

INFRASTRUCTURE TRENDS - #3: OUTCOMES-BASED APPROACH TO SOCIAL INFRASTRUCTURE

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Legal Briefings - By **Nicholas Carney and David Hugo**

In this series of short articles we look at the [current trends affecting infrastructure investment in Australia](#). This article considers trend #3 - Outcomes-based approach to social infrastructure

THE INFRASTRUCTURE IS THERE TO KEEP THE RAIN OFF THE SERVICES

Governments are looking more and more to the private and not-for-profit sectors in public service provision, as opposed to just capital asset development. For Governments, the costs of developing and constructing a public service asset, such as a hospital, may be much less significant than the cost of providing services from that asset over the long term. Efficiencies in service (rather than asset) delivery can present greater opportunities and cost savings, while improving the outcomes produced by infrastructure can significantly improve quality of life for citizens. All of this is increasing the focus on the services to be delivered from the assets, rather than the asset itself. In other words - the infrastructure is just there to keep the rain off the services.

WHAT IS DRIVING THIS TREND?

An ageing population, stubbornly low productivity and structural budget deficits mean that Governments need to drive every dollar further. Linking payments to the outcomes delivered by non-Government contractors is a powerful way to do this, especially where the outcome will produce long term savings for the Government. For example, paying a prison operator to reduce recidivism will produce savings which can be shared with the prison operator.

The other key driver is innovation. Outcomes-based contracts do not unnecessarily mandate the method of delivering the services. This encourages bidders to be creative in their proposals to Government, and allows the successful contractor to respond to changing circumstances during the term by adopting new technologies or processes. If the contract is structured correctly, these efficiencies will be shared between the State procuring party and the contractor, creating a win-win result.

WHERE CAN YOU SEE THIS TREND?

This trend is evident across all sectors involving Government-procured infrastructure. Early adoption has occurred in social infrastructure, such as health, corrective services and social housing, where the savings to Governments are most easily quantified. It is now being picked up in sectors such as ICT, ports and transport. For example, the current Region 6 Bus Transaction in NSW includes payments linked to outcomes consistent with the service timetables.

This is not a bipartisan issue and Governments on the left and the right are both embracing this concept and entrenching it in the way they operate. The NSW Government signalled its commitment to the approach when it introduced a new budgeting system which links payments made from Treasury to each of the Departments to the outcomes achieved by those Departments. This will drive the Departments to adopt similar measures when contracting with the private or non-Government sector. Similar changes are afoot in other jurisdictions.

WHAT DOES THIS MEAN FOR GOVERNMENTS?

When developing and procuring contracts for outcomes, Governments need to:

- be clear about the outcomes sought and how payments will be determined (eg abatements and rewards);
- be aware of the line between maintaining appropriate contractual controls over the private sector operator, while at the same time not over-regulating to the point of stymying the benefits of that operator's efficiencies and ability to innovate;
- consider any unintended consequences of the outcomes sought and the contracting structure – eg cherry picking. In a hospital, this might involve only accepting patients requiring more lucrative elective surgery. To manage this, we have assisted Government to develop provisions to penalise 'inappropriate transfers';
- specify how the outcomes will be measured. This may involve thinking about the counterfactual. For example, what would the recidivism rate be if the contractor did not deliver the services? If Government does not have this data on day one, then it may need a mechanism to transition to payment by outcome over the term of the contract,

rather than paying for outcomes on day one. This was the approach the NSW Government took under the Social and Affordable Housing Fund (which is detailed further below);

- adopt the most efficient contracting and commercial structure. In the social infrastructure space, the State may wish to deal with operator-led consortia. For example, the State may wish to contract directly with a proven hospital operator rather than infrastructure investment funds. While for social housing, legislation requires most of the States to contract directly with a 'community housing provider'.

Asset recycling, accounting and tax treatment is also relevant and various Governments are exploring structures that most efficiently use the Government's balance sheet. Off balance sheet structures may result in a different risk allocation to that which the market expects on a typical asset PPP.

WHAT DOES THIS MEAN FOR NON-GOVERNMENT PARTICIPANTS?

The trend in favour of outcomes-based infrastructure projects is relevant to traditional private sector parties such as sponsors, developers, financiers and O&M providers as well as not-for-profit participants.

When pursuing contracts for outcomes, non-Government participants should:

- be creative in how they propose to deliver the service, and be flexible in their approach to traditional PPP models;
- consider the most appropriate consortium structure – if the State wants an operator-led structure then additional equity investors may not be required;
- consider the most appropriate financing structure. Traditional project financing may not be appropriate for certain off balance sheet structures such as the Social and Affordable Housing Fund; and
- have regard to the competition and how they will approach the procurement. A not-for-profit may be exempt from taxes but may have less resources at their disposal and limited experience in such procurements.

CASE STUDY - SOCIAL HOUSING

Social and affordable housing is a major issue for most Australian Governments. In light of Australia's worsening housing affordability crisis, it is becoming increasingly difficult for lower income households to access housing on an independent basis. As a result, the demand for social and affordable housing is rapidly increasing - there are over 60,000 applicants on the waiting list for social housing in NSW alone. At the same time, State Governments are faced with unsustainable operating deficits and ageing public housing stock.

The solution requires Governments, the infrastructure sector and not-for-profit organisations to work together in partnerships, to experiment with new and innovative models, maximise and unlock land, and attract more private capital. Governments are employing a large range of strategies and initiatives to achieve this, presenting a significant opportunity for infrastructure investors.

In NSW, the Government has established the Social and Affordable Housing Fund which will facilitate access to 2,200 new dwellings in its first phase. The NSW Government will provide service providers with 25 years of operating subsidies that fund the gap between existing rental streams and the cost of securing and developing new stock for the provision of social housing. In doing so, the NSW Government will treat social housing as an accommodation service (rather than as an asset), with complementary wrap-around support services designed to assist social housing tenants to move into the private rental market. These services will be underpinned by a 'payment for outcomes' regime. Importantly, as part of these service-arrangements, Government will not provide any land, nor take an interest in the dwellings. Service providers will be required to source land themselves and the dwellings will not be handed over to the State at the end of the term.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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