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Dear Mike

KPMG response to Infrastructure: Facts and Issues

Thank you for the opportunity to comment on the September 2009 document Infrastructure: Facts and Issues.

We think that the development of a National Infrastructure Plan is a worthy and overdue initiative and are pleased to see that progress is being made towards it with the release of this precursor document. While the information contained in this document is still in the process of development, we commend you for seeking early input from stakeholders and industry experts.

As corporate financiers, we cannot claim to be sectoral experts, and have not sought to provide in depth response to the sectoral sections of the paper. We are confident that others can and will do so. We do, however, have knowledge of what the private sector requires to make investment decisions, the ways in which private finance can be leveraged through Public Private Partnerships (PPPs), and knowledge of government decision making through our advisory work in support of government. We provide our comments from these contexts against your suggested feedback headings.

Base information

Consistency of information

Consistency and comparability of information is important because government can be expected to have more investment opportunities available to it than it has resources to undertake those opportunities. Competing opportunities will then have to be ranked against each other on some basis such as economic impact, value for money or alignment with policy goals.

Our experience in other jurisdictions indicates that creating consistent information across sectors, assets and projects is an essential precursor to establishing a coherent forward looking plan. The more consistent the information is then the higher the potential for meaningful comparative analysis and better informed investment decisions.

The information must be reliable, relevant and timely. The initial focus should be on capturing relevant and materially reliable data about outputs and service levels related to each project. There is a trade-off between the granularity of data on one hand and the cost and time involved in gathering that data. On balance we favour a pragmatic approach which anticipates better quality data will be delivered over time but that initial data collection and the creation of output measures may require broad approximations and “rules of thumb”.

We suggest that the NIU develops a framework for data collection that recognises that consistent information that is relevant and materially reliable is an essential component of a National Infrastructure Plan.

Missing issues

Rural water – storage and irrigation

In our view great importance should be attached to finding longer term infrastructure solutions to the availability of year-round, clean water for irrigation purposes. Many local councils, private sector groups and development organisations are wrestling with these issues and a repeatable structure seems yet to be found. There seems to be clear evidence of a coordination failure in several of these schemes, where the possible beneficiaries include residential owner-occupiers, individual farmers, corporates and rural towns that creates a rationale for greater focus by the NIU.

Other countries have found ways to make the provision of water an investment-grade asset for private finance. It seems to us that the potential economic and environmental benefit set from year-round provision of clean water should be able to exceed other sectors, for example the benefits from increasing primary production regardless of drought conditions and using peak flow water better rather than stretching low flow allocations are clear.

We consider this too large and important an issue to be left to local authorities and assorted vested interests to reinvent wheels on. We encourage the NIU to include this area within its infrastructure plan.

Rural water – water treatment

Similarly, many local authorities are wrestling with the need to provide improved water treatment and sewage treatment facilities. Councils need to share knowledge and expertise so that they can generate economies of scale on large numbers of small projects. In some cases better solutions could be found by crossing local authority boundaries. Water treatment plants are again something that can become an investment proposition and correcting the coordination failure could see better and more efficient regional solutions able to be sourced from the private sector.

We would like to see local authority water and sewage treatment schemes included within the Infrastructure Plan and some policy thought devoted to assessing whether more cost effective solutions could be sought from the private sector.

Broadband and international connectivity

The government has signalled a strong commitment to the development of ubiquitous, open access, ultra fast broadband network in New Zealand. In addition to fundamentally changing the industry structure, this investment will substantially increase the connectivity of many New Zealanders and our key public institutions. It also has the potential to substantially alter the form of, and delivery mode, of all sorts of services. It is unclear to us how the pre-cursor plan contemplates the complex interaction and trade-off decisions between investment in current modes of service delivery and the associated infrastructure with the investment forms suitable in a country pursuing an ultra fast, internationally linked, digital economy.

IT projects with an infrastructure nature

The plan does not specifically include IT projects. We are aware of the Treasury's separate work to ascertain whether efficiency savings are possible through "single IT window" approaches and other shared services or outsourcing solutions.

Regardless, we see that there are several significant IT projects that have the characteristics of national infrastructure and could be included within the Infrastructure Plan. The best example we are aware of is the i-govt services development. If this project is pursued with the right outcomes in mind it could become a massive enabler of productivity gains throughout the public and private sectors, as many types of organisations streamline deadweight identity verification processes. We think that some such IT projects should have a place within the National Infrastructure Plan so that they are appropriately prioritised.

Cross sectoral issues

Role of private finance

The list of desired projects will always exceed the list of public funds. The reluctance to access private finance for public services underpinned by infrastructure assets has limited New Zealand's ability to meet the infrastructure gap in recent years. We are very glad to see a more pragmatic approach signalled in this document and other Treasury publications such as the recently released Guidance for PPPs in New Zealand.

The issue of prioritisation will apply as much to projects with private finance potential as it will to those that will be publicly financed. In our view, it will be important to apply a fairly sophisticated private finance filter to projects early in their development, rather than fly kites with the private sector as has been done in the recent past. This will both engender greater confidence from the private sector and allow a better prioritisation process for publicly funded projects.

There is some skill in determining which projects will stack up using private finance, but there is significant experience that can be accessed to assist with this. KPMG has recently provided seminars, including to NIU staff, where we set out high level criteria that can be used to judge the fit of a project to a PPP approach. We have also recently assessed one department's infrastructure programme for its match to PPP approaches. We would like to see this kind of high level filter applied earlier in the project development process to increase the level of certainty in the private sector about where they may be able to assist. We discuss this further in the next point.

Project pipeline

It is natural that there are limits to the absorptive capacity of some firms and sectors that will be crucial to the design, building and operation of infrastructure projects. We have seen this in the recent past in New Zealand in the context of road and rail projects in the Auckland region, where project saturation led to significant and unproductive cost inflation. There is a risk that, if not properly corralled, projects compete with each other in the short term for limited resources.

In other jurisdictions, a clear and ex-ante project pipeline has been established to address the issue of absorptive capacity. For example, Infrastructure Australia sets out a clear project pipeline including projects contracted, projects in the market and projects being considered. This approach provides a clear signal to partners. It allows private sector partners to plan ahead for the resources that they are likely to require and contributes to the commercial certainty that is required to promote investment in New Zealand. Ultimately, this will facilitate an increase in the breadth and number of projects that can be undertaken.

We suggest that the development of a project pipeline is an essential component of a National Infrastructure Plan.

Regulatory reform

Resource Management Act and PPP innovation

We perceive a significant issue as regards the operation of the RMA in the context of PPP competitions. In most cases the private sector will wish to leave resource consent risk with the government, given the government's greater experience with securing resource consents for major public infrastructure works such as roads, schools and prisons. This is common in most countries that use PPPs.

One of the real strengths of the PPP approach, however, is that use of an output specification can encourage the private sector to generate significant innovation in the design of the service solution. In many cases, this innovation is centred in the asset being created, and how that asset interfaces with the staff providing in or out of scope services.

We see significant constraints arising where private sector consortia may be unwilling to alter the terms of a resource consent given the timing uncertainty and cost overruns it could create,

unless a safe window can be created post appointment as preferred bidder. In the case of a significant building, such as a hospital or prison, the level of design (circa 10%) required to secure a resource consent could severely constrain the private sector's ability to provide a more cost effective design for both the services it offers and for the public services that will be delivered from within the PPP facility.

We would like to see the interface between the RMA and PPPs given greater consideration to ensure that maximum innovation potential can be wrung out of any PPP projects pursued.

Commerce Act

This is not the correct forum to discuss changes to the Commerce Act that may facilitate investment and innovation in infrastructure. However, we do note that any National Infrastructure Plan that includes the electricity, gas, water and airport industries must consider the impact on investment incentives of Part 4, Part 4A and Part 5 of the Commerce Act, which is the over-arching regulatory framework for these industries.

The intention of the National Infrastructure Plan to promote investment could be cut across by the regulated returns calculated by the Commerce Commission. The effect of this would be that capital is inefficiently allocated to projects in sectors that sit outside of the ambit of the Commerce Act. This in turn would cause unintended consequences, and both allocative and dynamic inefficiency.

Service level aspirations

Value for money definition

The precursor document references the concept of value for money on several occasions yet we are not clear that there is an accepted definition of value for money that relates to all classes of infrastructure. We consider that one of the stronger reasons for adopting PPP approaches is the set of financial disciplines that occur before an investment is made, both through the business case process and the tender evaluation process. This includes a definition of value for money that is both risk adjusted and long term, ie approximately the term of the asset's useful life. To have greatest effect on our infrastructure investment decisions, whether publicly or privately financed, value for money also needs to be based not only on the cheapest cost but also on the maximum efficiency and effectiveness of the investment.

We would like to see a clear definition of value for money adopted and spread more widely through National Infrastructure Plan considerations. In our view, a long term risk adjusted value for money test should be applied to all infrastructure investment decisions, regardless of funding solution.

Outcomes

A correct definition, and shared understanding, of value for money will lead us to avoid placing any ceilings on service level aspirations. Correctly formed, a value for money definition allows government to prioritise the marginal dollar of spending across a number of sectors or projects to maximise its marginal economic and social benefit.

In this conception of value for money, a more expensive project that delivers exponentially to desired outcomes is more desirable than a project that delivers services at minimal cost. A clear example of this would be a correctional facility whose operators have incentives to reduce recidivism among inmates. The upfront cost of building physical assets and designing projects to achieve this aim may be more than the lowest cost alternative. However, it is clear to us that the contribution of lower recidivism to social and economic outcomes should fit within any definition of value for money and any outcomes-orientated infrastructure framework.

We suggest that the National Infrastructure Plan be ambitious in the service level aspirations that it seeks, and facilitates innovation and investment to reach them. A clear and shared understanding of value for money will allow for an outcome-oriented view of service levels to be adopted.

We would be more than happy to discuss our comments in person if that was useful.

Kind regards



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