that this was best done through the discount rate.

8 Funding Markets and Competition

8.1 Focus of the Review

- Did the scale of the project and the breadth of the debt market influence the cost of debt that could be achieved?
- Do you have suggestions for how additional competitive pressures could be introduced to reduce debt margins?
- Other considerations with regards to the optimal number of bidders

8.2 Key Observations

- General view that the scale of the Project and breadth of the debt market had little impact on the cost of debt.
- A common view that liquidity in the debt and equity markets continues to recover strongly since the GFC. Debt market capacity is unlikely to be a material factor in driving financing terms.
- A post preferred bidder funding competition is one measure that could be used to maximise competition on financing terms. However there are downsides to this approach which should be considered, including less funder involvement at bid stage and the increased risk of commercial positions being reopened post bid.
- The NZTA could mandate that funders cannot go exclusive with one bidder, however in practice this is unlikely to achieve much.
- The majority of PPP projects elsewhere have been run with three bidders. Generally this is considered a suitable compromise between efficiency of process and the cost of procurement against competitive tension.

8.3 Did the scale of the project and the breadth of the debt market influence the cost of debt that could be achieved?

There was no indication from bidders that the scale of the Project and breadth in the debt market had a material impact on price. Bidders felt there was more than sufficient liquidity available in the market to fund the transaction on competitive terms.

Interviewees' feedback corresponds with our recent experience of the debt markets. PPP debt funders in the Australasian market typically go exclusive with one bidder which does increase the risk that capacity is tested in a bidding process with multiple bidders. However we note that there have been a number of very large PPP deals in Australia recently, including the A$3.6 billion East-West link, and market sources indicate that all three bids contained fully committed debt

financing on terms that did not represent a material premium above other recent transportation PPP transactions. This suggests there is at least A$10.8 billion of committed financing capacity available in the Australian PPP market at present. Similarly, we understand that funding margins continue to reduce as the competition amongst lenders is high and bank's cost of funds comes down.

Similarly, the availability of equity in the infrastructure market is high with a significant amount of pension fund money flowing into the sector post GFC but without sufficient deal flow to invest in and there is surplus international equity finance these types of transactions.. Having said that the market for New Zealand domiciled PPP equity is less liquid and this could be the only factor that might be a constraint from a financing liquidity perspective.

8.4 Do you have suggestions for how additional competitive pressures could be introduced to reduce debt margins?

The major way competitive pressures could be introduced is through a preferred bidder funding competition. The logic being that at the point of preferred bidder, the whole market would become available on which to compete and source debt. We attach a separate paper as Appendix Two that outlines the pros and cons of this approach. As a general rule, unless there is a clear rationale in terms of market capacity and the potential for a material improvement in financing terms, the benefits tend to be outweighed by the time and cost of running the process post bid and the increased risk that new issues are raised post bid by the lending group.

The other method is to require in the tender documents that funders cannot go exclusive with one bidder and this clause has been included in some Canadian PPP transactions in the height of the GFC. However, banks may only have the resource to staff one team in any event particularly in the Australasian markets. In practice there is little ability to enforce this clause and it unlikely to have any material impact.

8.5 Other considerations with regards to the optimal number of bidders

Whilst it was not a question that was directly asked of interviewees, a number did touch on the topic of the optimal number of bidders. Private sector participants indicated that having just two parties on the shortlist was a material consideration in their assessment of the opportunity. Most would not go as far as to state that if the Project had three bidders whether that would have excluded them from the process or not.

There is no way of knowing whether the shortlisting of more than two bidders would have resulted in a different outcome for the NZTA on this Project. However some of the pros and cons of shortlisting more than two bidders are outlined in the following table.

Pros and considerations of shortlisting more than two bidders

Pros	Considerations
• More bids = greater competition • "Insurance" against one bidder withdrawing or a non-compliant bid	• Additional time and cost of procurement • Stipend

• Two sets of IP potentially available to winning bidder	• Risk some parties withdraw due to a perception there is lower chance of winning / higher risk opportunity • Capacity in the financing market • Capacity in the advisory market

As a general rule, whilst it is not uncommon to have only two shortlisted bidders, the majority of PPP procurements tend to shortlist three as a reasonable trade-off between maximizing and maintaining competition against the efficiency of the procurement process and capacity and this is accepted by the international PPP bidding community. We note that Wiri Prison and Hobsonville Schools both initially shortlisted three bidders. Indeed, in some jurisdictions, such as the US, competition in the market is such that shortlisting four has become increasingly common.

In general we see some real benefits in considering a larger shortlist, particularly in terms of competition and insuring the integrity of the process. As outlined above, given the liquidity in the markets we would not expect that funding would necessarily provide a constraint in this regard. There are certainly some constraints in the local market for suitably skilled advisors, however in our experience most bidders are accessing international (mainly Australian) expertise to lead deals. The major risk that we see to appointing more than two is the opportunity becoming less attractive as a prospect to local parties, particularly local contractors and equity providers. This should be considered in conjunction with the stipend if more than two bidders are appointed.

On future deals we suggest that the NZTA publish initial procurement documentation using the term "up to three" bidders. This is consistent with the approach used on a number of other New Zealand PPP projects and provides for flexibility depending on the quality of responses received at the Expression of Interest stage.

A Appendix 1: Interview questions and interviewees

Public Sector Interview Questions

Introduction:

As part of the ongoing review of the Transmission Gully PPP Project (Project) by the NZ Transport Agency (Transport Agency) and commitment to optimising the PPP procurement process for future projects, the Transport Agency has appointed KPMG to participate in a review of the Project from a PPP practitioner perspective. As part of the review, the Transport Agency has requested that KPMG interview a small number of selected parties that represent a diverse set of views across the Project.

Format:

The interview will be conducted by KPMG staff and there will be no Transport Agency staff members present. We expect it will take approximately 1 hour. The views provided in the interview will help feed into a wider report, but will not be attributable to any particular party to ensure that people are able to express their views freely and frankly. KPMG staff are bound by terms of confidentiality in their contract with the NZTA. Please note that the report or elements of it may be made public (yet to be confirmed).

Topics:

The interview will focus on a select set of topics which are outlined below. Transport Agency values the feedback however it is entirely up to the interviewee if they prefer not to discuss certain topics.

Governance and NZTA Capabilities

- Was an efficient/effective balance struck between informing NZTA management, suitable project oversight and delegating decision making?
- Did you feel suitably informed during the bid process? Where you clear on the nature of decisions that were being delegated and to whom?
- Did you have suitable decision making authority during the process?
- Did the team and governance structure facilitate the retention of IP? How could this be improved?
- Was there an optimal mix between staff, contractors and advisors?
- How could the governance and project resourcing structure be improved?

Efficiency of process

- General thoughts on the efficiency of the procurement process distinguishing between EOI, RFP and PB phases?
- Do you think the process optimised competitive tension? In which areas were bids more or less competitive than you expected?
- Were submitted bids clear and understood? Should more or less time and resource have been spent analysing and clarifying bids? If so would this have changed the negotiated outcome?

- In your view if there was a higher evaluation weighting on commercial aspects in the bid evaluation including contractual derogations, would that have changed the outcome?
- What could NZTA have done to minimise the period of time at PB? How could bids be further developed at RFP stage in the future?
- In your view did the stipend improve competition and the quality of bids received? If it was increased/reduced would this have a material impact one way or other?
- Should NZTA be expected to contribute to cash flow impact at PB stage?

Risk Allocation

- In general was the risk transfer to the SPV effective? Does the project incentivise the SPV appropriately to achieve the desired outcomes?
- Did it represent optimal value for money? If not which elements in particular?
- Any comments on effectiveness and VfM using following topics as examples; insurance, the performance regime and change in law?
- In your view was the contractual framework at bid stage well developed? How did bidder's derogations change this? How did it develop post PB stage?
- How could effectiveness and vfm of the risk transfer be improved?

Optimising NZTA Funding

- From an internal NZTA perspective what factors might determine the optimal project funding structure ie operating vs capital?
- Does the NZTA value even annual payments or is it flexibility with regard a degree of sculpting? Is there particular value in front loading or back loading payments?
- Should the NZTA control these variables or leave as bid parameters?
- What benefits can you see from making a capital contribution to the Project? At construction completion or during?
- In your view would either of these would impact the effectiveness / vfm of the risk transfer in the Project?

Public Sector Comparator (PSC), Affordability Threshold (AT) and discount rate

- Do you understand the methodology for calculating value for money in the Project?
- In your view what did this mean for the quality of information NZTA needs to hold?
- What is your view of the suitability/achievability of the Affordability Threshold?
- In your view how would a dynamic PSC, AT or discount rate impact the approval or bid process i.e. if it were updated as a result of a) observable market movements i.e. interest rates or b) to reflect technical information as it comes to hand for example?
- Are there implications of an uncertain PSC or dynamic AT for the practicality of procuring a project with an outcomes focussed approach?

Private Sector Interview Questions

Introduction:

As part of the ongoing review of the Transmission Gully PPP Project (Project) by the NZ Transport Agency (Transport Agency) and commitment to optimising the PPP procurement process for future projects, the Transport Agency has appointed KPMG to participate in a review of the Project from a PPP practitioner perspective. As part of the review, the Transport Agency has requested that KPMG interview a small number of selected parties that represent a diverse set of views across the Project.

Format:

The interview will be conducted by KPMG staff and there will be no Transport Agency staff members present. We expect it will take approximately 1 hour. The views provided in the interview will help feed into a wider report, but will not be attributable to any particular party to ensure that people are able to express their views freely and frankly. KPMG staff are bound by terms of confidentiality in their contract with the NZTA. Please note that the report or elements of it may be made public (yet to be confirmed).

Topics:

The interview will focus on a select set of topics which are outlined below. Transport Agency values the feedback however it is entirely up to the interviewee if they prefer not to discuss certain topics.

Governance and NZTA Capabilities

- Do you have any views on the NZTA's governance and project resourcing structure?

Efficiency of process

- General thoughts on the efficiency of the procurement process distinguishing between EOI, RFP and PB phases (where relevant)?
- How important was the stipend a) in your decision to participate and b) in contributing to the quality of the bid? Any thoughts on the amount of the stipend?
- Were the level of costs that you incurred, less, about the same or more than you expected in delivering the bid? Why?
- What about during the post bid phase? What could be done to better manage/mitigate the cashflow impact at PB stage?
- What could NZTA do to minimise the period of time at PB? How could bids be further developed at RFP stage? What are the downsides of this?
- Were the bid requirements clear?
- Was there an appropriate weighting on price, quality and commercial in the bid evaluation?
- Was it clear to you how commercial factors would be evaluated?
- How did you determine the pros/cons of making certain contractual derogations?

Risk Allocation

- In general, in your view was the risk transfer to the SPV appropriate? i.e. did the contract incentivise the SPV appropriately to achieve the desired outcomes?
- In your view did the risk transfer position optimise value for money? If not which elements in particular?
- Any comments on the risk transfer using the following topics as examples; insurance, the performance regime and change in law?
- Generally how did you assess and quantify risk in this project? Is this different to other PPP projects you have been involved with? Other non-PPP projects?
- What could the Transport Agency do to achieve the outcomes in a more cost effective way?

Optimising NZTA Funding

- Are there material benefits from being able to sculpt payments (ie to match costs)?
- Would there have been benefits to you and/or the NZTA if there had been a capital contribution to the project?
- Any concerns /downsides with either of these approaches?
- In your view would either of these impact the effectiveness / vfm of the risk transfer in the Project?
- In your view, did the scale of the project and the breadth of the debt market influence the cost of debt that could be achieved? Do you have suggestions for how additional competitive pressures could be introduced to reduce debt margins?

Public Sector Comparator (PSC), Affordability Threshold (AT) and discount rate

- Did you feel you understood the calculation of the Affordability Threshold?
- How did you use the Affordability Threshold in the bid? How material was it in shaping the nature of your bid?
- How did the discount rate used in generating the NPV impact your bid?
- Is it important that the Affordability Threshold / discount rate is known and set at the start of the RFP process? What concerns or issues would be raised if it were subject to change during the bid either as a result of a) observable market movements i.e. interest rates or b) to reflect technical information as it comes to hand?

Respondents

Interviewee	**Company**
Derrick Adams	HEB
Dave Brash	NZTA
Aldo Cantori	Leighton Contractors
Peter Casey	NZTA
Brennan Daly	Leighton Contractors
Rod James	NZTA
Rob Lea	Laing
Dan Marshall	Treasury
Craig Nicholson	NZTA
Ian Purdy	ACC
Peter Robinson	Leighton Contractors
John Varndell	URS
Karen Mitchell	Transmission Gully PPP Project Manager

B Appendix 2: Deferred financing competitions

1 Background

PPP procurement processes typically require bidders to provide committed finance (debt and equity) as part of their proposals during the RFP phase.

A potential alternative approach is to omit the requirement to procure debt at the RFP stage and to run a financing competition at the preferred bidder ('PB') stage (referred to in this paper as a 'deferred financing competition').

Deferred financing competitions might be suitable where there are concerns in relation to market liquidity (for example, as a result of market constraints or for 'megaprojects' where the financing requirement is extremely large, meaning that multiple bidders might be unable to procure committed finance on reasonable terms) and/or where there is a desire to increase competition between potential financiers to drive improved pricing/terms.

2 Precedent

Domestic

We understand that a financing competition has been implemented as part of a current PPP procurement in New Zealand because the project is being delivered under a sole source procurement. Therefore the pros and cons should be discussed with The Treasury team involved in that project.

Offshore

In the UK PPP market, Authorities in the mid-2000s started to consider how to bring in more competition post-PB ie they noted bidders were losing with more competitive financing packages than could necessarily be secured from 'winning' banks at PB. This has since been extended under the UK government's 'PFI2' policy, this extends to the introduction of financing competitions for a portion of the private sector equity.[2]

In 2012 HM Treasury introduced draft guidance on when it may be appropriate to use a deferred financing competition. This was not popular with funders and there were increasing cases of banks deciding not to support bidders at bid stage if they were to be competed again downstream.

As a result there are actually very few formal examples of the PB funding competition in action. There were a small number of Hospital PFI deals (Northern Batch and Southmead Hospital) and its use became more popular in the aftermath of the GFC and in particular for large deals.
The M25 PFI project for example, used a model whereby bidders provided terms from at least one bank but they didn't have to cover 100% of the debt. This was principally due to lack of liquidity at the time. Post bid a competition was designed to set pricing but not structure. The process then included a mechanism to try and keep banks honest (which failed as bidders priced the capped downside risk into their bids). The market moved and ultimately the process became a book building process.
Based on that experience, this hybrid approach has been used on other large deals including the Crossrail rolling stock deal and was considered on the Dublin metro deal in 2010. We

[2] *A new approach to public private partnerships*, HM Treasury (December 2012) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/205112/pf2_infrastructure_new_approach_to_public_private_parnerships_051212.pdf

understand it may have been considered in some larger deals in Australia but is not currently used due to the availability of financing in the market.

3 Summary of options

There are a number of variations in running a deferred financing competition, which are outlined below.

- A full Funding Competition – bidders submit RFP's with shadow funding terms provided to them by the procuring authority. Debt is then competed post bid. In our experience this works best when there is a competitive banking market and well banked risk allocation i.e. as part of a relatively settled standard form contract. It is however open to abuse by bidders by reopening positions.
- A hybrid solution - as per M25 deal, bidders work with one or more funders to provide a minimum proportion of the debt (e.g. 25%) and then run a process at PB to bring other banks in. This helps mitigate some of the risk that a deal is not "bankable" post bid or that sufficient due diligence is not undertaken before RFP submission. The initial bank may push to be paid an incremental fee.
- Stapled financing – The procuring authority runs a funding competition in parallel with the RFP with the successful banks joining the PB. Stapled financings are common in the brownfield infrastructure market but much more challenging in greenfield transactions given the differences between bidder's designs and approaches.

The pros and cons of deferred financing competitions are summarised in the table below and which are discussed in sections which follow.

Pros	Considerations (some mitigated to some extent by hybrid solution)
• Potential cost savings from; (i) Greater competition because the entire financing market would be available to the preferred bidder; and (ii) Improving market conditions • Potential bid cost savings for losing bidders (less so for hybrid solution)	• Less funder involvement / due diligence at bid stage • Risk of issues arising at PB stage • Difficulties in evaluation by imputing financing structure on bidders – no ability to assess differences in "bankability" of one bidder over another • Potential impact on Affordability in terms change post bid • Extends PB timeframe (but potential savings at RFP stage) • Reduces potential for financial innovation at bid stage

4 Potential for cost savings

A deferred financing competition may drive improved debt pricing and/or terms on the basis that:

- It could drive additional competitive tension amongst potential lenders because the entire financing market would be available to the preferred bidder; and
- in a market where conditions are improving, a deferred financing competition enables Government to capture the benefit of these movements in the market (for example, in the form of reduced margins)

However, given the high levels of liquidity in the Australasian market at present, it is possible that there is no material pricing benefit because bidders should be able to drive competitive tension between potential lenders during the RFP phase, depending the size of the deal. Bidders often attempt to maintain their own level of competition throughout the procurement process by adopting an 'N minus 1 or 2' approach (i.e. by proceeding with sufficient headroom to enable a bank to be 'dropped' prior to financial close).

Quantifying the benefit of a PB funding competition is difficult. One method to estimate it is to look at the pricing differential between financing terms provided by different bidders on the same transaction. By way of indication, on four recent PPP transactions in Australia, the differential between the debt margins of the bidders ranged from 0-15bps during construction and 0-35bps during operations.

This can be cross checked against the pricing differential for a very large deal compared to smaller transactions with a similar risk profile. Publically available information is thin however one example, A$3.6 billion East-West link, market indications are that all three bids contained fully committed debt financing on terms that did not represent a material premium above other recent transportation PPP transactions.

There is significant overlap between the New Zealand and Australian funding markets. On this basis, for reasonably sized transactions and assuming market conditions continue to improve we would not expect a material savings on debt pricing as a result of increased competition at Preferred Bidder stage. In addition, tenor remains constrained in the current market; likely to be up to a maximum of 7 years can currently be achieved. Therefore the impact of a reduction in margins on the initial has a significantly lower comparative impact on the price than in the height of the market where long term financings were the norm. In a constrained tenor environment the more material determinant of the cost of financing is bidder's refinancing assumptions over the term of the concession.

There may be some benefits from continued improvement in market conditions, but wholly contingent on the market improving between bid submission and when the PB funding competition is run. These savings should be viewed in the context of some of the potential downsides outlined below.

5 Considerations

Funder involvement at bid stage

The NZ outcomes focussed approach to PPP is relatively unique and can drive consortium specific approach to risk allocation. The bankability of a bidder's structure must be confronted at bid stage and creates a material completion risk if it is not fully assessed until PB stage. In addition, leaving the completion of funder's due diligence to be completed post bid stage would also raise material completion risks and we would encourage bidders to procure 'financier due diligence' reports at bid stage (NZTA might mandate this approach). However, this would only work to the extent reports are relatively generic and limits the ability of lenders to personalise the nature of due diligence process. These risks could be partially mitigated by not eliminated under a hybrid solution outlined above.

Risk of issues arising at PB stage

Under a deferred financing competition it is possible that new commercial issues might be raised by financiers at a very late stage in the procurement process. Competitive tension driven by the deferred financing process may be partially effective in limiting the extent to which financiers raise commercial issues, however experience suggests that financiers do often depart from certain positions late in the process, including during competitive processes. This could create risks for the NZTA (for example, extended timeframes and/or sub-optimal compromises in relation to the risk allocation) and challenges for bidders (for example, financiers might require enhancements to the proposed security package; the final financing solution might affect the assumed approach to refinancing risk; etc.). This could result in the builder, O&M provider or equity changing their pricing if the risk allocation changes at the PB stage.

Evaluation Risk

A deferred financing competition would require the RFP evaluation to either be undertaken based on non-financial criteria or based on assumed financing solutions rather than 'banked' solutions. This creates two potential evaluation risks:

- *Affordability* – There is a risk that the financing solution is more costly than expected or that the financiers require changes which affect the D&C, FM or equity pricing. This could affect the affordability assessment undertaken against the PSC during the RFP evaluation process (for example, if the bid was only marginally below the PSC this could require scope to be removed at the PB stage, in the absence of competitive tension).
- *Comparison between bidders* – The PB will have been selected based on non-financial criteria and assumed financing costs. However, as discussed in the attached Appendix, different bids often attract different costs of finance (for example, due to the creditworthiness of consortium members, the security package, the negotiated risk allocation at subcontract level, etc). A deferred financing competition may not enable the NZTA to take this in account because the PB will have been selected before the cost of finance is known.

Cost and Timeframe

A deferred financing competition would require a separate process to be undertaken following the selection of the preferred bidder which would extend the timeframe of the procurement process. By way of example, we understand that UK processes have typically required approximately 7-8 weeks. This may be offset to a certain extent by savings pre-bid.

Bid costs

The extended procurement timeframe might result in increased bid costs for NZTA (for example, project team costs and advisory fees in relation to RFP development, proposal evaluation and conducting/overseeing the debt competition process at the preferred bidder stage).

However across the market as a whole there may be savings in costs since only the preferred bidder would negotiate the debt terms and financing agreements. However, as noted above we would encourage bidders to procure 'financier due diligence' reports at bid stage on the basis that not doing so would increase the risk of issues arising at the preferred bidder stage.

Potential for innovation

A deferred financing competition should have no impact of the level of innovation in design, construction or O&M service delivery. However, a deferred financing competition might impact commercial/financial innovation because:

- it might make it more difficult for bidders to develop innovative financing solutions during the RFP stage because they would be unable to test these ideas with financiers. Bidders have lost the ability to value optimise through the bidder making trade-offs between capital and cost inputs; and
- there would be limited or no opportunity for bidders to use innovative financing structures as a point of differentiation during the bid phase.

On the other hand it may be possible to test innovative structures at the preferred bidder stage.