



ASPI Discussion Paper

Private financing of the HQ Joint Operations Command

Mark Thomson
Program Director Budget and Management

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Background

In March 2004 the Minister for Defence announced that Defence's new HQ Joint Operations Command (HQJOC) would be privately financed. While similar projects have been undertaken in the United Kingdom and by Australian state governments, this represents a new approach to funding Defence infrastructure in Australia. As the Minister observed: *"the decision to privately finance the facility marked a sea change in Commonwealth procurement, as this was the first time Government had sought to privately finance the construction and maintenance of a major facility on a greenfield site."*

Thus, not only is this a costly project for a critical military capability, but it will also set important precedents for Defence and the Commonwealth. For these reasons, it's important to understand the benefits, costs and risks of the proposal.

A Request for Tender will be released in the middle of this year leaving little time to evaluate the myriad of technical issues that surround the arguments for and against private financing. This Discussion Paper has been prepared to quickly engage stakeholders on the key issues.

This Discussion Paper does not try to draw any firm conclusions and none should be inferred.

What is private finance?

Broadly speaking, private financing involved assets traditionally owned by the public sector being owned by the private sector. The public sector then purchases services from the private sector in order to maintain services to the community. In the UK, private financing has been used extensively for schools, prisons, hospitals, defence facilities and general infrastructure projects.

In some cases, private financing provides a clear saving to the Government by allowing more efficient use of the asset. This can occur in a number of ways including through third-party use of the asset, or by exploiting economies of scale available to the private sector. Current UK defence projects like this include the leasing of heavy tanks transport vehicles and the new contract for sea-lift capability. In Australia, a successful example is the Port Services contract let by Defence in the late 1990's (although this was never formally termed a private financing project). Future opportunities for Defence include the leasing of heavy transport and the provision of military accommodation.

But not all private financing projects can claim to deliver a clear saving. Instead, the argument relies on subtle concepts like economic opportunity cost, social time preference, and most importantly, risk transfer. The argument for private financing of HQJOC relies these sorts of factors.

What is being proposed?

The Government has decided that HQJOC will be constructed in Bungadore NSW just outside of the ACT. This purpose-built complex will replace a number of facilities presently dispersed around Sydney. The complex will house over 1000 personnel and extensive command, control and communications infrastructure. As well as improving the effectiveness of the ADF's command capability, the Government has said that the new arrangement will be more efficient although no personnel or operating cost targets have been announced.

The HQJOC complex will become operational in 2007-08 at a cost of around \$300 million. This represents a 50% increase in cost and at least a 6-month delay compared with planning figures released in January 2003.

In the past, Defence would have tendered for the design and construction of the complex. Once built, they would have then contracted separately for support services like building maintenance, catering, cleaning, physical security and information technology support. These support contracts would then be re-tendered every 5 years or so to get the best price the market can offer.

The proposed arrangement for HQJOC differs in two ways:

1. The successful tenderer will arrange finance for the project, and will eventually own the facility. Once the facility is commissioned, Defence will lease the headquarters for an *initial* period of between 20 to 30 years.
2. The contract will include all maintenance and support activities for the life of the contract.

Based on UK experience with similar projects, the commercial arrangement would be something along the following lines:

- A so-called 'special purpose vehicle' would be formed by one or several direct equity participants. This will usually be a consortium including the builder, support services provider and other direct financial investors.
- The consortium would collectively commit around 10% of the equity required for the project.
- The remaining 90% would come from senior financiers through bank debt or bonds. The consortium would build the facility and lease it to Defence on the basis of defined outputs or service standards.
- A single periodic lease payment (typically linked to inflation) would cover the repayment of debt, recovery of equity, return on investment, and the cost of ongoing support services.
- Lease payments are reduced if service standards are not met, and are increased if service standards are raised at the request of the lessee.

What are the advantages?

In announcing the project, the Minister said that the advantages of privately financing the facility included *“cost-effective transfer of risk to the private sector, improvements to financial and risk management throughout the life of the lease period and reduced financial exposure because lease payments are not required until the facility is successfully commissioned”*.

To understand what this means, we need to look in detail at the proposal and compare it with the conventional approach. In doing so, it's convenient to examine separately the two unique aspects of the proposal; the long-term contracting of support services as a consolidated package, and the private financing of the assets. In doing so, it's important to acknowledge that these issues are interdependent.

Pros and cons of bundling support services

The advantages of long-term contracting of support services as a consolidated package would appear to be:

1. A reduction in tendering costs by a factor of 5 or 6 over the duration of the twenty to thirty year contract. This applies to the costs passed on to Defence by the successful tenderer, as well as Defence's own costs in seeking and evaluating tenders every five years.
2. A reduction in the direct administrative cost borne by Defence for managing support services. However, the lessor will pass on the cost of managing the sub-components back to Defence, who will still need to monitor the delivery of services in any case.
3. Defence's long-term financial planning gains better visibility, and a degree of long-term surety, of the cost of ownership.

There are two possible disadvantages compared with the conventional approach of multiple shorter-term contracts for support services:

1. The loss of more frequent open competition to test the price of services so that gains in productivity benefit Defence.
2. The risk of monopoly rent seeking when changes are made to the services sought over the period of the 20 to 30 year lease.

However, both these disadvantages can be at least partially mitigated within a privately financed project by using appropriate contracting. This is important if flexibility and efficiency are to be achieved. It's less clear what happens when it comes time to renew the lease.

Aside from the bundling of support services, there are two further advantages due to having support services provided by the consortium that designed and built the facility:

First, the lessor has an incentive to design and build a facility that's efficient to maintain and operate.

Second, private financing can provide a heightened incentive for the lessor to deliver support services at the contracted level. The argument is that if they fail to meet agreed service standards not only are their profits at risk but also their equity in the project. However, this will only be true if Defence has the power to withhold payment in excess of the cost of the forgone services. Without such a disproportionate sanction, the leverage available to the Defence will be no different to that in a conventional contract (except for the disadvantage that they will be in a 20 to 30 year arrangement).

Without more detail on how the support services will be contracted, it's difficult to judge whether the advantages of private financing outweigh those of more frequent competition for the provision of support services. At least the Government seems persuaded when they say cite "*improvements to financial and risk management throughout the life of the lease period*" as one of the three advantages of the private finance route.

Pros and cons of privately financing the asset

It's useful to compare the conventional and privately financed alternatives for the HQJOC asset from three different perspectives, budgetary, fiscal and economic.

Budget impact

If the project is privately financed, the impact on the Commonwealth budget bottom line depends on whether the deal is categorised as a finance or operating lease, even though the actual cash impact will be the same.

The budget impact also depends on which part of the Commonwealth's financial statements you look at. Since 2001-02, the Government has highlighted the *underlying cash balance* (rather than the *fiscal balance*) as the budget bottom line, and we will therefore focus our attention there.

If the deal is categorised as an **operating lease**, the lease payments will move the *underlying cash balance* in line with the actual annual lease payments. This will shift the budget towards deficit every year once the lease commences. But the annual lease payments are likely to be small on the scale of potential surpluses or deficits, and are therefore unlikely to be of much concern.

Alternatively, if the deal is categorised as a **finance lease**, a large chunk of the twenty to thirty years of lease payments will hit the *underlying cash balance* in the year that the lease commences. This will shift the budget towards deficit on a scale that could turn a modest surplus into an embarrassing deficit.

In a **conventional purchase** of the facility, the *underlying cash balance* would be increased for two or three years prior to the lease commencing as the \$300 million is spent on the project. On a year-by-year basis, this would be a much smaller impact than that from a finance lease but much larger than that from an operating lease.

Thus, from the perspective of the short-term imperative to avoid a deficit and boost a surplus, the most attractive option is an operating lease and the least attractive is a finance lease. A conventional purchase lies in between.

Australian Accounting Standards, particularly AASB 1008 and AAS17, determine whether a particular lease may be classified as an operating or finance lease¹. At the risk of oversimplification (or even making a mistake) the following characteristics are usually associated with the two types of lease²:

An **operating lease** is usually considerably shorter than the expected useful life of the asset and is cancellable by the lessee at short notice with little penalty. In this way, the risk associated with the asset is transferred to the lessor. Because the lessee can seek alternatives, lease costs are determined by the market place. The lessor would usually cover maintenance, insurance and repair costs. The routine leasing of commercial property by the Commonwealth is through operating leases.

In contrast, a **finance lease** is usually for a longer-term and covers the majority of the economic life of the asset; is often non-cancellable or only cancellable at high cost to the lessee; and the lessee assumes all, or the major part, of the risks and benefits of ownership including maintenance, repairs, insurance, residual value and obsolescence. At the termination of the lease, the asset is usually transferred to the lessee for a specified sum.

The proposed private financing of HQJOC does not fit 100% in either category. In particular, the proposed arrangement lacks the flexibility of an operating lease because Defence has no real alternative other than to continue to use the facility for the duration of the lease and beyond. Similarly, the location of the asset ensures that it has no commercial value to the lessor aside from what can be extracted from Defence.

Conversely, there are several factors that distinguish the proposal from a purely finance lease as defined above. In particular, the proposed arrangement would see the lessor assume responsibility for repair and maintenance, and no mention has been made of Defence purchasing the asset from the lessor at the end of the lease. In fact, the implication is that the lease will be renewed at the end of the initial lease period.

Ultimately, the Auditor General will have to make a determination on how the lease is classified. This will be important. The proposed private financing of Navy's new Patrol Boats was scuttled, in part at least, by the decision to classify the proposed arrangement as a finance lease. And we expect the same was true of the decision to abandon much publicised plans to sell and lease back the Defence HQ complex at Russell.

Our guess – and it is only a guess – is that the proposed arrangement would more than likely be classified as a finance lease. The judgement being that the risks and benefits of ownership will unavoidably and predominately reside with Defence as lessee. If this is

¹ The Australian Accounting Standards Board.

² SA Government Department of Treasury and Finance: Leasing Guidelines.

true, the Government's decision to proceed with the private financing of the HQJOC reflects confidence that the long-term benefits outweigh the one-off impact on the budget bottom line. Alternatively, it says something about the Government's optimism concerning the strength of the projected surplus in 2007/08.

Of course, what really matters is not the cosmetics of the budget bottom line but the actual fiscal impact on the Commonwealth and ultimately the taxpayer.

Fiscal impact

The easiest point to make about the fiscal impact – that is, the actual expenditure as opposed to the impact on the budget bottom line – is that under a private financing arrangement no payments would be made until 2007/08 when the lease comes into operation. This explains the advantage cited by the Minister of “*reduced financial exposure because lease payments are not required until the facility is successfully commissioned*”. But this is only a small part of the fiscal differences between a conventional and private financing arrangement, which we now explore.

The financial impact on the Commonwealth due to a conventional acquisition will be:

1. \$300 million spent over a 2 or 3 year period as the facility is constructed.
2. Interest at the prevailing bond rate on the \$300 million for as long as the Commonwealth remains in net debt by at least that amount, or interest on the difference between the \$300 million and any outstanding debt if the Commonwealth's net debt is smaller. This represents the opportunity cost of not retiring outstanding debt.

If a private financing arrangement is employed, the financial impact on the Commonwealth will be:

1. Lease payments.
2. Interest on the cumulative lease payments at the prevailing bond rate for as long as the Commonwealth remains in net debt by at least that amount, or interest on the difference between the cumulative lease payments and any outstanding debt if the Commonwealth's net debt is smaller. This recognises that lease payments can just as well be used to retire Commonwealth debt as capital investment funds.
3. Ongoing tax revenues from profits made by the lessor and financiers through the life of the lease.

In both cases there will also arise offsetting tax revenues from income and other taxes incurred during the construction of the facility. These are identical in each case and can be ignored. (Unless private financing results in a tax break causing the Commonwealth to forego revenue it would otherwise receive.)

Estimating and comparing the fiscal impact of the two options is made difficult by a number of unknowns including that we can't foresee when, if ever, the Commonwealth will be debt free. However, the biggest uncertainty is the cost of the lease payments. This, in turn, depends on a number of factors including on what happens to the building at the end of the lease. If Defence buys the property at the end of the lease, which is often the case with finance leases, then the lease costs will reflect anticipated recouping of the residual value of the asset by the lessor. We will assume that that this will not happen, because the lease has been described as being 'initial'.

Over the life of the arrangement between Defence and the lessor the lease costs must recoup *at least* the following:

- the cost of interest payments on the outstanding value of the loan taken out by the lessor to finance the construction of the facility,
- any payment of the principle borrowed by the lessor, and
- a return on investment on that proportion of assets owned by the lessor.

Because the Commonwealth has no option but to renew the lease, and the contractor no alternative use for the facility, the repayment of the principle borrowings could comfortably be spread over several renewals of the lease.

Notwithstanding these unknowns there are two observations that can be made:

1. On the basis of previous experience with the sale and lease back of office accommodation by Commonwealth, a 25 to 30 year lease at commercial accommodation rates will cost well in excess of a conventional acquisition.
2. No matter what sort of arrangement is put in place to privately finance the project, the cost of borrowing will exceed that which the Commonwealth would incur. And this will unavoidably result in a premium to be paid over the life of the project.

These points are expanded on below.

Commercial lease

Analysis of three sale and lease-back projects by the ANAO in 2001³ revealed that the break-even point – where savings became additional costs incurred by leasing – was between eight and eleven years. In each case the lease was classified as an operating, rather than a financial lease.

To estimate the relative fiscal impost on the Commonwealth of purchasing HQJOC outright compared with leasing at a commercial rate, we need to take account of the opportunity cost of retiring Commonwealth debt for every payment made. Figure 1 compares the cumulative debt arising from the two options, where no account has been taken of unquantifiable offsetting tax revenues. At first, the commercial lease is cheaper than a conventional acquisition. But after around twenty years the commercial lease

³ Commonwealth Estate Property Sales. ANAO Report #4, 2001-02.

becomes more expensive and stays that way. Depending on the life of the building, the overall additional cost could amount to several billions.

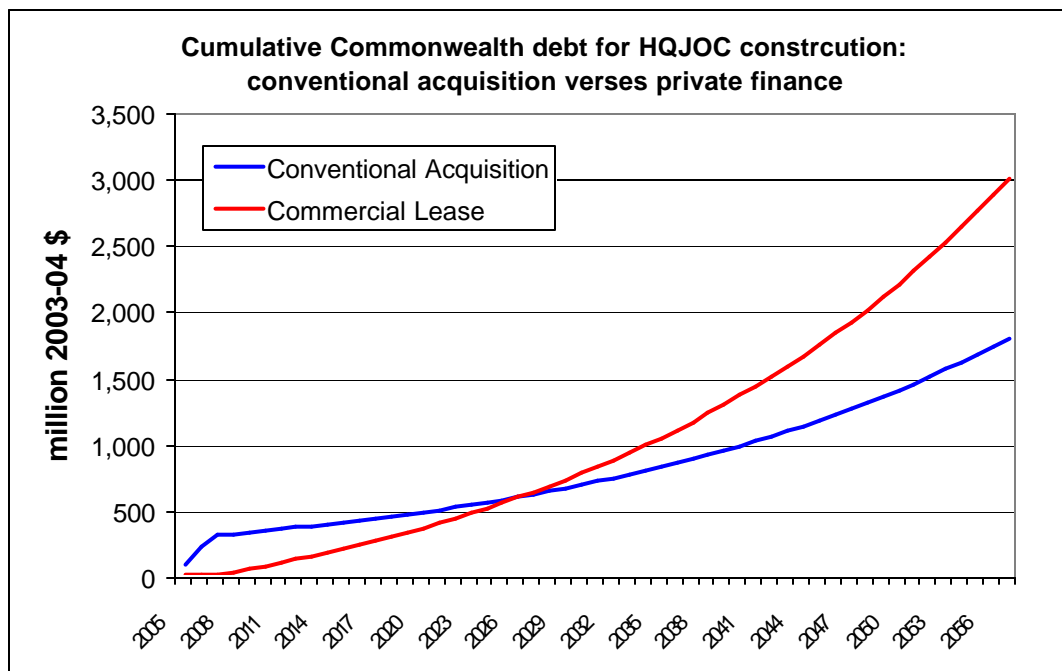


Figure 1: Cumulative Commonwealth debt for HQJOC assuming Commonwealth remains in debt.

The estimate in figure 1 assumes that:

- The initial commercial lease rate for the asset (exclusive of support services) equals 8% of the acquisition cost of the asset. This is more optimistic than the roughly 10% figure found by the ANAO in 2001.
- The lease cost is assumed to increase in line with the annual CPI inflation rate. Inflation is assumed to be 2.5% per annum consistent with the long-term Treasury target.
- The Treasury bond rate is taken to be 6.25%.

If the Commonwealth retires its debt the calculation is simplified somewhat but the qualitative result remains unchanged; well within the life of the building, the cost of leasing will exceed that of purchase.

Relative cost of finance

Under a long-term finance lease arrangement the lease payments could, in principle at least, be less than commercial rates. Although this begs the question of why the lessor would accept a return below that available commercially. In this case, the determinate factor becomes the cost of finance to the lessor which is always going to be higher than that which the Commonwealth can raise.

It's hard to put a single figure on the margin, but over the past 21 years the Treasury bond rate has averaged 2.8% below the 'variable large business indicator lending rate' tracked by the RBA. But this almost certainly overstates the difference because finance is more likely to come from a private bond issue. For example, the bond issue employed to privately finance the GCHQ project in the UK was 1.8% above the reference HM Treasury bond rate⁴. The additional cost of borrowing \$300 million over twenty-five years at 1.8% above the prevailing bond rate of 6.25% is \$384 million (in 2003-04 dollars assuming 2.5% per annum inflation). Alternatively, if the Commonwealth were to move out of its net debt position, the premium paid would be the full interest on \$300 million at 8.05% over twenty-five years or \$821 million (again in 2003-04 dollars assuming 2.5% per annum inflation). These figures only cover the initial lease period.

In principle, a lessor could arrange finance at a lesser rate by borrowing from, say, the US markets. But this would entail a foreign exchange risk that would be translated into an additional premium to be passed on to Defence. In the increasingly efficient global financial market, the net result would little different from domestic borrowing.

In some cases, the higher cost of private sector borrowing can be offset by the lessor using the assets to generate extra revenue. For example, through the sale of concessions for commercial activity on the site (like the shopping mall that envelopes Sydney airport), or by charging for third party use of the asset when not in use by the lessee. In the case of HQJOC, the former avenue is very limited and the latter is impossible due to security considerations and the remoteness of the site.

Thus, irrespective of the details, it's difficult to escape the conclusion that using private borrowing to finance the project will result in a substantial additional cost to the Commonwealth. But private finance can still be good value-for-money. It all depends on what's gained in exchange for the added expense.

There are two arguments routinely used to justify paying more to privately financing an asset. First, that there is a net economic benefit from using private rather than public finance. Second, the additional cost pays for the so-called 'transfer of risk' from the Commonwealth to the private sector. We now consider these two factors.

Economic impact

In investment analysis it's usual to discount the impact of future cash flows to take account of the opportunity cost of alternative uses of the money. This explicitly biases the analysis towards expenditure patterns that spend less in the near-term and relatively more in the long-term. This is done using a discount rate to calculate the so-called net present value (NPV) of future spending. Over long time periods, even a modest discount rate can all but ignore future spending in the analysis. Discounting reduces values as quickly as compounding increases them. For example, a 10% discount rate applied over 50 years, only counts one half of one percent of the spending in the final year.

⁴ GCHQ New Accommodation Program, UK NAO Report HC 955, 2002-03.

In the foregoing discussion, no discount rate has been applied beyond that *implied* in the direct opportunity cost of retiring government debt at the bond rate. There are two economic arguments for employing a discount rate.

The first is so-called **social time preference** that expresses the community's preference to receive benefits now and pay for them later. A generous way to view this is that, as living standards rise, more value is put on a dollar's worth of spending today than on a dollars worth of spending in the future when dollars are easier to come by. Whatever the rationale, spiraling levels of personnel debt attest to the strength of the preference.

While the community might indeed have a strong preference to have now and pay later, that does not mean that such an approach amounts to sound long-term economic management by the Government. Treasury's 2002 Intergenerational Report projected mounting fiscal pressures on the Commonwealth as Australia ages in the coming decades. Just as the Government is asking people to ignore their social time preference and save for their retirement, the same approach can be applied to the Commonwealth's own management. Buying a facility like HQJOC as an investment – and thereby avoiding paying for it several time over through lease payments – makes good sense in light of the looming fiscal tightening later this century. Consequently, it's hard to accept that social time preference is a good reason to bias the analysis towards the private financing option. In a very real sense a dollar spent in 2050 will be much more precious than a dollars spent today.

In any case, if the project is financed at the expense of retiring Government borrowings rather than through the raising of new taxes, the social time preference will be satisfied because the project will not be paid off until some point in the future while the benefits will arise now.

The second is the **social opportunity cost** imposed by having public spending displace private investment which can use the funds more efficiently. However, this does not apply in this case. The outright purchase of the facility by the Commonwealth does not in any way displace a more efficient alternative private investment. Rather, it simply displaces the equally efficient (or inefficient) private financing of the construction of an identical facility at the same site. No matter what happens, \$300 million of national wealth will be tied up in the HQJOC facility. The only differences will be the extra funds paid by the taxpayer over time if it's privately financed.

As a point of comparison, the UK discount their prospective project cash flows by 3.5% per annum to take account of *social time preference* when comparing investment options, but they make no allowance for *social opportunity cost*.

There is a third rationale sometimes used to justify (or increase) the discount rate used in investment analysis; accounting for risk. The problem here is determining how large the premium should be. The UK do not include a risk factor in their discount rate, but instead explicitly cost and include risk into their business cases⁵.

⁵ The Green Book: Appraisal and Evaluation in Central Government. HM Treasury.

Irrespective of how risk is accounted for, it's the critical issue for private financing. The question is; does the premium to be paid by private financing buy the Commonwealth something worthwhile in terms of reduced risk?

Risk impact

One of the key arguments for private finance is that it transfers risk from the public to private sector where it can be better handled. Indeed, the announcement of the decision to privately finance the HQJOC project stated that private financing would result in the *cost-effective transfer of risk to the private sector*. There are two claims being made here; first that risk is transferred to the private sector, and second that this is being done cost-effectively. These are discussed separately below.

Does risk transfer work?

The UK has some 451 projects already operational under private financing arrangements and their experience is an invaluable resource. A recent paper by the UK Treasury⁶ argues strongly for the effectiveness of public financing in both transferring and reducing the risks of (appropriately chosen) public sector construction projects.

To quote the report on cost and schedule risk: *“HM Treasury research into completed PFI [Private Finance Initiative] projects showed 88 per cent coming in on time or early, and with no cost overruns on construction borne by the public sector. Previous research has shown that 70 per cent of non-PFI projects were delivered late and 73 percent ran over budget;”* And on client satisfaction with the operational performance of privately financed projects: *“Over three quarters of clients surveyed reported their PFI projects performing as expected or better.”*

Effective risk management is the key benefit claimed for private financing. This is accomplished by allocating the risks between consortium partners on the basis of who is most able to deal with them. For example, the builder will carry the risk for initial construction. Because consortium members have equity in the project, they all have a lot at stake – especially since payments do not commence until the construction phase is complete and the lease commences. In this way, private financing provides strong incentives to deliver on time, within budget and at specification.

The senior financiers, who hold 90% of the equity, play an important role by overseeing the project, allocating risk amongst the consortium and undertaking initial due diligence. Understandably, the senior financiers ensure that the great majority of risk rests with the consortium and its sub-contractors. And they ensure that the contract is enforced through step-in provisions that allow them to replace consortium members or subcontractors if they fail to perform.

⁶ PFI: meeting the investment challenge. HM Treasury, July 2003.

A recent UK Audit Office report⁷ on construction projects confirms that private financing delivers price certainty and timely delivery of quality assets. However, the same report said that it was not possible to judge whether these projects could have achieved these results using a different procurement route. To understand how this can be, it's necessary to look behind the seemingly impressive claims made in the aforementioned HM Treasury report.

The critical benchmarks for non-privately financed project performance quoted in the HM Treasury report come from an earlier UK Office of Government Commerce report⁸. This provides important context for the data. To begin with, the quoted cost increases come with the caution that the figures include the spending of contingency funds, which represent a deliberate risk-management tool in conventional acquisitions rather than a cost blow-out. In addition, the sample of projects is far from representative of best-practice. Only 12% of the projects provided incentives for the constructor to perform, and only 31% of the projects pursued a Design and Build approach that transfers risk to the contractor⁹. The same report also said that customers reported generally high satisfaction.

Thus, on the basis of available UK data, it's clear that private financing can be effective in delivering results. Whether it's unique in doing so is unknown.

Is the risk transfer cost-effective?

In rough terms, we know what the additional cost of private financing will be; the capital value of the asset will be paid for several times over through its life. Whether this is worth paying depends on the likelihood and consequence of the risk being transferred. For the HQJOC project the scale of the risks inherent need not be guessed at. Defence has years of experience in facilities construction, maintenance and service delivery. The scale of the risks should be quantified (proportional to their likelihood) and added into the projected cash flow for the conventional acquisition option being used for comparison. Given that there is a wealth of real data available to Defence from their own experience, there is no excuse for naively adding a risk premium factor through a discount rate.

Finally, it's worth noting that while the official UK agencies are supportive of private financing as a value-for-money alternative to conventional acquisition, there is some skepticism outside of government. A random survey of public sector accountants by the UK Association of Chartered Certified Accountants¹⁰ reported that:

“Only one percent of the respondents strongly agreed that PFI generally provides value for money whilst well over half of the respondents disagreed with this statement. The survey also showed that most public sector accountants believe that public sector organisations are prevented from achieving value for money as PFI is the only available option for obtaining much needed capital investment in public services. In addition, less

⁷ PFI: Construction Performance, UK NAO, HC 371 2002-03.

⁸ Benchmarking the Government Client, Stage Two Study, UK OGC, 1999.

⁹ Modernising Construction, UK NAO, HC 87 2000-01

¹⁰ ACCA Members' Survey: Do PFI Schemes Provide Value for Money?, ACCA, 2002.

than 1 in 7 of those returning the questionnaire felt that PFI schemes are objectively tested to see if they would provide value for money.”

Ten questions

As is appropriate for a discussion paper, we conclude with a list of questions for further consideration:

1. What is the scale and likelihood of risks in a conventional approach to building the facility? Defence spends around \$350 million on major capital facilities per annum. Historical data can be analysed to find the likelihood and scale of problems that arise. While military equipment projects have a poor record, the usual perception of Defence facility projects is that they are ‘quiet achievers’ with few major problems. So what does the data say? When answering, remember to take proper account of the use of contingency funds as a risk management tool.
2. What is the scale and likelihood of risks in a conventional approach to maintaining and operating the facility? Defence spends over \$300 million a year on facilities operations involving an estate worth more than \$9 billion. What are the risks and how much do they cost per annum? In answering this question, it’s very important to distinguish between actual risks and the simple failure to plan for the routine costs of ownership.
3. How much opportunity is there for a private sector consortium to build an efficient to maintain facility beyond what a conventional acquisition can deliver? Is best practice in efficient building design a closely guarded secret or are there industry standards that can be employed? Does Defence currently take proper account of through-life costs when designing its facilities? If not, why not?
4. What sort of discount rate should be used in calculating the net-present-value of competing options? Should the notion of social-time-preference be rejected in light of the fiscal crunch projected by Treasury’s Intergenerational Report? Does social-opportunity-cost have any role when the funds will still end up being spent on the same asset. And can any justification be found for applying a risk premium when there is a mountain of data to support an explicit quantification of the project risks? Over what period should a comparison be made? What is the planned economic life of the building?
5. What contractual arrangements will be used to ensure that Defence retains the flexibility to change it’s use of the facility in the future, and what mechanisms will be employed to ensure periodic testing of the cost effectiveness of support services provided?
6. What makes the HQ Bungadore viable and value-for-money as a private finance project, when the leasing of the HQ at Russell was rejected? The level of security and sensitivity is similar at both facilities, and the HQJOC has an even less credible claim for having an alternative use.

7. What other mechanisms can be used to manage the construction risk of the project. Could the project be done as a fixed price prime contract with incentives and penalties? What is Defence's experience with this sort of approach? There is no evidence to show that private finance is the only way to transfer risk to the public sector for projects.
8. What is the expected margin between Commonwealth bonds and the private debt available for this project?
9. Why can't the government (perhaps through DOFA) play the role of senior financier for the project in a hybrid approach? The consortium would still put up their 10% equity so that the incentives are focused where the risks are being managed, but the main cost driver would be avoided by the Government providing the remaining 90% of the finance at the prevailing Treasury bond rate. To ensure that the consortium delivers, the government's 90% stake in the project could be managed by a commercial entity on a fee-for-service basis.
10. How much public disclosure is appropriate given the precedent being set by this project? Will the business case analysis, and so-called 'public sector comparator' be made public?

16 Mar 2004

MIN53/04

TENDER PROCESS STARTS FOR NEW DEFENCE HQ

Defence Minister Robert Hill today announced the start of a two-stage tender process for the Australian Defence Force's new joint operational headquarters at Bungendore in New South Wales.

"The project to build a state-of-the-art headquarters for the new Joint Operations Command to command and control the ADF's operations moves a step closer today," Senator Hill said.

Senator Hill said first stage of the tender process would be to call for Registrations of Interest later this month from companies to finance, construct and maintain the facility. The second stage will be to issue a Request for Tender in the middle of this year for the delivery of the facility with the preferred tenderer to be appointed by November. The new \$300 million headquarters will combine seven existing military headquarters and agencies situated in and around Sydney.

Construction of the new facility is expected to start in the middle of next year. Preliminary engineering and design studies have been undertaken. The Draft Environmental Impact Statement was released for public comment in October last year and the supplementary report is being prepared. It is expected the new headquarters, with about 1000 operational staff, will be fully operational in 2007-08.

Senator Hill said the decision to privately finance the facility marked a sea change in Commonwealth procurement, as this was the first time Government had sought to privately finance the construction and maintenance of a major facility on a greenfield site.

"The successful tenderer will be responsible for the design, construction, financing, operation and maintenance of the new headquarters as well as providing infrastructure and ancillary support," Senator Hill said.

"When the facility is commissioned, Defence will lease the headquarters for an initial period of between 20 to 30 years. Although contract security staff will undertake the physical security requirements of the new headquarters, Defence will retain oversight and responsibility of security, in much the same manner as at a number of other Defence establishments. Defence will also retain responsibility for the delivery of the command, control, communications and information systems."

Senator Hill said the private financing of the facility would provide the Government with some significant advantages throughout the term of the lease arrangement.

The advantages include cost effective transfer of risk to the private sector, improvements to financial and risk management throughout the life of the lease period and reduced financial exposure because lease payments are not required until the facility is successfully commissioned.