



AUDITOR-GENERAL  
AUSTRALIAN CAPITAL TERRITORY



PA 99/25

11 March 2003

The Speaker  
ACT Legislative Assembly  
South Building  
London Circuit  
CANBERRA ACT 2601

Dear Mr Speaker

In accordance with the Authority contained in the *Auditor-General Act 1996*, I transmit to the Legislative Assembly my Report titled "*Belconnen Indoor Aquatic Leisure Centre*".

This audit was managed and conducted by Greg Martin with the assistance of Bobby Pawagi of this Office.

Yours sincerely

A handwritten signature in black ink, appearing to read 'John A Parkinson'.

John A Parkinson

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# **1. REPORT SUMMARY**

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## **INTRODUCTION**

1.1 This Report presents the results of an audit of the management of implementation of the Belconnen Indoor Aquatic Leisure Centre (the Centre).

1.2 The Centre is the first project providing public facilities which would traditionally have been built, owned and operated by the ACT Government but which instead is to be built, owned and operated by the private sector. A substantial capital contribution of \$10m is to be provided by the Government to the private sector developer/operator.

1.3 As the contribution is for a significant amount and the private sector Build, Own and Operate (BOO) approach is new to the Government it was decided that an Audit of the project was warranted.

## **BACKGROUND**

1.4 In 1994 the then Government announced its intention to provide a swimming pool complex for the Belconnen Region. Various studies were performed to establish a need for the pool and select a suitable site for its construction.

1.5 In 1998 the then Government made an announcement that the pool would be constructed for an expected cost of \$15m and, subject to geological tests, be located on the corner of College Street and Eastern Valley Way, Belconnen.

1.6 In August 1999 Cabinet agreed to recommendations which outlined a detailed approach for the implementation of the project. The approach was expected to minimise the Government's exposure to costs and risks.

1.7 It was the intention of the then Government to limit the Government's contribution to the Centre to a one off grant which initially was to be \$8m. This was later increased to \$10m. The objective was to have an indoor swimming pool centre built in Belconnen by the private sector without the Government being exposed to ongoing financial liabilities or risks.<sup>1</sup>

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<sup>1</sup> "Call for Detailed Proposals Belconnen Indoor Swimming Pool", December 2000 pp 4-5.

1.8 In April 2000, Cabinet was advised that a preferred developer/operator for the project had been identified through a tender process. There were, however, a number of outstanding matters to be negotiated. Not all of these matters could be resolved and as a result the tender process was terminated.

1.9 Cabinet agreed in December 2000 that a new public tender process be undertaken. A preferred proponent was selected in the second process and contractual arrangements have proceeded to completion. The Centre is now being constructed.

1.10 The responsible Minister and Cabinet were provided with a large quantity of advice during the period 1995-2002. The Cabinet Decisions and Cabinet Submissions relevant to the project are listed in **Appendix B** to this Report.

## **AUDIT SCOPE AND APPROACH**

1.11 The Audit focussed on the period ending with the execution of legal agreements between the Government, the developer/operator and the financier.

1.12 The Audit reviewed Cabinet submissions and contractual documentation and obtained assurance from the Government Solicitor's Office in order to identify whether risks had been effectively allocated to the developer/operator as intended. An assessment of political, operational, ownership, design and site risks was included in the Audit. Cabinet submissions, decisions, numerous consultants' reports, the department's files and Treasury files were reviewed in this process. A wide range of better practice material was also reviewed including those for risk management processes – **Appendix C**.

1.13 Benchmark data for leisure centres, was provided to the Audit by the Centre for Environmental and Recreation Management – University of South Australia. Discussions were held with various local Governments with large-scale aquatic leisure centres.

## **LIMITATION ON AUDIT SCOPE**

1.14 The conduct of the Audit and the content of this Report should not be taken as providing a complete assurance that no inefficiencies or ineffectiveness exist for the project or its outcomes.

## AUDIT OBJECTIVES

1.15 The objectives of the Audit were to provide independent opinions to the Legislative Assembly on whether:

- timely and thorough financial and economic assessments of the options for meeting the Government's decision to provide the Belconnen Leisure Centre were undertaken prior to the project proceeding; and
- the private sector provision of the Belconnen Leisure Centre will expose the Government to excessive costs or other risks.

## AUDIT OPINIONS

1.16 The independent opinions drawn on the audit objectives are set out following:

### AUDIT OPINIONS

- *Timely and thorough financial and economic assessments of the options for meeting the Government's decision to provide the Belconnen Leisure Centre were not undertaken prior to the project proceeding.*
- *The private sector provision of the Belconnen Leisure Centre is unlikely to expose the Government to excessive costs or other risks.*

## BASES OF AUDIT OPINIONS

### Financial and Economic Assessments (see Chapter 2)

1.17 The independent audit opinion that *timely and thorough financial and economic assessments of the options for meeting the Government's decision to provide the Belconnen Leisure Centre were not undertaken prior to the project proceeding* is based on the following findings:

- early analyses did not include a cost benefit study;
- a later assessment of public benefits was not incorporated in an analysis comparing all the options for the Centre;
- a detailed financial analysis comparing all reasonable options to deliver the Centre was never carried out; and
- no comprehensive business case for capital works funding for the Centre was prepared.

### **Summary**

1.18 The initial consideration of options for the provision of the Centre was timely but not thorough. It did not include a cost benefit analysis and was based on limited financial projections. A thorough financial analysis and public benefits assessment was performed for a narrow range of public approach options but a sound business case was not prepared.

1.19 The privatisation approaches being considered were not fully analysed for their financial impacts. Re-consideration of the options in the final decision phase to proceed with the Centre also did not include thorough financial comparisons.

1.20 The Audit's view is that the Centre project was not the subject of timely, thorough comparative financial and economic analyses of a full range of potential alternatives.

### **Exposure to Costs and Risks**

1.21 The independent audit opinion that *the private sector provision of the Belconnen Leisure Centre is unlikely to expose the Government to excessive costs or other risks* is based on the following findings.

- Cabinet's intentions for the core facilities to be included in the Centre are likely to be achieved. (see *Chapter 4*)
- Cabinet's intention to limit the Government's contribution for the Centre to \$10m is likely to be achieved. (see *Chapter 4*)
- Cabinet's intention to legally allocate specified risks to the developer/operator is likely to be achieved. (see *Chapter 4*)
- Cabinet's intention that access to the Centre's core facilities for the public will be assured is likely to be achieved. (see *Chapter 4*)
- The Government's costs using the private sector build, own and operate (BOO) approach are likely to be no greater than the costs that would have been incurred if the Centre was Government constructed, owned and operated. (see *Chapter 5*)

### **Summary**

1.22 The Audit's opinion is that overall the BOO method of private sector provision of the Centre is unlikely to expose the Government to excessive costs or risks. This is because the Government's contribution has been legally capped at \$10m and the Government has transferred

substantial risk to the developer/operator for that cost. It is emphasised, however, that the Government remains exposed to some risks.

## **EXPOSURE TO RISKS**

1.23 As mentioned the Government remains exposed to some risks. In negotiation processes not all risk can be allocated to the private sector.

1.24 The risks listed below are potential only. The details of these risks are set out in *Chapter 6*.

- The Government may become exposed to additional financial costs through political risk.
- The Government may become exposed to pool services being delivered to the community at less than required standards as the Government has no flexible mechanisms which provide an incentive for the developer/operator to fully comply with required standards of service.
- The Government may become exposed to the costs of maintaining the Centre's operations if the developer/operator breaches the project agreement as a performance bond to cover the Government's costs has not been put in place.
- The Government may become exposed to the completed Centre not fully meeting final design requirements for the Centre as the project agreement does not require that the completed Centre complies with final design specifications.
- The Government may become exposed to Cabinet's intention for government contributions to be confined to core facilities not being achieved as there is no legal provision which can be used to enforce Cabinet's intention<sup>2</sup>. (see *Chapter 4*)

### ***Summary***

1.25 The Audit considers that the level of risk exposure is acceptable given the limit on the Government's contribution to the facility and the fact that risk can never be completely avoided. This conclusion must be tempered by the recognition that, because of the nature of the Aquatic Centre project, political risk exists and this may result in the Government accepting liabilities even though legally it is not required to do so.

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<sup>2</sup> The use of the Government's contribution on core facilities will be monitored. (Chapter 4)

1.26 Particular attention is drawn to the issue of political risk. Readers should peruse the comments on this form of risk in *Chapter 6. Appendix A* to this Report explains the risk in more detail. The appendix is an extract from an article titled '*Public Private Partnership Projects Can Effect a State's Credit Rating*' published in the August 2002 edition of the Standard and Poor's magazine 'Credit Focus'.

## CONCLUSION

1.27 The Audit's opinion is that overall the BOO method of private sector provision of the Centre is unlikely to expose the Government to excessive costs or risks.

1.28 On the subject of financial analyses the audit opinion is that analyses were not timely or thorough and did not include a full range of potential alternatives. It is understood that government officials conducted their analyses and other planning for the Leisure Centre in the context that both the then Government and Opposition were committed to provision of a Centre. In this situation Government officials may have accepted that the decision to provide the Centre was 'fait accompli' and therefore expending time and resources on extensive analyses was not warranted.

## FUTURE ACTIONS

1.29 The Audit has made a number of suggestions for further action. For a full understanding of these suggestions readers should refer to the Chapters which contain the reasons for making the suggestions. The suggestions arise from the findings of this specific audit. The suggestions therefore must not be taken as a complete set of guidance for contractual arrangements with private sector organisations.

### **Financial and Economic Analyses (Chapter 2)**

*Suggested Action 1* – For all major projects, thorough and detailed financial and economic analyses should be prepared and the information produced taken into account for decision-making and resource allocation.

*Suggested Action 2* – Treasury guidelines should always be followed in the preparation of financial and economic analyses referred to in Suggested Action 1 to ensure that resource allocation decisions are based on acceptably prepared quality information suitable for the purpose intended.

*Suggested Action 3* – Departures from Suggested Actions 1 and 2 should only occur when Cabinet or a Minister direct that financial and economic analyses are not to be performed.

*Suggested Action 4* – Any Cabinet or Ministerial direction that financial and economic analyses are not to be performed should be in writing and include the reasons why the analyses are not to be performed.

### **Political Risk (Chapter 6)**

*Suggested Action 5* – For all major projects Cabinet should ensure it understands the political risks inherent in the projects before committing the Government to the projects.

*Suggested Action 6* – The Government’s total exposure to existing politically sensitive projects should be taken to account in the assessment of the political risks inherent in potential new projects.

### **Operational Risk (Chapter 6)<sup>3</sup>**

*Suggested Action 7* – Contracts with private sector organisations for delivery of significant core public services should provide for payment withholding mechanisms which can be used as a sanction to motivate ongoing sound operational performance.

*Suggested Action 8* – Contracts with private sector organisations for delivery of significant core public services should require contractors to provide a performance bond of sufficient amount to cover any Government costs which may be incurred to continue the delivery of the services if the contractor ceases to deliver the services prior to expiration of the contract term.

### **Design Risk (Chapter 6)**

*Suggested Action 9* – Contracts with private sector organisations for delivery of significant core public infrastructure should require that the completed project is to comply with final design specifications.

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<sup>3</sup> A circular from the ACT Procurement Board for projects with a value less than \$20m and Treasury’s circular for the Private Provision of Public Infrastructure for projects with a value greater than \$20m may be suitable mechanisms for suggesting that agencies give due consideration to adopting the risk management mechanisms in Suggested Actions 6-9.

## CHIEF EXECUTIVES RESPONSE

1.30 In accordance with section 18 of the *Auditor-General Act 1996*, a final draft of this report was provided to the Chief Executive of the Department of Education, Youth and Family Services. Substantive comments received from the Chief Executive are referred to in the following paragraphs.

### **Response to Absence of Complete Financial and Economic Analyses**

1.31 In her response the Chief Executive advised her views on why a complete business case for the Centre had not been prepared.

*The audit report draws attention to the lack of financial and economic assessments of options for providing the leisure centre. The audit report suggest that one reason may have been that officials concluded that government commitment to the project was such as to make such assessments non-productive.*

*The attention given by the then Government to the project and its commitment to proceeding with it is clearly evidenced by the number of Cabinet submissions dealing with the project and its public statements at the time. It is worth recording however that all projects over \$.025m are required to have a comprehensive business case as part of the process of developing a draft capital works program for consideration by Government. The Leisure Centre project had been listed in the draft capital works program. Had it remained a capital works project it would have been the subject of a comprehensive business case notwithstanding Government's strong commitment to its provision.*

*Because of competitive neutrality concerns however, the Government commissioned an assessment feasibility study of the public cost and benefits of the project in 1998 to establish whether grounds existed for the public provision of a leisure centre. As a consequence of the assessment the Government decided not to proceed with the Leisure Centre as a capital works project but, rather to provide a subsidy for \$8m, later increased to \$10m. In neither case was departmental advice sought prior to the decision about the level of the subsidy. With an estimated total cost of construction of \$15m, the then Government subsidy decision meant that the focus became one of striking a balance between attracting commercial interest and minimising the risk to the Territory. As the audit report concludes, this balance was achieved.*

***Audit Comment on the Chief Executive's Response***

1.32 The Chief Executive's response implies that if the Centre had remained in the Capital Works Program a full business case would have been performed. In the Audit view a business case should be prepared for all major projects involving government funding and not only projects in the Capital Works Program. All major projects must be the subject of a comprehensive business case process which includes thorough financial and economic analyses of a wide range of options (including the option not to proceed).

1.33 The Chief Executive refers in the third paragraph of her response to an 'assessment feasibility study of the public costs and benefits of the project'. That study is outlined at *paragraphs 2.12 and 2.17* of this Report. The Chief Executive indicates the Government decided not to proceed with the Centre as a capital works project but rather for the Government to provide a subsidy to a private sector developer/operator as a consequence of the assessment. This is generally correct but does not alter the Audit's view that a full business case should be prepared for all major projects whether provided as part of the Capital Works Program or otherwise.

**Chief Executive's Response to Future Ownership Risk**

1.34 In her response the Chief Executive advised her views on a second mortgage to protect the Territory's interests in the Centre.

*The audit report (paragraphs 6.23, 6.29 and 6.32) may give the impression that the second mortgage security is no longer required and that Territory funds will be made available without the production of a Territory mortgage. The Government Solicitor's Office advises that neither situation is correct and that the Project Agreement provides that a pre-condition to the Territory's contribution of its funds is the execution of the Territory's mortgage. The Government Solicitor's Office further advises that the Territory's second mortgage cannot be executed before the first mortgage is signed and this is yet to occur<sup>4</sup>.*

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<sup>4</sup> Additional advice provided by the Government Solicitor's Office to the Audit included that a first mortgage with a project financier was executed by the developer/operator in February 2003.

*Audit Comment on the Chief Executive's Response*

1.35 The Audit is pleased that the Chief Executive's response confirms that the second mortgage security will be executed before any funds are provided to the developer/operator. The Audit considers that the second mortgage is an essential safeguard for the Territory.

## **2. ASSESSMENT OF THE OPTIONS**

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### **INTRODUCTION**

2.1 This Chapter provides the results of the Audit's assessment of whether timely, complete and thorough financial and economic assessments of the options for constructing and operating the Centre were performed prior to construction commencing.

### **BACKGROUND**

2.2 The Centre was initially intended to be Government designed, constructed and operated. The Cabinet's approach to providing the Centre changed, however, when competitive neutrality issues led to the consideration of a privatised facility.

2.3 The options were re considered when the first tender process to identify a private sector developer/operator for the Centre did not identify a suitable proponent.

### **ELECTORAL COMMITMENTS**

2.4 In its 1995 election platform the then Opposition (Liberal) announced a firm commitment to construct an aquatic centre in Belconnen should it be elected. The Liberals were successful at the 1995 election.

2.5 In the lead up to the 1998 election the Liberal Government published a plan to improve sports and recreational opportunities over the next three years. The plan confirmed the Liberal's commitment to an aquatic centre in Belconnen.

2.6 The Liberals, in Opposition and in Government, made clear commitments during two election campaigns that the residents of Belconnen would be provided with an aquatic centre. The Labor Party (now the Government) made similar commitments in the 1995 and 1998 election campaigns.

2.7 There is no doubt that there was bipartisan political commitment to the provision of aquatic facilities in Belconnen. It was in the context of these well known political commitments that government officials conducted the assessments of options for the Centre described in this Chapter.

## **SIGNIFICANT FINDINGS**

- *Early analysis did not include a cost benefit study.*
- *A later assessment of public benefits was not incorporated in an analysis comparing all the options for the Centre.*
- *A detailed financial analysis comparing all reasonable options to deliver the Centre was never carried out.*
- *No comprehensive business case for capital works funding for the Centre was prepared.*

## **AUDIT APPROACH**

2.8 It would be expected in the normal course of events that assessment of options to deliver a major facility for the public would include an examination of all reasonable alternatives, be performed early in the decision making process and be based on a thorough analysis. The analysis would be expected to include rigorous financial and economic analyses including a complete cost benefits analysis. The ‘do not proceed’ option would be included.

2.9 The Audit reviewed the analyses which were prepared for the Centre. In its review the Audit took to account the existing and contemporary Treasury guidance for business case preparation for Capital Works Projects. The contemporary Treasury guidance is based on guidelines prepared by Partnerships Victoria, which the Audit also used a guidance.

## **FINANCIAL AND ECONOMIC CONSIDERATION OF THE OPTIONS**

### **Government Construction and Operation of the Centre**

2.10 Two reports were prepared based on the Centre being Government constructed and operated. Brief comments on these studies follow.

2.11 Siting Study (January 1998) – This study was used as the basis for a draft business case. Treasury rejected the draft business case as the study’s consideration of the options did not include a benefit cost analysis and presented only a short-term financial analysis of the project. The Audit agrees with the Treasury action.

2.12 Public Benefit Assessment and Feasibility Study (March 1999) – This study was performed as a result of competitive neutrality issues and not to develop a business case. The study covered three options for the Centre based on a Government constructed and operated facility. A public benefits assessment was performed and reported in the study. The public benefit assessment was inconclusive on whether the Centre would provide net public benefits.

2.13 The study included a detailed financial analysis. This, however, was only for the purpose of estimating how much subsidy would be required to support the public construction options.

***Audit Comment***

2.14 The financial and economic consideration of the options to provide the Centre in the January 1998 study were not sufficiently comprehensive for the preparation of a business case.

2.15 The financial and economic examination of the options to provide the Centre reported in the March 1999 study was comprehensive in that it included an assessment of public benefits and a detailed financial analysis, however the financial analysis was confined to publicly constructed options.

**Privatisation of the Centre**

2.16 Three relevant documents included some discussion and analysis of the Centre being privately constructed and operated. Brief comments on these follow.

2.17 Public Benefit Assessment and Feasibility Study (March 1999) – The idea of privatisation of the Centre through a Build, Own, Operate (BOO) option was recommended but only discussed in the study in general terms. The study did not subject the BOO option or other potential private options to any detailed financial analysis or benefit cost analysis. (This study was previously mentioned in this Chapter under the heading ‘Government Construction and Operation’. The study mainly comprised analysis of a Centre with basic facilities similar to those that have been publicly constructed in the past.)

2.18 Consultants’ Report (July 1999) - Consultants commissioned by the department recommended a Build Own Operate and Transfer approach (BOOT) with a 30 year lease term of the Centre. The consultants recommended that the project be built and operated by the

private sector with the land to be leased to the developer/operator for a 30 year period. At the end of 30 years the lease would transfer back to the Government.

2.19 The consultants' report included no financial analyses of the BOO and BOOT alternatives.

2.20 Cabinet Submission (August 1999) – This Cabinet Submission recommended that Cabinet:

*(b) agree that the Belconnen Indoor Aquatic Leisure Centre be constructed and operated by the private sector on either a build, own, operate and transfer basis or a build own and operate basis;*

2.21 The content of the submission included descriptive information on the BOOT and BOO alternative approaches but no analyses of their financial impacts.

#### ***Audit Comment***

2.22 The potential for a BOOT or BOO option to be adopted appears to have been recognised late in the decision making process. There is documentation of these options being considered at this stage. The documentation, however, does not include analysis of the financial and economic impacts of the options.

#### **Re-consideration of Options in November 2000**

2.23 A Cabinet Submission, prepared in November 2000, identified six options to progress the Centre.

2.24 The options provided to Cabinet for consideration were identified as:

1. do not proceed;
2. negotiate with the conforming tenderer for a pool only on the Jamison site;
3. re-tender for private sector provision;
4. undertake a selective tender process for private sector provision;
5. build only an indoor 50m pool and associated facilities as a capital works project; and
6. proceed with a leisure centre as a capital works project.

2.25 The submission recommended Option 3 - “that public tenders be called again based on a Government contribution of \$8m and located at the Belconnen Town Centre site” and that the term of the lease be increased to 99 years.

2.26 Cabinet agreed to proceed with Option 3 –with one substantial change to the recommendation, the Government contribution was increased to \$10m. No mention of the contribution being increased from \$8m to \$10m was included in the submission.

2.27 The Cabinet submission included the following statement in relation to Option 1.

*The risk with Option 1 (Do not proceed) is the damage from the criticism about our failure to honour our election commitment.*

2.28 The Liberal Government’s election commitment to provide the Centre is outlined in *paragraph 2.4* of this Report. The existence of the commitment eliminated the option of not providing the Centre.

### ***Audit Comment***

2.29 There seems to have been no financial or cost benefit analysis prepared which directly supported the Cabinet decision to re-tender for private sector construction and operation. Nor was there a financial analysis supporting the decision to increase the Government contribution from \$8 to \$10m or to increase the lease term from 30 years to 99 years. The ‘do not proceed option’ was excluded from consideration for political reasons.

## **BUSINESS CASE PREPARATION**

### **Introduction**

2.30 Except in rare circumstances, for all significant projects, it would be expected that a business case would be prepared which demonstrated whether a preferred option for delivering a project will maximise the community benefits from the project and whether the capital investment is economically sound.

2.31 It is standard practice for business cases to be prepared in accordance with Treasury guidelines. Sound business cases are required before projects are given approval to proceed. Recent better practice guides advise that business cases should be completed prior to proceeding to tender.

### **Government Construction and Operation of the Centre**

2.32 In January 1998, the Office of Financial Management (OFM)<sup>5</sup> advised the Department of Business, the Arts, Sport and Tourism (BASAT) that the Siting Study January 1998 did not “stack up” and a detailed business case was required.

2.33 Subsequently BASAT prepared a draft business case to support the Centre being considered for the 1998-99 Capital Works Program.

2.34 In February 1998, a final version of the business case was submitted to OFM. In April 1998 OFM advised that it would not support the business case in its current form as it did not “fully expose” all costs of the project.

### **Private Development of the Centre**

2.35 The November 2000 Cabinet Submission which supported the Cabinet decision to re-tender for a private sector developer/operator included the comment that the Department of Treasury advised that a full business case needed to be considered before the Centre was included in the 2001-02 Capital Works Program. The sponsors of the submission, the Department of Education and Community Services, supported this action. However, no business case was prepared.

### ***Audit Comment***

2.36 The Audit’s review of available documentation shows that a standard business case was never prepared as part of the decision making process for the construction and operation of the Centre.

### **CONCLUSION**

2.37 The initial consideration of options for the provision of the Centre was timely but not thorough. It did not include a cost benefit analysis and was based on limited financial projections. A thorough financial analysis and public benefits assessment was performed for a narrow range of options for the Centre but a sound business case was not prepared.

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<sup>5</sup> Prior to the formation of the Department of Treasury in 1999 the Office of Financial Management within Chief Minister’s Department reviewed business cases for major projects.

2.38 The privatisation approaches of BOOT or BOO options were not fully analysed for the financial impacts of the two alternatives before the BOO approach was agreed to by Cabinet. Re-consideration of the options in the final decision phase to proceed with the Centre also did not include thorough financial comparisons.

2.39 The Audit's view is that the Centre project was not the subject of timely and thorough comparative financial analyses of a full range of potential alternatives.

2.40 Earlier it was explained that government officials conducted their analyses and other planning for the Leisure Centre in the context that both the Government and the Opposition were committed to provision of a Centre. In this situation Government officials may have accepted that the decision to provide the Centre was 'fait accompli' and therefore expending time and resources on additional extensive analyses was probably judged by the officials as being non-productive.

## **SUGGESTED ACTIONS ARISING FROM THIS CHAPTER'S FINDINGS**

### ***Suggested Action 1***

2.41 For all major projects, thorough and detailed financial and economic analyses should be prepared and the information produced taken into account for decision-making and resource allocation.

### ***Suggested Action 2***

2.42 Treasury guidelines should always be followed in the preparation of financial and economic analyses referred to in *Suggested Action 1* to ensure that resource allocation decisions are based on acceptably prepared quality information suitable for the purpose intended.

### ***Suggested Action 3***

2.43 Departures from *Suggested Actions 1* and *2* should only occur when Cabinet or a Minister direct that financial and economic analyses are not to be performed.

*Suggested Action 4*

2.44 Any Cabinet or Ministerial directions that financial and economic analyses are not to be performed should be in writing<sup>6</sup> and include the reasons why the analyses are not to be performed.

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<sup>6</sup> For example, as suggested by the Treasury department in a response to this Report, where such a direction is given in a Cabinet context then the minutes of the meeting could in the normal course of events record that direction. Where a Minister gives a direction officials should record the direction in a note to file.

### **3. SELECTION OF DEVELOPER/OPERATOR**

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#### **INTRODUCTION**

3.1 This Chapter provides the Audit's assessment of the selection of the private sector proponent to design, develop and operate the Centre. The Chapter reports on whether the best available proponent was selected.

#### **SIGNIFICANT FINDINGS**

- *The best available proponent was selected. There was only one viable bid received.*

#### **FIRST TENDER PROCESS**

3.2 Two tender processes were carried out. At the conclusion of the first tender process there were unresolved issues related to the project cost and to the viability of the bid. As a result the first tender process did not identify a successful proponent.

#### *Audit Comment*

3.3 The Audit agrees with the decision that no suitable proposal was received in the first tender process and the correct course of action was not to proceed.

#### **SECOND SELECTION PROCESS**

3.4 As stated a second tender process was undertaken. The second process was completed in June 2001 and a preferred developer/operator selected. As with the first process, the Audit reviewed the process and is satisfied that on the whole the procedures followed were sound.

#### **LIMITED COMPETITION**

3.5 Cabinet were advised in November 2000 that there had been a limited number of viable proposals received in the first tender process and that it was likely that there would be limited interest in a second tender process. This proved to be the case. Not only was there limited competition, only one of the bids received was viable.

***Audit Comment***

3.6 The second tender evaluation process assessed that only one bid was viable. The Audit's review of the tender documentation supports that assessment. Of the available competition the best bid was selected.

***Further Audit Comment***

3.7 The Audit did not review why competition to develop and operate the Centre was sparse. One possible contributing reason could be that market awareness was not effectively created among potential developers of the opportunity to develop the Centre. A second reason could be that the project was inadequately defined and this caused potential developers to be wary of the project.

**CONCLUSION**

3.8 The Audit assessed that the best available proponent was selected. This was primarily because there was only one viable proponent identified in the process.

## **4. ACHIEVEMENT OF GOVERNMENT INTENTIONS**

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### **INTRODUCTION**

4.1 This Chapter provides the Audit's assessment of whether Cabinet's significant intentions are likely to be achieved through the privatised method of developing and operating the Centre.

### **FINDINGS FROM THIS CHAPTER**

#### **Positive Findings**

- *Cabinet's intentions for the core facilities to be included in the Centre are likely to be achieved.*
- *Cabinet's intention to limit the Government contribution for the Centre to \$10m is likely to be achieved.*
- *Cabinet's intention to legally allocate specified risks to the developer/operator is likely to be achieved.*
- *Cabinet's intention that access to the Centre's core facilities for the public will be assured is likely to be achieved.*

#### **Risk Finding**

- *The Government may become exposed to Cabinet's intention for government contributions to be confined to core facilities not being achieved as there is no legal provision which can be used to enforce Cabinet's intention.*

### **AUDIT APPROACH**

4.2 The Audit's assessment of whether Cabinet's significant intentions are likely to be achieved was based primarily on an evaluation of what has, or will be, achieved against what was intended to be achieved as outlined in Cabinet decisions.

4.3 As a first step the Audit examined the relevant Cabinet decisions and submissions to identify what Cabinet's intentions were for the Centre. The Audit then assessed the extent to which the significant intentions have been implemented or are likely to be implemented.

4.4 An August 1999 Cabinet Decision sets out Cabinet's intentions in relation to the provision of the Centre. These can be categorised under

the headings of:

- core facilities;
- Government contribution;
- allocation of risks; and
- public access to facilities.

4.5 Each category is discussed in the remainder of this Chapter.

### **CORE FACILITIES**

4.6 Both the project agreement made between the Government and the developer/operator, and the crown lease of the site granted to the developer/operator, require that the Centre will incorporate “core facilities”. The “core facilities” are listed in the definition sections of the project agreement as follows:

- heated 50 metre indoor pool with moveable bulkhead;
- seating for 800 spectators;
- timing equipment and public address systems; and
- an aquatic pool incorporating water activities and which is convertible to a three lane 25 metre warm-up area.

4.7 Similar core facilities are included in the Crown Lease.

4.8 The core facilities included in the project agreement and the crown lease are consistent with the core facilities which the Cabinet intended should be provided in the Centre.

#### ***Audit Comment***

4.9 The Cabinet’s intentions concerning core facilities to be included in the centre will be achieved as long as the completed Centre complies with the crown lease and the project agreement.

### **GOVERNMENT FINANCIAL CONTRIBUTION**

4.10 In April 1999 Cabinet agreed to proceed with the Centre subject to the Government financial contribution not exceeding \$8m. A later Cabinet decision increased the contribution to \$10m.

4.11 The Government had four intentions in relation to the Government contribution. These were that the contribution:

- would be spent on core facilities;
- would not be paid until certain conditions were fulfilled;
- would not exceed \$10m; and

- would guarantee public access to the Centre's core facilities.

### **Contribution to be Spent on Core Facilities**

4.12 It was seen as important by Cabinet for the Government contribution to be expended on the core facilities at the Centre and not subsidise facilities from which the developer/operator could expect to profit. The profit making facilities were to be funded by the developer/operator.

4.13 The project agreement conditions for payment of the Government contribution to the developer/operator does not include that the payments be used only for core facilities. The project agreement treats all contribution payments as being towards the total cost of the centre.

4.14 The Audit sighted a letter prepared by the quantity surveying firm engaged by the Department of Education and Community Services to monitor the developer/operator's construction costs. The letter provides an assurance that the Government's contribution will be monitored to ensure the contribution does not exceed the estimated costs of the core facilities.

### ***Audit Comment***

4.15 There are no specific legal conditions requiring that the Government's \$10m contribution is used only for expenditure on the Centre's core facilities. Monitoring by the Government's quantity surveyor however should result in assurance that the Government contribution is approximately equivalent to the cost of the core facilities. There is no legal basis however to support these efforts.

### **Contribution not to be Made Until Certain Conditions Fulfilled**

4.16 In August 1999, the Cabinet stated its intention for the conditions upon which the payment of the Government contribution should be made as follows:

*the Government's financial contribution be provided only after a substantial component of private sector funding has been applied to the project and subject to evidence of the proponent's capacity to finance the remaining construction;*

4.17 Conditions have been included in the completed project agreement with the developer/operator that give effect to the Cabinet's intentions.

4.18 The project agreement requires that the Government is not required to make contributions to the Centre until the developer/operator's funds have been fully expended and the cost to complete the construction of the facility is no more than \$10m.

***Audit Comment***

4.19 The Cabinet's intention for the Government contribution to only be paid to the developer/operator upon the fulfilment of certain conditions is likely to be achieved as suitable conditions are stipulated in the legal agreement made between the Government and the developer/operator.

**Contribution Not to Exceed \$10m**

4.20 Cabinet's intention was that the Government contribution was not to exceed \$10m.

4.21 The project agreement legally limits the contribution to \$10m. This provides assurance that the Government's contribution will be limited to \$10m.

***Audit Comment***

4.22 The Cabinet intention for the Government contribution to be no more than \$10m is likely to be achieved as the limitation is incorporated in the legal agreement made between the Government and the developer/operator.

**ALLOCATION OF RISKS**

4.23 The August 1999 Cabinet Submission included an attachment titled 'Risk Allocation Table'. The table identified risks including design, construction, site, finance, ownership and operational risks, and the intended allocations of these risks between the developer/operator and the Government. Cabinet agreed to this allocation of risks.

***Risks Allocated to Developer/Operator***

4.24 The Audit requested the Government Solicitor's Office to assist the Audit by identifying whether the twenty five risks intended to be allocated to the developer/operator were effectively allocated by the legal agreements made between the developer/operator and the Government. The Solicitor's Office provided comprehensive confirmation that apart from one significant exception this was the case.

4.25 The significant exception is that there is no provision in the agreement requiring the developer/operator to compensate the Government for costs the Government may incur as a result of the agreement being terminated through the developer/operator failing to meet the agreement's terms (sometimes referred to as "step-in" costs).

***Audit Comment***

4.26 With the exception of one significant departure, Cabinet's intended allocation of risks to the developer/operator has been implemented. (See also *Chapter 6*.)

**PUBLIC ACCESS TO THE CENTRE**

4.27 It was Cabinet's intention that continuing public access to the Centre was to be assured.

4.28 This was to be achieved by requiring prospective developer/operators to specify their pricing regime for public access to the Centre in their tender bids and for evaluation criteria for the pricing regime to be part of the tender evaluation process.

4.29 The successful developer/operator's bid included the pricing regime. The pricing regime was considered in the tender evaluation process and is included in the project agreement made between the Government and the developer/operator.

4.30 In addition the project agreement requires the facility to be open at specified times year round except for Christmas Day and Good Friday.

***Audit Comment***

4.31 The project agreement includes a requirement that the developer/operator keep the Centre open during periods and times when the public would be expected to access the pool. This, combined with an entry fee structure which is reasonably affordable, should result in the public's access to the Centre being assured.

**CONCLUSION**

4.32 The Audit assessed with one exception that Cabinet's intentions are likely to be implemented. The core facilities intended to be implemented have been included as legal requirements in documentation; the twenty five risks on the whole have been accepted and reflected in

agreements as have public access to the facilities in terms of opening times and attendance fees.

## 5. COMPARATIVE COSTS

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### INTRODUCTION

5.1 This chapter provides the results of the Audit's comparison of the likely cost to the Government of different approaches to delivering the Centre. The estimated costs of the private Build, Own and Operate (BOO) method to provide the Leisure Centre were compared with an estimate of the costs which would have been incurred if the traditional approach of providing the Centre had been adopted i.e. the Government funding full construction and operation of the Centre.

### SIGNIFICANT FINDING

#### Positive Finding

- *The Government's costs using the private sector build, own and operate (BOO) approach are likely to be no greater than the costs that would have been incurred if the Centre was Government constructed, owned and operated.*

### BACKGROUND

5.2 Most large public aquatic leisure centres proposed or recently built in jurisdictions across Australia include similar facilities to those intended for the Belconnen Centre. It is typical for these centres to have significant dry facilities (e.g. gymnasium, aerobics, kiosk, coffee lounge, function halls etc).

5.3 In almost all cases the construction of aquatic leisure facilities has been financed by a combination of state and Local Government funding. Ownership of these facilities and the associated land has generally remained with Local Government bodies. The capital cost of these facilities, depending on their individual design components, ranges between \$15-17m. The total cost of the Belconnen Centre has been estimated to be \$15m.

5.4 The operation of most of the facilities is contracted out to private developer/operators. Although some facilities generate an operating surplus it is not uncommon for aquatic leisure centres to generate operating losses. The Government owner of the centre usually funds the losses in the form of a subsidy. It is rare for publicly owned aquatic leisure centres to generate sufficient revenue to recover capital costs and/or produce a commercial return on investment.

## INDICATIVE COST COMPARISON

5.5 To assess the comparative costs the Audit made two cost estimates. The first was for the private approach being implemented (the BOO approach) and the second was if the facility had been Government constructed and owned.

5.6 As aquatic centres rarely recover capital costs or generate a commercial return on investment the comparisons were restricted to a comparison of operating revenues, initial capital contributions and land values.

5.7 The estimates should be regarded as indicative. The purpose of the estimates was to identify whether the BOO approach adopted by the Cabinet could result in costs significantly exceeding the costs which would have been incurred if the Centre was Government constructed and operated.

### Private Provision

5.8 Under the privatised Build, Own and Operate (BOO) approach the Government will make a once only capital contribution for the construction of the Centre. The Government will receive no operating revenue from the Centre and will not provide any operating subsidies or contribute to future maintenance or refurbishment of the Centre.

5.9 All profits will belong to the developer/operator and all losses will be the developer/operator's responsibility.

5.10 The Government has sold the land to the developer/operator at market value and therefore has foregone any future capital gain from the land including that for an alternative use.

5.11 The project agreement limits the Government's cost to a \$10m contribution to the construction of the Centre. Legally this is the only direct cost to the Government.

5.12 As stated the Government has sold the land for the Centre directly to the developer/operator for \$0.5m. As the Government has sold the land it has foregone any future revenue from the site in the form of capital gains or rental. The present value of the alternative use of the site as medium density housing (as per the Department of Education and Community Service's valuations) is \$1.5m. Therefore the present value of the future revenue foregone by the Government is approximately

\$1.5m. This is an indirect cost to Government.

5.13 For a privately provided Centre the Audit’s broad estimated net cost to Government is as shown in Table 5.1.

<b>Table 5.1 BOO Approach</b>	<b>\$m</b>
<b>Costs</b>	
Capital Contribution	10.0
Future revenue foregone	1.5
	11.5
<b>Revenue</b>	
Price paid by developer/operator for Centre Site	0.5
<b>Net Cost</b>	\$11.0

### **Government Owned and Operated Facility**

5.14 A traditional approach could have been adopted. Using this approach the Government would pay for the construction of the Centre and meet the ongoing costs of its continued operations and ongoing maintenance. In this case the Government would have retained the land on which the Centre is being constructed and consequently would incur any costs or benefit from any gains arising from the land.

5.15 The audit estimated the net present cost of the project as a Government owned and operated facility using a range of assumptions and scenarios. The Audit’s estimates of net present cost in all the estimated scenarios showed that the costs which would have been incurred if the Centre was Government constructed and operated would have been greater than for the BOO approach adopted by the Cabinet.

### ***Audit Comment***

5.16 The Audit’s estimates indicate that cost to the Government from adopting a Government constructed and operated approach would likely have been greater than the chosen private provision approach.

### **CONCLUSION**

5.17 The Audit’s estimates indicate that the Government’s costs using the BOO approach are likely to be no greater than the cost that would be incurred if the Centre was Government owned and operated.

## **6. GOVERNMENT EXPOSURE TO RISKS**

6.1 The Audit included assessing the extent to which the Government is exposed to risks from public pressure (political risk), substandard operational performance, the financial non-viability of the developer/operator, changes in ownership, non-delivery of the facility design and conditions of the pool site. The results of the assessments are summarised in this Chapter.

### **POLITICAL RISK**

#### **Introduction**

6.2 It must be recognised that there are certain risks which, although they may be legally transferable from the Government to the private sector, can never be fully transferred for political reasons. For core public services Governments cannot avoid remaining exposed to certain risks even though binding contract arrangements which legally transfer the risks have been agreed. This is because the existence of ‘implied’ Government guarantees to deliver core public services to the community are a political reality.

6.3 The guarantees arise because the electorate expects that if core services are not adequately delivered by a private sector contractor the Government will take the action necessary to ensure the community receives the services. In a political sense Governments cannot escape their responsibilities to the community by telling the community that the responsibilities have been contracted to the private sector.

6.4 Government’s face political pressures that can lead them to accept liabilities for privately provided projects for which they are not legally responsible. These contingent liabilities cannot be eliminated. The pressure on government to intervene in failing projects is likely to be particularly acute if the degree of political embarrassment is high. For further information on political risk please refer to **Appendix A** to this Report.

#### **Significant Finding**

- *The Government may become exposed to additional financial costs through political risk.*

## **Community Expectation**

6.5 As did the previous Government, the current Government has made public commitments on various occasions that an aquatic leisure centre would be available to the public in the Belconnen region. These commitments established an ‘implied Government guarantee’ that the Belconnen community will have an aquatic centre.

6.6 In the case of the Leisure Centre, because of the implied guarantee, the Government could in certain circumstances find it unavoidable to contribute funds for the Centre above those legally required by the project agreement. For example, a need for the Government to contribute additional funds could be triggered by a blow-out in the project cost which the developer/operator is unable to finance from its own sources. The Centre’s operations proving to be financially non viable could also generate a need for the developer/operator to obtain extra funds. If the developer/contractor could not obtain the extra funds necessary to ensure the Centre was constructed and/or operated as promised, the community would expect the Government to contribute the additional funds.

### ***Audit Comment***

6.7 While legally the Government is required to contribute a maximum of \$10m the Government may become exposed to ‘political’ risk if, for example, the construction cost escalates or the Centre’s operations prove to be financially non-viable. If the total project cost blows-out or the Centre becomes non-viable the Government is likely to be politically obliged to meet its ‘implied’ guarantee to complete the Centre and/or to financially support its continued operations. The existence of this political risk must be recognised.

## **OPERATIONAL RISK**

### **Introduction**

6.8 The Audit included assessing the risk to which the Government could be exposed if the developer/operator does not operate the Centre in accordance with requirements set out in the project agreement. To assess the risk the Audit reviewed whether the legal agreement with the developer/operator and/or the crown lease include sanctions or other mechanisms which the Government can use to ensure the developer/operator meet its project agreement obligations.

### **Significant Findings**

- *The Government may become exposed to pool services being delivered to the community at less than required standards as the Government has no flexible mechanisms which provide incentives for the developer/operator to fully comply with required standards of service.*
- *The Government may become exposed to the costs of maintaining the Centre's operations if the developer/operator breaches the project agreement as a performance bond to cover the Government's costs has not been put in place.*

### **Available Sanction**

6.9 The project agreement sets out significant events that may trigger termination of the project agreement and the crown lease. These include failure by the developer/operator to operate the Centre in accordance with the project agreement's requirements.

6.10 Invoking the project agreement termination provisions is the only sanction legally available to the Government if the developer/operator does not meet its project agreement obligations.

### ***Audit Comment***

6.11 If the developer/operator does not meet its project agreement obligations the Government has a powerful sanction available to it i.e. termination of the project agreement. It seems unlikely, however, that the Government would use the termination sanction other than for significant and repeated performance breaches of the project agreement. Lesser breaches are unlikely to be seen to warrant taking the drastic action of terminating the agreement. The Government may therefore be exposed to the risk of continuing marginal under performance.

### **Useful Mechanisms not Adopted**

6.12 The Audit has identified two mechanisms that may be included in agreements with private sector organisations to ensure that the organisations provide services and facilities to the standards intended. These are withholding payments and requiring the private sector organisations to enter into performance bonds. No mechanisms of this nature are included in the legal agreements for the Centre.

6.13 *Payment Withholding Mechanisms* – Legal agreements between governments and private sector organisations delivering services on behalf of governments sometimes include provisions allowing for payments due to the private sector organisation to be withheld if the developer/operator is failing to deliver services to the required standard.

6.14 A majority of aquatic centres are operated using payment withholding provisions as ongoing performance incentives. As mentioned there are no provisions of this nature in the legal agreements for the construction and operation of the Centre.

6.15 *Performance Bonds* – Performance bonds are capital sums paid by private sector organisations contracted to deliver services on behalf of governments. The payments are held in trust. In the event that the private sector organisation becomes insolvent, or needs to be replaced for non-performance, the government can access the bond to meet the costs of providing the services until alternative arrangements can be made.

6.16 The detailed proposal documentation developed prior to the legal documents for the Centre being finalised referred to a \$.25m guarantee which was to be included in the project agreement for the Centre. The completed agreement however does not include either a guarantee or a performance bond.

6.17 It is noted that the need for leisure centre developer/operators to be replaced occurs on occasions. For example, a management group which provided leisure centre management on a contract basis for several local government councils became insolvent in 2002.

## **FUTURE OWNERSHIP RISK**

### **Introduction**

6.18 The Audit included assessing the risks to which the Government may become exposed in the event that the current developer/operator is replaced as owner of the Centre by another organisation. Replacement could occur, either as a result of the developer/operator voluntarily selling the Centre, or the Centre being sold by a liquidator/receiver following the developer/operator being placed into liquidation or receivership.

6.19 To assess this risk the Audit reviewed the legal agreements and the crown lease to identify whether the Government had control over who the Centre can be sold to in the future.

### Significant Findings

- *The Government in most foreseeable circumstances will be consulted on the appointment and suitability of a new developer/operator in the event of the Centre developer/operator becoming insolvent.*
- *An agreement with the developer/operator and the developer/operator's financier, which will give the Government some control over the quality of a replacement developer/operator by the project's financier, has been finalised.*
- *A second mortgage which could protect the Government's position in the line of creditors in the event of receivership had not been completed at the time of preparing the final draft of this Report.*

### Voluntary Sale of the Centre

6.20 The Crown Lease for the land on which the Centre is located was granted on 20 May 2002. The lease includes the following clauses:

*The Lessee shall not assign or transfer the Crown Lease without the consent of the Executive for the period commencing on the date of commencement of the lease and ending on the thirtieth anniversary of Practical Completion; and*

*The Executive shall consent to the transfer of the Crown lease provided that the person to whom it is proposed that the lease should be assigned or transferred has entered into the Project Agreement, or another agreement in substitution therefore to satisfaction of the Government;*

### Audit Comment

6.21 Since clauses included in the crown lease are transferable between lessees the Government has adequate control if the Centre's ownership is voluntarily transferred by the developer/operator. Under the crown lease the Centre can only be transferred by the current developer/operator to an organisation which accepts the same operating obligations that are held by the current developer/operator.

**Liquidation or Receivership of Developer/Operator**

6.22 The Government's position in the event of liquidation or receivership of the developer/operator was considered. Advice was sought from the Government Solicitor as to whether the Government's position could be adversely affected should a creditor be successful in having the developer/operator placed in receivership (eg could the project agreement be set aside).

6.23 The Government Solicitor advised that the terms of the Crown Lease would apply to the receiver in most circumstances. The terms of the Crown Lease require compliance with the terms of the project agreement.

6.24 An agreement between the Government, the developer/operator's financiers and the developer/operator was signed by the necessary parties on 18 February 2003. One purpose of the agreement is to ensure that the financier will consult with the Government as to the suitability of a new developer/operator if selling the Centre.

6.25 Also, a second mortgage for the Government is intended. The purpose of the second mortgage is to protect the Government's interests in line with other creditors in the case of the developer/operator's insolvency. At the time of completing the final draft of this Report the mortgage had not been finalised.

***Audit Comment***

6.26 The Government's position is protected for ensuring that the Centre continues to be operated in accordance with the project agreement in the event that the developer/operator goes into liquidation or receivership.

6.27 Because the second mortgage has not been completed the Government's position as creditor is at some risk should the developer/operator become insolvent.

6.28 In response to the proposed draft of this Report and additional information requests the Audit was advised in late February of the latest developments on the completion of a second mortgage. The Audit's comments on the agency's response are provided in *paragraph 1.38 of Chapter 1* of this Report.

## DESIGN RISK

### Introduction

6.29 This Audit included assessing whether the Government could be exposed to risks that the completed Centre will not be suitable to meet Cabinet's intentions for the Centre as a result of being constructed to a design which is inconsistent with the original design concept and the final design specifications.

### Significant Finding

- *The Government may become exposed to the completed Centre not fully meeting final design requirements for the Centre as the project agreement does not require that the completed Centre complies with final design specifications.*

### Relevant Project Agreement Provision

6.30 The project agreement includes the following clause.

*The Government may, but is not obliged to, review the Design Documentation to monitor compliance with the Detailed Proposal.*

6.31 The principle of allocating design risk to the developer/operator relies on the Government avoiding becoming directly involved in the design and construction of the project and thus inadvertently "taking back" risk which has been allocated to and accepted by the developer/operator. The inherent risk in this "hands off" approach is that the project delivered may not conform with the requirements of the final design.

6.32 The Audit identified two ways to mitigate this risk without becoming directly involved in the design. The first is for agreements between the parties to specify that the completed project must comply with the final design of the proposed project. The second is monitoring to ensure that the final design reflects the design concept and the project delivered conforms with the final design.

6.33 The project agreement for the Centre does not specify that the final design is the project deliverable. The project agreement only allows the Government to require compliance with the design put forward in the detailed proposal.

## **Monitoring**

6.34 The relevant Department of Urban Services project officer has advised the Audit that a comparison of the final design and concept design submitted in the tender proposal has been performed. The results of the assessment were satisfactory.

6.35 The project officer has advised the Audit that conformance of the construction of the project with the design concept and final design will be monitored as part of the Government quantity surveyor's assessment of cost to completion.

## ***Audit Comment***

6.36 An accepted methodology for private provision of infrastructure includes design risk being allocated to the private sector. This methodology has been followed for the Centre and is reflected in the project agreement.

6.37 There may be a downside to this approach if, as has occurred with the Centre, the "hands off approach goes so far as to not fully specify the project deliverables in the legal agreements. As deliverables have not been specified in the project agreement monitoring activities are ineffective for legally enforcing that the Centre will be fully constructed according to the final detailed design proposal.

## **SITE RISK**

### **Introduction**

6.38 The Audit included assessing the risk to which the Government could become exposed as a result of the existence of a fault line and of ground water on the site at which the Centre is being constructed. To assess the risk the Audit reviewed the legal agreement and crown lease to identify who would be required to meet costs which could be incurred if the fault line or ground water caused unexpected problems.

### **Identified Site Faults**

6.39 Two geo-technical survey reports prepared by consultants commissioned by the Government identified that a fault line runs through the site and that ground water is also present. Based on their findings the consultants made recommendations about how best to position a swimming pool on the site.

6.40 At the Audit's request officials obtained assurances from the developer/operator, which confirmed that the intended design for the pool would address the risk identified in the geo-technical survey as posed by the fault line.

### **Relevant Project Agreement Provision**

6.41 The project agreement includes that the developer/operator accepts liability for, and assumes the risk of, all costs, losses, expenses and damages it may suffer or incur arising out of or in connection with the conditions and the characteristics encountered on, in, under, near, or in connection with the land and its surroundings.

### ***Audit Comment***

6.42 Advice provided by the Government Solicitor's Office to the Audit is that the project agreement effectively allocates the site risks to the developer/operator. The Government will therefore be able to rely on the clauses in the project agreement in the event of problems arising from the fault line or the ground water. It should be noted this could be an area of political risk if, for example, the developer/operator does not have funds to rectify the problem and consequently the pool becomes unavailable to the public.

## **CONCLUSION**

6.43 The Audit assessed the Government's exposure to risks from political risk, substandard operational performance, the financial non-viability of the developer/operator, changes in ownership, conditions of the pool site and non-delivery of the facility design. As described in this Chapter the assessments revealed that the Government remains exposed to a number of risks.

## **SUGGESTED ACTIONS ARISING FROM THIS CHAPTER'S FINDINGS**

### **Political Risk**

#### ***Suggested Action 5***

6.44 For all major projects Cabinet should ensure it understands the political risk inherent in the projects before committing the Government to the projects.

***Suggested Action 6***

6.45 The Government's total exposure to existing politically sensitive projects should be taken to account in the assessment of the political risks inherent in potential new projects.

**Operational Risk*****Suggested Action 7***

6.46 Contracts with private sector organisations for delivery of significant core public services should provide for payment withholding mechanisms which can be used as a sanction to motivate ongoing sound operational performance.

***Suggested Action 8***

6.47 Contracts with private sector organisations for delivery of significant core public services should require contractors to provide a performance bond of sufficient amount to cover any Government costs which may be incurred to continue the delivery of the services if the contractor ceases to deliver the services prior to expiration of the contract term.

**Design Risk*****Suggested Action 9***

6.48 Contracts with private sector organisations for delivery of significant core public services should require that the completed project is to comply with final design specifications.



## **APPENDIX A – GOVERNMENT’S CREDIT RATING**

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### **EXTRACT FROM: PUBLIC PRIVATE PARTNERSHIP PROJECTS CAN AFFECT A STATE’S CREDIT RATING**

**(Published in Standard & Poor’s journal ‘Credit Focus’ August 2002 edition)**

#### **The Governments Contingent Liability**

Governments also face political and financial pressures and incentives that can lead them to accept liabilities for which they are not legally responsible. Although not a PPP project, a recent example of this is state governments picking up some of the liabilities of the failed HIH Insurance Ltd.

Clearly, assessing how future governments may react to a PPP project that is under financial pressure is very difficult and unavoidably subjective. These contingent-type liabilities cannot be eliminated by better-designed projects or by better-worded documentation. They arise because governments will react to a whole range of pressures and incentives facing them in the event of a PPP project encountering financial difficulties, not just to the legal technicalities in the project's documentation.

#### **Political Incentives**

Where voters strongly identify a particular PPP project with the sponsoring government, it may be politically difficult for the government to adopt a “hands-off” approach if that project gets into difficulty. The following factors influence the degree of voters' identification.

- Public support for the project - the extent to which the government has invested its own political prestige in the project through strong public identification with it and support to the proponents in dealing with any opposition to the project.
- Essentiality of the service - governments will continue to be held accountable by the community for the continuity of essential services, regardless of who is providing them.

- Legal support - the extent to which legislative backing is required for the project (for example, for land acquisition, enforcing user charges, and for providing legal indemnities).
- Financial support - the extent to which the government provides financial support by way of a direct use of taxpayers' funds or contributing assets at below market value.

The pressure on governments to intervene in failing projects is likely to be particularly acute if the continuity of an essential service is threatened or the degree of political embarrassment for a government is high. An example of the latter may be the failure of a project during its construction phase, leaving half built structures as a reminder to voters of a failed government initiative.

### **Financial Incentives**

There may also be financial incentives for a government to financially support a PPP project beyond what it is legally obliged to do. For example, recently the Victorian government provided additional funds to the financially troubled private-sector operators of the Melbourne public transport system. In doing so the government stated that one of the reasons for its action was that it considered that a cheaper option than allowing the operators to fail and then having to restart the franchising out process.

### **Reasons for Government Not to Bail Out Financially Troubled PPPs**

It is important to note that a PPP in financial difficulty does not mean a government bailout is inevitable. There are also powerful incentives for governments not to bail out projects. For example, a bailout sends wrong signals to prospective bidders for upcoming PPP projects that the government will rescue them if they bid too aggressively. A bailout is less likely where the private-sector parties can absorb the financial losses or can be replaced.

## APPENDIX B – CABINET SUBMISSIONS AND DECISIONS

<b>Titles of Cabinet Submissions and Decisions</b>	<b>Date</b>	<b>Dec. No.</b>	<b>Sub. No.</b>
<i>Sport, Recreation and Racing Budget Strategy 1995-97 to 1997-98 (part of)</i>	31/07/95	5214	4194
<i>1997-98 Draft Capital Works Program (part of)</i>	16/12/96	5949	
<i>Revised 1997-98 Draft Capital Works Program (part of)</i>	03/02/97	5976	4838
<i>Strategic Review of Swimming Pools and Related Facilities (part of)</i>	02/04/97	6096	4927
<i>Strategic Review of Swimming Pools and Related Facilities – Results of Community Consultation (part of)</i>	15/12/97	6565	4825
<i>Revised Draft Capital Works Program 1998-1999 (part of)</i>	20/04/98	6718	5521
<i>1999-2000 Draft Capital Works Budget Submission (part of)</i>	21/12/98	7133	5784
<i>Belconnen Leisure Centre</i>	27/04/99	7313	5907
<i>Belconnen Leisure Centre – Government Approach</i>	09/08/99	7442	5992
<i>Belconnen Indoor Swimming Facility</i>	26/04/00	7838	6238
<i>Belconnen Indoor Swimming Pool Complex Report</i>	11/09/00	8023	6365
<i>Belconnen Indoor Swimming Pool Complex</i>	04/12/00	8142	6442



## **APPENDIX C – RISK MANAGEMENT PROCESSES**

The ACT Government Procurement Board has adopted AS/NZS 4360:1999 the basis for risk assessments of all procurement proposals for goods, works or services for the Territory of a value greater than \$50,000. Reference to the risk management process is made in Category 2 and Category 6 of the Board’s Policy Framework. The following overview of risk management processes is partly developed from this standard and is intended to provide a useful introduction to this approach.

Risk management is defined as a ‘logical and systematic method of establishing the context, identifying, analysing, evaluating, treating, monitoring and communicating risks associated with any activity, function or process in a way that will enable organisations to minimise losses and maximise opportunities.’<sup>7</sup>

The risk management process has five main steps. These steps are:

- establish the context;
- identify the risks;
- analyse the risks;
- assess and prioritise the risks; and
- treat the risks.

There is an overarching process of continually monitoring and reviewing the five steps in the risk management process.

It is important that an appropriate level and standard of documentation is maintained of the risk management process described to ensure that the process is done correctly, to enable decisions or processes to be reviewed and to demonstrate accountability.

### **Establishing the Context**

It is essential that the environment within which the project is set is adequately defined. An important part of this step is establishing how

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<sup>7</sup> “Risk Management AS/NZS 4360:1999” Standards Australia, Standards New Zealand

much risk is acceptable and identifying the major risks and suitable criteria to assess the level of risk posed.

The relevant stakeholders should be identified and their interests defined so that they can be taken into consideration.

### **Identifying the Risks**

This step involves identifying the risks, which arise from all aspects of the environment in which the project is set. “Unidentified risks can pose a major threat to the project and project sponsor. It is important that the wide range of risks is identified.”<sup>8</sup>

Good risk identification involves examining all sources of risk and the perspective of stakeholders so that analysis can consider the contribution each makes to the likelihood and the consequences of the risk.

### **Analyse the Risks**

The likelihood and consequence of each risk should be established. Managers generally use their experience, judgement, and intuition to make qualitative decisions in arriving at which risks pose a major threat to the outcome of a project.

Risks that require management are usually ranked as being extreme, very high, medium, low. The consequences of extreme risks would be expected to threaten the whole project and the sponsoring agency. The consequences of very high risks would threaten the continued effective function of the project and require top level management and ministerial intervention. It is reasonable to expect that senior management would be involved in controlling extreme and very high risks and have detailed research and plans for its management in place. Documentation for the management and mitigation of these risks should be of a high standard and demonstrate that the consequences, likelihood and approaches to manage the risks have been properly assessed.

The consequences of medium risks could subject the project to significant additional costs or delays. The consequences of low risks would threaten the efficiency or effectiveness of some aspect of the

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<sup>8</sup> “Guidelines for Managing Risk in the Australian Public Service” MAB/MIAC Report No.22 October 1996, page 23.

project. It is reasonable to expect that routine procedures have been put in place and followed to manage these types of risk.

### **Assess and Prioritise the Risks**

The various risks identified should be assigned a risk rating and ranked in order. Acceptance of a risk is an acceptable management option. Sound reasons for accepting a risk include:

- the level of risk is so low that the cost of treatment is not warranted;
- there is no known treatment available or the treatment is beyond the control of the manager; and
- the opportunities presented outweigh the threats to such a degree that the risk is justified.

### **Treat the Risks**

A method of treatment should be developed and clearly identified for those risks that have been classed as being unacceptable. Steps should be taken by management to avoid, reduce or transfer risks.

The risks associated with a project can be completely avoided by simply not proceeding with the project for example. A risk can be reduced or mitigated by minimising its likelihood or consequences. The inclusion of suitable clauses in a contract can minimise the impact of undesirable event occurring or if it does occur the financial impacts.

A risk can be transferred by shifting the responsibility for the risk to another party by contract, insurance, legislation or administrative process for example.

The options for treating risks should be evaluated in terms of benefits and costs. Options which are likely to provide the most effective risk reduction for the least outlay being the preferred option.

It is not usually feasible to eliminate all risk and proceed with a project. Consideration should be given as to whether the residual risk remaining after treatment is acceptable.

### **Continually Monitor and Review**

Both in the implementation of and after the completion of a project, risks need to be monitored and reviewed as risks may change over time. Monitoring and review of risks may be hindered if the arrangements for

the provision of a project extend over a lengthy period as risks can be expected to change over time.

### **Allocation of Risks**

In recent times, Government's have sought to identify ways to include private sector capital in the provision of public sector infrastructure. In addition to the traditional procurement processes this approach involves detailed risk assessment and allocation of risk between the public and private sector.

This approach involves the development of a fully costed model, including the cost of risks, competitive neutrality and construction expenditure, of what it would cost Government to build own and operate the Centre. This fully costed model or Public Sector Comparator is compared with fully costed private bids for the project to determine which bids for the Centre present value for money to the Government. The principles of risk identification, allocation and transfer between the public and private sector remain important practices to be followed in projects with a lesser value. These principles were considered by the Audit.

## **PREVIOUS AUDIT REPORTS<sup>9</sup>**

### ***Reports Published in 2003***

1. Effectiveness of Annual Reporting
2. Belconnen Indoor Aquatic Leisure Centre

### ***Reports Published in 2002***

1. Special Purpose Review of Part of the Commission of Audit Report on the State of the Territory's Finances at 31 October 2001
2. Operation of the Public Access to Government Contracts Act
3. Governance Arrangements of Selected Statutory Authorities
4. Frameworks for Internal Auditing in Territory Agencies
5. V8 Car Races in Canberra – Costs and Benefits
6. Annual Management Report for the Year Ended 30 June 2002
7. Financial Audits with Years Ending to 30 June 2002

### ***Reports Published in 2001***

1. Financial Audits with Years Ending to 30 June 2000
2. Enhancing Professionalism and Accountability
3. Market Research and Marketing (Second Report)
4. Peer-Based Drug Support Services Tender – 1998
5. The Administration of Payroll Tax
6. Annual Management Report for the Year Ended 30 June 2001
7. Managing Canberra Urban Parks and Open Spaces
8. Canberra Tourism and Events Corporation – Relocation to Brindabella Business Park
9. Agents Board – Financial Administration of Training Grant Program
10. Corrective Services – Review of Certain Allegations
11. Financial Audits with Years Ending to 30 June 2001
12. The Freedom of Information Act

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<sup>9</sup> 46 Reports were issued prior to 1996. Details can be obtained from the ACT Auditor-General's Office or the ACT Auditor-General's homepage: <http://www.audit.act.gov.au>.

### ***Reports Published in 2000***

1. Bruce Stadium Redevelopment — Summary Report
2. Bruce Stadium Redevelopment — Value for Money
3. Bruce Stadium Redevelopment — Costs and Benefits
4. Bruce Stadium Redevelopment — Decision to Redevelop the Stadium
5. Bruce Stadium Redevelopment — Selection of the Project Manager
6. Bruce Stadium Redevelopment — Financing Arrangements
7. Bruce Stadium Redevelopment — Stadium Financial Model
8. Bruce Stadium Redevelopment — Actual Costs and Cost Estimates
9. Bruce Stadium Redevelopment — Market Research and Marketing
10. Bruce Stadium Redevelopment — Stadium Hiring Agreements
11. Bruce Stadium Redevelopment — Lawfulness of Expenditure
12. Bruce Stadium Redevelopment — Governance and Management
13. Annual Management Report for the Year Ended 30 June 2000

### ***Reports Published in 1999***

- 1 Stamp Duty on Motor Vehicle Registrations
- 2 The Management of Year 2000 Risks
- 3 Annual Management Report for Year Ended 30 June 1999
- 4 Financial Audits With Years Ending to 30 June 1999

### ***Reports Published in 1998***

- 1 Management of Preschool Education
- 2 Lease Variation Charges - Follow-up Review
- 3 Major IT Projects - Follow-up Review
- 4 Annual Management Report for Year Ended 30 June 1998
- 5 Management of Housing Assistance
- 6 Assembly Members' Superannuation and Severance Payments to Former Members' Staffers
- 7 Magistrates Court Bail Processes
- 8 Territory Operating Losses and Financial Position

- 9 Financial Audits with Years Ending To 30 June 1998
- 10 Management of Schools Repairs and Maintenance
- 11 Overtime Payment To A Former Legislative Assembly Member's Staffer

***Reports Published in 1997***

- 1 Contracting Pool and Leisure Centres
- 2 Road and Streetlight Maintenance
- 3 1995-96 Territory Operating Loss
- 4 ACT Public Hospitals - Same Day Admissions  
Non Government Organisation - Audit of Potential Conflict of Interest
- 5 Management of Leave Liabilities
- 6 The Canberra Hospital Management's Salaried Specialists Private Practice
- 7 ACT Community Care - Disability Program and Community Nursing
- 8 Salaried Specialists' Use of Private Practice Privileges
- 9 Fleet Leasing Arrangements
- 10 Public Interest Disclosures - Lease Variation Charges and Corrective Services
- 11 Annual Management Report for Year Ended 30 June 1997
- 12 Financial Audits with Years Ending to 30 June 1997
- 13 Management of Nursing Services

***Reports Published in 1996***

1. Legislative Assembly Members – Superannuation Payments/Members' Staff – Allowances and Severance Payments
- 2 1995 Taxi Plates Auction
- 3 VMO Contracts
- 4 Land Joint Ventures
- 5 Management of Former Sheep Dip Sites
- 6 Collection of Court Fines
- 7 Annual Management Report For Year Ended 30 June 1996
- 8 Australian International Hotel School
- 9 ACT Cultural Development Funding Program
- 10 Implementation of 1994 Housing Review
- 11 Financial Audits with Years Ending to 30 June 1996

### **Availability of Reports**

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