Financial analysis inputs for Partnerships Victoria projects

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# Guidance

* + 1. Purpose

This guidance outlines:

* + - inputs for both the public sector comparator (PSC) and public private partnership (PPP) bid evaluation discount rates; and
    - the reference source for the inflation forecasts to be used in the financial analysis.

This guidance note is publicly available and may be amended occasionally.

* + 1. Policy requirement

The National PPP Guidelines provide a methodology for determining the discount rates to be used in comparing the PSC with bids and determining whether PPP procurement offers value for money.

Procuring agencies should consult the Department of Treasury and Finance on the appropriate discount rates:

* + - to be applied to the PSC; and
    - to be used when assessing responses to the request for proposal.

The National PPP Guidelines focus on developing the discount rate for social infrastructure projects i.e. projects with net cash outflows for government. Different considerations will apply for economic infrastructure projects.

The appropriate national guidance is found in the National PPP Guideline Volume 5: Discount Rate Methodology, which should be read in conjunction with this guidance. The guideline includes a range of indicative asset beta factors as one of the key inputs in determining discount rates. Procuring agencies must consult with the Department of Treasury and Finance to determine the appropriate asset beta factor to be used based on project specific considerations.

* + 1. Discount rate inputs for the public sector comparator and Partnerships Victoria bids
       1. Risk free rate, market risk premium and asset betas

Table 1: Inputs to discount rate analysis for Partnerships Victoria projects

|  |  |  |
| --- | --- | --- |
| Input | Value | Source |
| Risk free rate | 1 month daily average of the 10 year Treasury Corporation of Victoria bond interest rate | Treasury Corporation of Victoria |
| Market risk premium | 6 per cent real; or  a specific premium calculated from current market data | National PPP Guidelines Volume 5: Discount Rate Methodology |
| Asset betas (for availability social infrastructure projects) | Table 2 in Section 3.3.2 of National PPP Guidelines Volume 5 may be used as a guide[[1]](#footnote-1) | Table 2 in Section 3.3.2 of National PPP Guidelines Volume 5: Discount Rate Methodology |
| Asset betas | Bespoke asset betas can be calculated for specific projects based on market data | Section 3.3.2 of National PPP Guidelines Volume 5: Discount Rate Methodology |

Key considerations in determining the discount rate inputs:

The table of inputs is intended to be applied in accordance with the National PPP Guidelines Volume 5: Discount Rate Methodology, which outlines the methodology for developing discount rates to be used to assess the relative value for money of the PPP bids compared to the PSC[[2]](#footnote-2).

At the time a procuring agency prepares the final PSC for a project, it should consult with the Department of Treasury and Finance and Treasury Corporation of Victoria for advice on the risk free rate that should be utilised for the project.

The risk free rate will be determined using a one month daily average of the 10 year Treasury Corporation of Victoria bond interest rate, unless Treasury Corporation of Victoria and Department of Treasury and Finance determine that this is inappropriate in prevailing market conditions and advise that an alternative rate should be used.

The risk free rate for a project should not be changed after the final PSC has been completed. However subsequent movements in financial markets should be considered when determining the range of rates to be utilised in conducting a sensitivity analysis as described in section 5 of the National PPP Guidelines Volume 5: Discount Rate Methodology.

However, the State can reserve the right to make an adjustment to the risk free rate at the time bids are submitted, if it is deemed that a significant movement in the risk free rate has occurred since request for proposal release. Any adjustments would be determined by the State and advised to bidders.

* + - 1. Discount rate adjustment for State contribution

The Partnerships Victoria Requirements provide for modified financing options, which include State contributions. The intent of the State contribution is to minimise the cost of finance by reducing the amount of the private finance, but without reducing the fundamental PPP risk transfer principles. Where a project is applying a State contribution, the procuring agency should consider any impact on the risk allocation and therefore the systematic risk premium calculation in the PPP bid evaluation discount rate.

The discount rate analysis should assess the extent of any additional risks retained by the State as a result of the State capital contribution relative to the privately financed component of the project. The assessment is influenced by the amount and timing of the State capital contribution(s).

In precedent projects, a significant capital contribution has resulted in an adjustment to the systematic risk premium and PPP bid evaluation discount rate (<0.5 per cent). Therefore two PPP bid evaluation discount rates have been disclosed to bidders for:

* + - quarterly service payments; and
    - capital contributions.
    1. Determining the inflation forecasts for use in Partnerships Victoria projects
       1. Use of the inflation rate in the PSC

This section discusses the appropriate source of general inflation forecasts to use in constructing the PSC and assessing bids for Partnerships Victoria projects.

Measuring inflation is a complex issue and it is generally accepted that no single price index can measure all aspects of inflation or meet every user’s needs. However, because of the availability of the consumer price index (CPI), the confidence placed in it, and its high quality, it is now often used as a general measure of inflation. The CPI reflects the changes in the amount the average consumer pays for a fixed basket of goods and services. Inflation, as discussed below, is assumed to reflect movements in the CPI.

Value for money in Partnerships Victoria projects is determined, in part, by comparing bids with the PSC. The financial evaluation centres on comparing the PSC with the costs to government of the payments reflected in each bid over the full contract term.

The PSC should be prepared on a nominal basis and before income tax. Inflation should be taken into account in constructing the PSC. Generally this should be done by applying the current long‑term inflation forecast, as published in the budget. The same rate is to be used in bid evaluation. Typically, the Government indicates in the request for proposal the general rate of inflation to be used in its bid evaluation. This allows for standardised comparisons both between bids and with the PSC.

* + - 1. Recommended forecast sources

It is recommended that general inflation forecasts (for both the development and services phases) be taken from the budget papers for the purposes of constructing the PSC and assessing bids. As the official budget forecasts, they should be used to ensure consistency across the whole of government.

For project purposes, the rate used should be the most recent available forecast published in the budget papers (or budget update) at the time the full PSC is constructed. The request for proposal would advise bidders about this rate to promote consistency in assumptions between the PSC and the bids. This rate would be used for all subsequent project modelling (i.e. once the request for proposal has been released, the rate would not be updated during the tender process).

This is consistent with the way the interest rate is treated as an input into the discount rate modelling. The discount rate is determined using the interest rate current at the time the PSC is constructed.

* + - * 1. Development phase inflation forecasts in the PPP bid

The private sector party usually takes the risk on inflation during the development phase (by bidding a fixed nominal price for all development activities as part of their total contract price), which may be calculated using current industry/sector specific escalation rates applicable to the project. As discussed above, CPI related capital costs should be indexed by the private party using the CPI forecasts in the forward estimates, or the projections (depending on the duration of the development phase) in the budget papers.

However, to the extent that it is proposed that an element of inflation or escalation risk during the development phase is to be passed back to the State, the State would need to specify and agree the relevant applicable rates. In this instance, general inflation (if applicable) would be taken from the CPI forecasts in the forward estimates, or the long-term projections (as applicable) in the budget papers.

When evaluating different payment structures (e.g. index/CPI linked structures and/or the use of additional indexation factors), the State will make adjustments to the PPP bid evaluation discount rate in accordance with the revised allocation of CPI/inflation risk bid between the State and the private sector party.

* + 1. Operating phase inflation forecasts in the PPP bid

Consistent with the PSC methodology, the long-term CPI and wage price index forecasts and projections from the budget papers (as relevant) should be used by the private party in escalating their costs over the services phase. Other industry/sector specific indices may also be applicable, depending on the nature of the project.

1. Each project’s asset beta should be verified on a case-by-case basis, having regard to the project’s specific risk profile and level of systematic risk [↑](#footnote-ref-1)
2. The PSC represents the most efficient public procurement cost to achieve required service delivery outcomes. [↑](#footnote-ref-2)