AUDITOR-GENERAL’S REPORT

PERFORMANCE AUDIT

The New Schools Privately Financed Project

In accordance with section 38E of the Public Finance and Audit Act 1983, I present a report titled The New Schools Privately Financed Project.

R J Sendt
Auditor-General

Sydney
March 2006
Contents

Foreword

Executive summary 1

1. Introduction 9
   1.1 The New Schools Project 10
   1.2 Privately financed projects 12
   1.3 Government policy 12
   1.4 This audit 13

2. Was the business case clearly defined? 15
   2.1 What we looked for 16
   2.2 DET’s requirements 17
   2.3 DET’s assessment of alternatives 17
   2.4 Affordability 20
   2.5 Preferred allocation of risks 20
   2.6 Project scoping 21

3. Was the process sufficiently competitive? 23
   3.1 What we looked for 24
   3.2 Competition and transparency 25
   3.3 Bid evaluation 27
   3.4 Scope for innovation 28
   3.5 Development of the public sector comparator 29

4. Are performance standards adequately established and monitored? 33
   4.1 What we looked for 34
   4.2 Incentives for performance 34
   4.3 Performance standards 35
   4.4 Performance reporting 36
   4.5 Additional contract safeguards 38
   4.6 Contract administration and oversight 40

Appendices 43
   Appendix 1 Terms used in this report 44
   Appendix 2 About the audit 45

Performance Audits by the Audit Office of New South Wales 47

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Foreword

The Government has indicated its desire to encourage private investment in infrastructure where this results in better and more efficient delivery of public services.

In the right circumstances - and if properly managed - privately financed projects (PFPs) can deliver better value for money than traditional public sector procurement.

However the PFP approach brings new risks to government. PFP deals are often complex and typically involve commitments over several decades. There are particular challenges in ensuring that the contract arrangements can deal with changing circumstances over such a long period and that the potential benefits are in fact realised.

This report looks at the New Schools Privately Financed Project, launched in 2001 to provide NSW government schools primarily in new urban release areas. Nine new schools were built under this project, with a further ten schools to be provided over the next three years under a second PFP contract.

Our audit examined whether the processes for awarding these contracts were adequate to maximise the potential for value for money.

Although the report focuses on the provision of new schools, its findings and recommendations are relevant to all agencies considering privately financed projects to provide public infrastructure.

Bob Sendt
Auditor-General

March 2006
Executive summary
Executive summary

The NSW Government is increasingly turning to the private sector to help provide public infrastructure using public-private sector partnership (PPP) type contracts.

In recent years the NSW Department of Education and Training (DET) has let two major contracts of this kind to provide NSW Government schools in new urban release areas.

There are many forms of PPP. Each needs to be assessed on its merits. The New Schools Privately Financed Project is a form of public-private partnership known as a privately financed project (PFP).

We examined this new approach to see whether the processes for awarding the first privately financed schools contracts were adequate to maximise the potential for value for money.

Audit opinion

In our view the contracts in the New Schools Privately Financed Project were established and let in a way that greatly assists their potential for delivering value for money.

We found that DET developed:

- a clearly defined business case with the objectives of a faster supply of schools, possible cost savings, innovation and simplified services management
- good tender lists with competitive tension maintained throughout the tender processes
- a sound performance monitoring and reporting system, with provision for it to intervene in the case of poor contractor performance.

The contracts in the New Schools Privately Financed Project are at an early stage of their 30 year lives and the savings and other benefits are not guaranteed. The contracts will need to be carefully managed over the 30 year period to ensure that benefits are realised and that costs do not escalate beyond expectations.
Recommendations

We recommend that DET and Treasury adopt a number of measures to further improve the potential of the *New Schools Privately Financed Project* to offer value for money:

- DET should consider applying elements of the PFP approach (including risk allocation, effective project management and an enhanced focus on quality of service) to its other projects - such as the refurbishment of existing schools - particularly where major new works are envisaged (section 2.3)
- DET’s school planning processes should be improved to provide a greater certainty of requirements when entering a PFP contract (section 2.6)
- Treasury and DET need to disclose more complete contract documents relating to the *New Schools Privately Financed Project*, as is the practice in Victoria and as recommended by the Richmond report (section 3.2)
- DET needs to use the information and method of the public sector comparator, appropriately updated or modified, to assist in accurately comparing the costs, benefits and risks of different approaches (section 3.5)
- DET needs to expedite completion of the Contract Administration Manual. The Manual also needs to be regularly reviewed and updated during the 30 year life of the *New Schools Privately Financed Project* (section 4.6)
- DET and Treasury need to ensure that the cross-agency *Project Management Steering Committee* can oversight and report on whether the *New Schools Privately Financed Project* continues to offer value for money (section 4.6)
- DET needs to work with Treasury to design an appropriate evaluation process to review whether the project continues to provide value for money (section 4.6)
- Treasury needs to update and expand its *Guidelines for Privately Financed Project* in order to continue to ensure a consistent, transparent and accountable approach to PFPS in NSW (section 4.6).
Executive summary

Key audit findings

The New Schools Privately Financed Project is known as a privately financed project (PFP). It is a form of public-private partnership. The NSW Department of Education (DET) and NSW Treasury are among the first in NSW to use this new approach for infrastructure needs.

Government policy is to maximise private investment in infrastructure to the extent that this results in better and more efficient delivery of existing public services.

Government policy also supports a total asset management approach to acquiring, maintaining and upgrading physical assets to provide services to the community.

PFPs are attractive to private investors, contractors and governments for different but related reasons. Briefly:

- income tax assessment legislation permits deductions to investors for early year losses, interest, fees and depreciation claims for private infrastructure projects
- contractors can secure large ongoing contracts over a longer term than is possible with conventional tender work; they also have more scope to develop better designs
- governments can achieve a number of objectives, such as simplifying management processes, lowering procurement costs and ensuring that assets are maintained.

Chapter 1: Introduction

We looked for a clearly defined business case, to explain how DET had chosen the PFP approach. It is important for the successful delivery of any project that an organisation states its requirements clearly from the start. Otherwise there is the risk that it will end up with a project that does not meet its real needs. Also, prior to going out to tender, a procuring organisation needs to demonstrate that the proposed project is likely to provide more value for money than other projects.

We found that DET:

- clearly defined its requirements from the outset. Its objectives included a faster supply of schools, possible cost savings, innovation and simplified services management
- presented a persuasive case that the proposed project was likely to provide value for money when compared to other options, although this was not supported by comprehensive financial and economic analysis of all the alternatives
- established that the project was likely to be affordable, but new schools were only advanced one or two years earlier than would otherwise have been expected
- identified that allocation of risks between the public and private sectors most likely to deliver better value for money
- scoped the project to maximise its prospects of achieving value for money. But we also found that the process involved a number of changes made to the lists of schools as detailed planning and negotiation progressed.
Chapter 3: Was the process sufficiently competitive?

We looked to see whether there had been genuine competition between bidders.

We found that DET:

- managed to create good tender lists and maintain competitive tension throughout the tender processes. These processes were, for the most part, sufficiently transparent to ensure that the market was well informed
- retained qualified external advisors, identified the key contractual issues likely to arise and developed a considered approach to the evaluation process
- set its current school buildings specifications as the minimum requirement, which provided greater certainty in relation to the final product but may have limited further innovative design
- evaluated all aspects of the bids received and then chose as preferred bidder the one that offered it best value
- employed the public sector comparator for added competitive tension, particularly in the final stages of negotiation with the successful proponents
- assumed that the public sector comparator could not achieve efficiencies from bundling new schools, as this would have exceeded the level of funding available using traditional means.

The cost of the public sector comparator exceeded the net present cost of the private sector bid. The 'saving' was achieved with the help of risks transferred to the private sector.

The public sector comparator is very sensitive to the assumptions made. We found that, whilst on the whole they seemed reasonable, some of the assumptions could reasonably be questioned.

Chapter 4: Are performance standards adequately established and monitored?

We looked for adequate performance monitoring and incentives. The Government needs to be in a position to confirm that the private party is performing according to the output specifications in the contract. Savings and other benefits do not automatically flow from a PFP. Whatever the estimated value for money of such a contract when it is first signed, any subsequent poor management can result in higher costs, wasted resources, impaired performance and public concern.

We found that:

- the incentives for performance are clearly designed to encourage good performance by the contractor, with appropriate benchmarks
- the reporting and monitoring system has been thoroughly prescribed and is considered appropriate for the task. However, as it is largely reliant on self-monitoring by the contractor, DET will need to carefully oversight and regularly audit the effectiveness of the system
- there are adequate contract mechanisms that DET can use to make changes to school facilities, or to intervene as necessary - such as in the case of poor contractor performance
- DET had not as yet completed work on a Contract Administration Manual to identify what needs to be done by whom and when
- there needs to be an appropriate process of review, removed from the day-to-day function of contract administration.
Response from the Department of Education and Training

I refer to your letter dated 15 February 2006, concerning the Performance Audit conducted on the New Schools Public Private Partnership Project.

The Department of Education and Training recognises the value of the audit in reviewing the management of the project and its processes.

A number of recommendations in the report that arise from the first new schools project have already been implemented in the second new schools project:

- Improved planning processes that allow both certainty of requirements yet allowing flexibility to substitute projects in an efficient and cost effective manner to take into account changes in growth rates and patterns over the capital delivery period;
- Clear review in business cases of the capacity of surrounding schools and demographic demand;
- Ensuring that the bidders had a clear understanding of DET requirements during the bidding phase;
- Simplified and improved abatement systems.

The Department proposes to implement and/or explore other issues raised by the report, including the finalisation of a contract administration manual for the two projects and the establishment of a Contract Steering Committee.

I am pleased that the review confirms our opinion on the success of the delivery model for new schools in terms of clearly defined business cases, capital cost savings, faster delivery of schools than under traditional procurement and simplified and effective services management. Please convey my appreciation for the conduct of the review to the relevant officers involved.

(signed)

Andrew Cappie-Wood
Director-General of Education and Training
Managing Director of TAFE NSW

Dated: 1 March 2006
Response from NSW Treasury

Thank you for providing me with a copy of the final draft of the Performance Audit New Schools Privately Financed Project and inviting me to comment on the report.

I note that your findings are very positive and recognise the rigorous processes that have been established for privately financed projects in the areas of project development, tendering and performance monitoring of the contractor. These processes have maximised the potential for these new schools, and other privately financed projects, to provide value for money for the public.

The recommendations you make are generally consistent with our own findings from the New Schools Privately Financed Project Post Implementation Review and the Premier’s Department recent Review of Future Provision of Motorways in NSW. As such Treasury has already implemented or is in the process of implementing changes to address these recommendations.

In particular, your recommendation that Treasury publicly disclose more complete contract documents for privately financed projects is being implemented by revising Ministerial Memorandum 2000-11 Disclosure on Information on Government Contracts with the Private Sector. Consistent with this forthcoming Memorandum, the full contract deed (excluding confidential information) for the recently signed Newcastle Mater Hospital Redevelopment Privately Financed Project has been posted on the NSW Government Tenders website.

Also, consistent with your recommendations, Treasury will be updating and revising the Working With Government Guidelines for Privately Financed Projects to take into account the findings of all recent reviews of privately financed projects. This will be undertaken after the Public Accounts Committee has released their findings for their Inquiry into Public Private Partnerships, expected by April 2006.

Treasury and the Department of Education and Training have also agreed to form a cross-agency Project Management Steering Committee to oversight the ongoing management of the contract.

I would also like to take the opportunity to clarify and elaborate on a few areas that you mentioned in your report.

There are a number of reasons why governments privately finance social infrastructure. These include: to lower infrastructure costs, transfer appropriate risks to the private sector, incentivise adequate contractor performance, single point of contract for a range of services, focus on whole-of-life costs and ensuring Government assets are adequately maintained. The Government does not privately finance social infrastructure to smooth out lumpy capital payments to spreading payments over the long-term (refer Section 2.2) or to achieve off-balance sheet financing. In fact, these transactions are usually on-balance sheet.
In the case of the New Schools Privately Financed Project, the Government repayments of the capital cost of the facility are deemed to be a finance lease. In addition, the Government is deemed to be the owner of the schools because the Government primarily retains demand and residual value risk. Therefore a liability offset by an asset of equivalent value is recorded on the Government’s Statement of Financial Position, once the facilities are operational. The fees for maintenance and other services are expensed. Therefore, the accounting treatment for a social infrastructure project is similar irrespective of whether it is privately financed or financed using Government debt.

Your report indicates (Section 3.5) that unless the public sector comparator (PSC) assumes that schools can be bundled under traditional procurement, the PSC is unlikely to ever be less than the private sector’s bid. The PSC is based on the most efficient, likely and currently available method of providing the defined infrastructure and services.

The PSC reasonably assumes that bundling was not likely in the case of traditionally procuring schools given DET had never previously bundled schools. In addition, there is evidence to suggest that, even after the first Privately Financed New Schools Project, DET would not have bundled schools if traditional procurement had been pursued. Furthermore, given DET has never bundled schools, it is unlikely that the efficiencies achieved under PFP procurement would be fully realised if they were bundled under traditional procurement.

In this context, it should also be noted that the PSC assumes that DET would meet the service specifications and standards and adequately fund the life-cycle maintenance program. These assumptions are necessary to ensure the PSC is comparable with private sector bids but they are untested in practice and hence may be favourable to public sector procurement.

Finally, I would like to thank you and your staff for the co-operative approach taken during the course of the audit and the opportunity to comment on the report.

(signed)

J Pierce
Secretary

Dated: 1 March 2006
1. Introduction
1.1 The New Schools Project

The NSW Department of Education and Training (DET) is the largest provider of educational services in Australia. DET operates more than 2,400 sites, enrols 1.2 million students and has an asset base valued in excess of $15 billion.

In recent years DET has let two major public-private sector partnership type contracts to provide NSW government schools in new urban release areas. This new approach is called the New Schools Privately Financed Project.

New approach

Under the new style contracts the contractor must:

- design, construct and commission specified school facilities at its own cost, by specified dates. These school facilities include all the schools’ buildings, fixtures, fittings, equipment, electrical goods, furniture, grounds, playgrounds, paths and gardens
- provide operational, cleaning, security, safety, utility, maintenance and repair services for each school facility
- hand the school facilities over to the State, or a new contractor nominated by the State, at the termination of the contract.

This replaced the traditional procurement approach which uses individual school construction contracts and many short-term service and supply contracts.

First contract

The first contract of $137 million involved 9 schools. Bids from the private sector were first sought in October 2001, and a contract was let in December 2002. The schools are:

<table>
<thead>
<tr>
<th>School</th>
<th>Location</th>
<th>Opened</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dapto PS</td>
<td>West Dapto</td>
<td>2004</td>
</tr>
<tr>
<td>Ironbark Ridge PS</td>
<td>north west Sydney</td>
<td>2004</td>
</tr>
<tr>
<td>Kellyville Ridge PS</td>
<td>north west Sydney</td>
<td>2004</td>
</tr>
<tr>
<td>Sherwood Ridge PS</td>
<td>north west Sydney</td>
<td>2004</td>
</tr>
<tr>
<td>Tallowood SSP</td>
<td>north west Sydney</td>
<td>2004</td>
</tr>
<tr>
<td>John Edmundson HS</td>
<td>Liverpool</td>
<td>2005</td>
</tr>
<tr>
<td>Shell Cove PS</td>
<td>Shellharbour</td>
<td>2005</td>
</tr>
<tr>
<td>Woongarah PS</td>
<td>Woongarah/Warnervale</td>
<td>2005</td>
</tr>
<tr>
<td>Glenwood HS</td>
<td>north west Sydney</td>
<td>2005</td>
</tr>
</tbody>
</table>

The process of awarding the first contract was protracted and contractual agreement was reached almost a year later than originally envisaged. Two schools, due to open in 2003, had to be removed from the PFP process and provided using traditional individual construction contracts; two new schools were substituted in their place.
Second contract

The second contract of $178 million involved 10 schools. It was handled more quickly. Bids from the private sector were first sought in May 2005, and a contract was let in December 2005. The schools are:

<table>
<thead>
<tr>
<th>School</th>
<th>Location</th>
<th>Opening</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hamlyn Terrace PS</td>
<td>Central Coast</td>
<td>2007</td>
</tr>
<tr>
<td>Ashtonfield PS</td>
<td>Maitland</td>
<td>2007</td>
</tr>
<tr>
<td>Ropes Crossing PS</td>
<td>Mt Druitt</td>
<td>2008</td>
</tr>
<tr>
<td>Second Ponds Creek PS</td>
<td>Blacktown</td>
<td>2008</td>
</tr>
<tr>
<td>PS (to be announced)</td>
<td>south west Sydney</td>
<td>2009</td>
</tr>
<tr>
<td>PS (to be announced)</td>
<td>Shellharbour</td>
<td>2008</td>
</tr>
<tr>
<td>PS (to be announced)</td>
<td>south west Sydney</td>
<td>2009</td>
</tr>
<tr>
<td>HS (to be announced)</td>
<td>north west Sydney</td>
<td>2009</td>
</tr>
<tr>
<td>SSP (to be announced)</td>
<td>north west Sydney</td>
<td>2007</td>
</tr>
<tr>
<td>HS (to be announced)</td>
<td>Central West</td>
<td>(to be determined)</td>
</tr>
</tbody>
</table>

Note: PS is a primary school, HS is a high school, SSP is a special needs school.

Aerial view of Glenwood High School opened in 2005
1.2 Privately financed projects

The New Schools Privately Financed Project is known as a privately financed project (PFP). These are a form of public-private partnership – a more general term covering any contracted relationship between the public and private sectors to produce an asset or deliver a service.

PFPs have been developed and introduced extensively in the UK during the last decade. These have included the provision of improved school facilities.

PFPs involve the creation of an asset through private sector financing and ownership control for a concession period. They also involve the delivery of some services associated with the asset for a defined, but typically very long, period. The public sector may make monthly payments for the services throughout the contract period. The effect is that the initial capital cost is borne by the private sector and progressively reimbursed by the monthly payments.

Attraction of PFPs

PFPs are attractive to private investors, contractors and governments for different but related reasons. Briefly:

- income tax assessment legislation permits deductions to investors for early year losses, interest, fees and depreciation claims for private infrastructure projects
- contractors can secure large ongoing contracts over a longer term than is possible with conventional tender work; they also have more scope to develop better designs
- governments can achieve a number of objectives, such as simplifying management processes, lowering procurement costs and ensuring that assets are maintained.

Differences

This type of project is structured differently from other forms of public-private partnership - such as some toll roads. For example:

- in the New Schools Privately Financed Project the contractor operates a facility under licence and receives payments from the Government; the contractor carries no risk that the number of school children will be less than expected. The Government is considered to be the owner of the asset and an equivalent liability is recorded in the State accounts
- in a toll road the contractor typically operates a business franchise, assumes the risk that traffic might be less than expected, and charges users directly through tolls. The private sector is considered to be the owner of the asset and there are no liabilities recorded in the State accounts.

1.3 Government policy

The NSW Department of Education and the NSW Treasury are among the first in NSW to use this new approach for infrastructure needs. Their actions immediately followed the November 2000 release of a NSW Government ‘green paper’ that stated:
Introduction

Private sector involvement

The Government aims to maximise private investment in infrastructure to the extent that this results in better and more efficient delivery of existing public services.

The private sector could build new schools as well as renovate and upgrade existing schools.


Value for money test

In 2001 the NSW Government followed this with its release of *Guidelines for Privately Financed Projects*. This states that opportunities for PFPs will be investigated where it is clear that the private sector’s packaging of facilities offers better value for money than traditional Government procurement.

Total Asset Management

The PFP approach also strongly reflects the total asset management approach adopted by the NSW Government. The Government’s *Total Asset Management* policy was first released in 1992 to improve asset management practices in agencies. This requires a comprehensive and structured approach to acquiring, maintaining and upgrading physical assets to provide services to the community. Its purpose is also to remove agency bias towards the acquisition of new assets, often achieved at the expense of maintaining existing assets.

The PFP approach achieves this by ‘packaging’ acquisition and maintenance into a single contract.

Our 2005 performance audit report *Implementing Asset Management Reforms* found that the *Total Asset Management* policy provides a best practice framework to improve asset management in NSW.

1.4 This audit

This audit examined whether the processes for awarding the first privately financed schools contracts were adequate to maximise the potential for value for money.

The audit scope and focus covered the Department of Education and Training’s *New Schools Privately Financed Project* - specifically the:

- work leading up to the award of the first contract for 9 schools
- experience with that contract
- experience of similar work delivered through traditional public sector delivery
- work leading up to the second contract for 9 schools.

In particular, we looked for:

- a clearly defined business case to explain how DET had chosen the PFP approach (see chapter 2)
- genuine competition between bidders, followed by sound evaluation (see chapter 3)
- adequate performance standards and monitoring, to assure quality and timeliness of services (see chapter 4).
Introduction

The audit was informed by, and wishes to acknowledge the value of, the Research and Information Paper *New Schools Privately Financed Project Post Implementation Review*, December 2005, which summarises Treasury’s and DET’s review of the first contract.

An explanation of the terms used in this report can be found in Appendix 1. Further information on the scope, criteria and approach of the audit can be found in Appendix 2.
2. Was the business case clearly defined?
Was the business case clearly defined?

At a glance

We looked for a clearly defined business case, to explain how DET had chosen the PFP approach.

We found that DET:

- clearly defined its requirements from the outset. Its objectives included a faster supply of schools, possible cost savings, innovation and simplified services management
- presented a persuasive case that the proposed project was likely to provide value for money when compared to other options, although this was not supported by comprehensive financial and economic analysis of all the alternatives
- established that the project was likely to be affordable, but new schools were only advanced one or two years earlier than would otherwise have been expected
- identified the allocation of risks between the public and private sectors most likely to deliver better value for money
- scoped the project to maximise its prospects of achieving value for money. But we also found that the process involved a number of changes made to the lists of schools as detailed planning and negotiation progressed.

2.1 What we looked for

It is important for the successful delivery of any project that an organisation states its requirements clearly from the start. Otherwise there is the risk that it will end up with a project that does not meet its real needs. Also, prior to going out to tender, a procuring organisation needs to demonstrate that the proposed project is likely to provide value for money when compared to other options that could address its needs.

Value for money consists not simply of the lowest cost, but the best combination of cost and quality over the whole life of a project. Evaluating value for money involves assessing non-financial, as well as financial, benefits and costs.

We looked at whether DET had:

- a clear understanding of its requirements
- demonstrated that the proposed project was likely to provide value for money when compared to other options that could address its needs
- established that the proposed project was likely to be affordable
- identified that allocation of risks between the public and private sectors that was most likely to deliver better value for money
- scoped the project to maximise its prospects of achieving value for money.
Was the business case clearly defined?

Kellyville Ridge Public School
opened in 2004

2.2 DET's requirements

We found that DET’s requirements were clearly defined from the outset. Its objectives included a faster supply of schools, possible cost savings, innovation and simplified services management.

In mid 2000 DET indicated to its advisors that it was interested in reviewing the possibility of a PFP for the following reasons. A PFP:

- draws on the recurrent rather than capital budget and helps smooth out funding requirements (as payments are made each month, rather than as lump sums)
- allows a faster supply of schools instead of staging the developments (as capital costs could be spread over a long term)
- may generate cost savings
- provides the potential for innovation and more efficient use of resources
- potentially simplifies management due to the opportunities for combining all services, other than teaching and administration, within a single entity.

2.3 DET's assessment of alternatives

We found that DET presented a persuasive case that the proposed project using a PFP approach was likely to provide value for money when compared to other projects using different procurement models, although this was not supported by comprehensive financial and economic analysis of all the alternatives.
### Studies of PFP approach

DET commissioned a number of studies into the benefits and limitations of the PFP approach and the private sector’s capabilities.

In 2001, prior to the first contract, a consultant examined the procurement of nine new schools and advised DET that the PFP approach offered the greatest potential for improved value for money based on:

- risk transfer - allowing those risks to be allocated to the party best able to manage them
- use of an output-base specification - DET had until then used a traditional approach to procurement which was detailed and prescriptive as to the inputs required from the private sector and allowed little scope for innovation in facility and service delivery
- use of long term contracts - allowing the private sector scope to recover the initial investment, develop alternative approaches to service delivery and focus on whole-of-life costing. The outsourcing contracts managed by DET were typically for three to five years, whereas under a PFP procurement it would be possible to obtain a contract duration of up to thirty years
- performance measurement and incentives - payment to the contractor would only commence when a satisfactory flow of the services, to the required standard, was provided. Ongoing payments to the contractor would depend on it continuing to meet the specified performance criteria
- use of private sector management skills - the private sector would have much greater discretion over how the educational facilities and related services equipment would be provided and maintained than they would under a traditional procurement.

### Comparison with traditional procurement

DET had consultants prepare an economic appraisal, a feasibility assessment, and a preliminary public sector comparator to assess traditional procurement. These studies suggested that over the 30-year period covered in the analysis, savings in the order of 7-10% were achievable in new schools construction, fit-out and operations. DET concluded that the new approach was likely to be affordable and offer value for money.

### Assessment of other options

A comprehensive study of other available options was not undertaken. As noted in the post implementation review, the appraisals that DET conducted did not always document the capacity or availability of existing public schools to cater for demand, although the business case for the second contract did look at the impact on surrounding schools of doing nothing. This makes it difficult to assess whether or not the appraisals adequately considered demand management, non-construction strategies or opportunities to improve the performance of existing public school facilities.
Was the business case clearly defined?

In 2005, prior to the second contract, DET partly redressed this by retaining a consultant to examine four alternative procurement models:

1. private sector construct; public sector financed; public sector design and delivery of non-core services
2. private sector design, develop and construct; public sector financed; public sector delivery of non-core services
3. private sector design, develop, construct and maintain (for 4-6 years); part private sector financed; public sector delivery of all other non-core services
4. privately financed project and private sector delivery of some/all non-core services.

These models were qualitatively (although not quantitatively) assessed. Confirming earlier advice, the consultant concluded that:

- demand risk (such as related to the future school population) remains with the State under each of the procurement models
- models 3 and 4 are ‘packaged approaches’ and arguably allow DET to concentrate on the delivery of the educational curriculum, without having to worry about the delivery of services
- model 4 offered the greatest potential for value for money from innovation and the greatest whole-of-life affordability.

However, in the absence of a comprehensive financial and economic analysis of the alternative procurement methods for provision of school facilities - as with the public sector comparator analysis of traditional procurement (described in section 3.5) - it is not possible to judge whether the New Schools Project could not have achieved similar results using a different procurement route. There are major benefits from the PFP approach in areas of risk allocation, effective project management and an enhanced focus on quality of service. But while such benefits may be strongly associated with PFP procurement, they are not necessarily unique to it. In section 3.5 we recommend use of the information and method of the public sector comparator to better examine other alternatives.
 Recommendation

DET should consider applying elements of the PFP approach (including risk allocation, effective project management and an enhanced focus on quality of service) to its other projects - such as the refurbishment of existing schools - particularly where major new works are envisaged.

2.4 Affordability

We found that DET established that the project was likely to be affordable. But, for the most part, it was unable to secure any major increase in funds by adopting the new approach.

Funding needs

DET originally looked to the PFP process as a means of securing additional funds not otherwise available to it. It advised the Government that declining levels of capital funding had resulted in the deterioration of established schools and had inhibited the development of new schools.

DET’s annual capital allocation for schools had fallen from $150 million in 1996-97 to $130 million in 1998-99. DET argued that this problem could be solved using the PFP approach, as the capital needed for new schools could be spread over a 30 year period.

The Treasury considered that private sector provision of government services simply meant that one form of liability in the State’s balance sheet, debt, was replaced by another form of liability, the obligation to pay the private sector services provider. It argued that DET’s funding should not be permitted to exceed its approved capital works program.

The Government decided that DET’s capital allocations would be reduced over seven years by an amount equal to PFP construction costs, but not exceeding the cost of public sector delivery. This was to reflect the capital allocation no longer needed for these schools. DET would be able to retain any capital savings and accelerate some school construction over a 7 year period. As a result DET made some small savings arising from the PFP and new schools were advanced one or two years earlier than would otherwise have been expected.

2.5 Preferred allocation of risks

We found that DET identified the allocation of risks between the public and private sectors most likely to deliver better value for money.

Impact on value for money

Appropriate risk allocation between the public and private sectors is key for achieving value for money on projects of this type. In many cases the private sector is better placed to manage risks that traditionally the public sector has borne. If, however, the public sector seeks to transfer a risk that the private sector cannot manage, value for money will reduce as the private sector seeks to charge a premium for accepting such risks. Similarly, value for money will reduce if the public sector retains a risk that it cannot manage.

The NSW Government’s Working with Government Guidelines stress that the aim is to optimise risk allocation so that value for money is maximised in each project on a whole-of-life basis; the aim is not to maximise risk transfer from government to the private sector.
DET’s risk assessment

DET developed a risk matrix to determine the appropriate allocation of project risks between the public sector and the private sector proponent. Based on this, and based on soundings of what the market was prepared to bear, DET determined that risks should be transferred as shown below.

<table>
<thead>
<tr>
<th>DET’s plan to transfer risk to the private sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>• design risk should be transferred to the private sector operator and ultimately to the design and construction contractor</td>
</tr>
<tr>
<td>• construction risks including delivery to cost and to time, should be transferred to the private sector operator</td>
</tr>
<tr>
<td>• day to day risks of operating the facilities should all be transferable to the private sector operator</td>
</tr>
<tr>
<td>• the contractor should take on the risk of making available schools to an acceptable standard when required for the purpose of education delivery</td>
</tr>
<tr>
<td>• the contract should be structured with a payment mechanism linked to the consumer price index, a risk carried by the State</td>
</tr>
<tr>
<td>• once the contract takes effect, the risk of interest rate changes should pass to the contractor</td>
</tr>
<tr>
<td>• the private sector would not take the risk on the number of pupils attending school.</td>
</tr>
</tbody>
</table>

In our view DET’s plan for risk transfer was well suited to the circumstances and to securing value for money.

2.6 Project scoping

We found that DET had scoped the project to maximise its prospects of achieving value for money.

Making best use of the PFP approach

This meant that:

• the size and scope had to be large enough to attract the interest of possible partners. The size of the project also had to be large enough to enable DET to adequately evaluate the benefits of PFP and assess its potential for wider application. Discussion with industry suggested that the capital expenditure for a minimum viable project was in the range $50 - $100 million

• the financing of the project had to be within the current budget capacity of DET

• the project had to be consistent with the priorities already proposed in the Department’s asset acquisition forward program

• the project needed to be able to be clearly defined, preferably within a coherent geographical area which would enable it to stand alone if required

• to reduce complexity the project should include only new schools, as these were not encumbered by existing long term service contracts for maintenance, cleaning and security. It was also considered that new schools provided greater flexibility for innovative design, a significant value for money driver in PPP arrangements.
Based on these principles, the first contract (PFP1) required the contractor to:

- construct nine new build (six primary schools, two secondary schools and one special needs school)
- open six schools by 1 January 2004 and a further three schools (one secondary and two primary) by 1 January 2005.

Subsequently the second contract (PFP2) required the contractor to:

- construct nine new build schools (seven primary schools, one secondary schools and one special needs school)
- open two primary schools and a special needs school in 2007, three primary schools in January 2008; and three schools (one secondary, two primary) in January 2009. Another secondary school was later added to replace one lost by fire.

Both PFPs required the contractor to:

- create a positive environment for teaching and learning in accordance with modern best practice
- procure the project at a cost and quality that delivers demonstrable value for money
- ensure that the project is consistent with the public interest in terms of effectiveness, accountability, probity, equity, employee issues, public access, consumer rights, security, privacy and public consultation.

The planned new schools were located in areas of urban growth and based on assessments of long-term enrolments. The Department prepares annual demographic projections for new growth areas. Broadly speaking, it considers the need for a new primary school for every 1,600 - 2,000 dwellings and a new high school for very 4,500-6,000 dwellings. It aims to cater for the long-term enrolment pattern of an area in permanent accommodation, with demountables holding peak enrolments.

Whilst long-term enrolments appear to have been properly assessed, there were a number of changes made to the lists of schools as detailed planning and negotiation progressed. This was due to several factors arising from council approvals, consultation with stakeholders and the actual timing of construction. In some cases the changes were little more than a change in name or a minor change in location, but in some cases schools were deleted from the lists and new schools substituted. This affected the competitive process in both contracts.

We agree with comment in the post implementation review that it is desirable to have a high degree of certainty of outcome when entering into a PFP contract. It is also important that bidders are not asked to plan and cost schools that do not proceed.

DET’s school planning processes should be improved to provide a greater certainty of requirements when entering a PFP contract.
3. Was the process sufficiently competitive?
At a glance

We looked to see whether there had been genuine competition between bidders.

We found that DET:

- managed to create good tender lists and maintain competitive tension throughout the tender processes. These processes were, for the most part sufficiently transparent to ensure that the market was well informed. Transparency could be further enhanced if the contracts were more accessible to the public
- retained qualified external advisors, identified the contractual issues likely to arise and developed a considered approach to the evaluation process
- included broad educational objectives, which proved difficult to relate directly to school infrastructure proposals
- set its current school buildings specifications as the minimum requirement, which provided greater certainty in relation to the final product but offered little scope for further innovative design
- evaluated all aspects of the bids received and then chose as preferred bidder the one that offered it best value
- employed the public sector comparator for added competitive tension, particularly in the final stages of negotiation with the successful proponents
- assumed that the public sector comparator could not achieve efficiencies from bundling new schools, as this would have exceeded the level of funding available using traditional means.

3.1 What we looked for

Essential to getting good value for money is a procurement process that is as fully competitive as possible throughout the whole period of the procurement.

Part of this competition arises from use of the public sector comparator. The public sector comparator (PSC) is a risk-weighted model of the costs associated with a proposal under a government-financed method of delivery. It serves a dual purpose of helping to decide whether to adopt the PFP approach or otherwise, then helping to negotiate the best agreement.

So we looked to see whether:

- the processes for awarding the privately financed partnership schools contracts were sufficiently competitive and transparent
- DET had properly evaluated all aspects of the bids received and then chose as preferred bidder the one which offered it best value
- the assumptions used in the public sector comparator appeared reasonable.

We did not conduct a probity audit. Government guidelines required that a probity auditor be appointed to monitor the bid process throughout and provide advice to the steering committee and the CEO of DET. This was done and the probity auditor issued a number of reports testifying to the adequacy of arrangements from a probity perspective.
3.2 Competition and transparency

We found that DET managed to create good tender lists and maintain competitive tension throughout the tender processes. These processes were, for the most part, sufficiently transparent to ensure that the market was well informed.

The tender processes worked like this.

The Government’s Budget Committee approved the requests for tenders and the selection of the preferred proponent. The overall project was overseen by a steering committee, chaired by DET.

In each case a project evaluation committee and specialist advisory committees, comprising staff from DET, NSW Treasury, NSW Treasury Corporation and the Department of Commerce, with the assistance of specialist consultants, evaluated the bids. The engagement of a probity auditor provided additional assurance that the processes were conducted in a fair and equitable manner.

DET received eleven registrations of interest in PFP1. Four of the registrants were short-listed to submit detailed proposals for the project.

Following assessment, two proponents were invited to submit Best and Final Offers. On 3 December 2002 the NSW Treasurer announced the selection of the preferred proponent for PFP1. The proponent offered an actual bid of roundly $132.7 million, which was adjusted upwards by $4.0 million to $136.7 million to ensure comparability with the State’s allocation of risks better carried by the private sector. The proponent’s bid was the amount sought from the State, including all future service payments over the contract period, discounted to provide a present equivalent value.

DET received five registrations of interest in PFP2. Three of the registrants were short-listed to submit detailed proposals for the project.

DET let PFP2 in December 2005. In this case the proponent offered an actual bid of around $143.7 million, which was similarly adjusted upwards by $5.0 million to $148.7 million to ensure compatibility with the State’s allocation of risks better carried by the private sector. Again, the proponent’s bid was based on their future service payments over the contract period, discounted to provide a present equivalent value.

Finally, the second contract also adopted a variant proposal to replace a Central West school destroyed by fire. This increased the net present cost to $178 million.
Was the process sufficiently competitive?

**Childcare centres**

A feature of the winning proponent’s bids is that, in addition to the school facilities, many of the school sites also support privately run childcare centres. The bidding process encouraged this type of initiative.

![Childcare centre next to Kellyville Ridge PS](image)

**Transparency**

We found that the processes for awarding the privately financed partnership schools contracts were relatively open and transparent.

Notwithstanding this, we found that transparency could have been improved by:

- ensuring that bidders had a better understanding of DET’s requirements (this was done in the second contract)
- providing greater disclosure of contract details.

**Bidder engagement strategy**

The post implementation review reported that probity concerns could have limited DET’s communications with bidders for the first contract, particularly in providing background and explanation of its requirements. This could have limited transparency and contributed to the delays in negotiations over the first contract. DET developed a bidder engagement strategy for the second contract to ensure that bidders had a better understanding of its requirements, without compromising probity.

**Contract Summary**

Transparency was assisted by the publication of a *Contract Summary*, as required by the Government’s *Guidelines for Privately Financed Projects*. The Audit Office confirmed that the Summary satisfied the disclosure provisions of the Guidelines. Although the summary is short on detail in a number of areas - as it is intended only as a summary - it does include key information such as the service requirements, monthly payments to be made, evaluation criteria and weightings used to select the preferred bidder, and the results of the public sector comparator. These summaries are available to the public on the NSW Treasury website.

Some other jurisdictions require greater disclosure than NSW, which helps to remove the public’s concern with the secrecy associated with private-public partnerships. For example in Victoria all Departmental contracts over $10 million are required to be disclosed in full on the Victorian Government Purchasing Board’s website, together with the Request for Tender documents. If, based on freedom of information criteria, clauses have been excluded from the contracts, a note explaining the reason for the exclusion must be included.
In December 2005 a Review of Future Provision of Motorways in NSW (the ‘Richmond report’) by the State’s Infrastructure Implementation Group recommended that all project deeds and other agreements signed on behalf of the Government should be released. If specific documents are not going to be disclosed, there should be a specific list of these documents, a reason why they are being withheld, and if/when they will be released in the future.

**Recommendation**

Treasury and DET disclose more complete contract documents relating to the *New Schools Privately Financed Project*, as is the practice in Victoria and as recommended by the Richmond report.

### 3.3 Bid evaluation

We found that DET retained qualified external advisors, identified the contractual issues likely to arise and developed a considered approach to the evaluation process. It evaluated all aspects of the bids received and then chose as preferred bidder the one that offered it best value.

The bid evaluation process looked like this.

**Key contractual issues**

Drawing on experience overseas and interstate, DET identified the key contractual issues likely to arise during the procurement including:

- risk transfer - determining those risks best allocated to the private sector
- use of an output-base specification - under a PPP approach the services provided needed to be specified by DET as required outputs to allow the private sector scope for innovation in facility and service delivery
- long term nature of the contracts - this was viewed as a key condition for delivering value for money because of the scope it gives to recover the initial investment, develop alternative approaches to service delivery and focus on whole of life costing
- performance measurement and incentives - payments to the contractor would depend on it meeting the specified performance criteria.

**Evaluation criteria**

The project evaluation committee and its advisory committees evaluated the proposals in terms of the proponents’ demonstrated capacities to meet the following criteria (weighted as shown):

- DET’s educational objectives (15% - changed to 10% for the second contract)
- the project’s financial requirements, including the “value for money” of the proponents’ prices and the proponents’ financial strength (30%)
- the project’s legal requirements, including compliance with the terms of a draft contract (30%)
- the project’s technical requirements, including the deliverability of the proponents’ technical proposals, design excellence, attention to quality and safety issues and compliance with all relevant policies, codes and standards (15% - changed to 20% for the second contract)
- the project’s facilities management requirements (25%).
Was the process sufficiently competitive?

Of these, the educational objectives proved the least tangible. They included:

- promote effective learning within quality learning environments
- provide a well rounded education that values and supports the intellectual, creative, physical, social and emotional development of each child
- promote lifelong learning.

Specific relationships between school infrastructure and student outcomes are difficult to quantify. Partly because of this, DET set its current school buildings specifications as a minimum requirement.

External advisers

We looked to see whether DET appointed good quality external advisers after a competitive bid process. Good quality external advisers can be essential to the successful negotiation of a PFP. The best way to secure such advisers is after a proper competition since one can then choose from a range of good quality firms. The principle behind such competition is to obtain advisers who will provide the best value for money. We found that DET sought competitive offers and appointed qualified external advisors to assist it to evaluate the bids received and to negotiate a final contract.

Although the costs to DET of establishing the first contract reached $3.5 million, including the cost of DET’s in-house resources, the costs associated with the second contract are expected to be considerably lower at $2 million.

3.4 Scope for innovation

A major reason for adopting the PFP approach was that it would allow the private sector to explore new school designs and new ways of providing the services sought.

So there was an expectation that the private sector would introduce innovative solutions to reduce the whole of life cost of the schools. For example, one expectation was that there would be a high level of upfront construction expenditure in order to reduce ongoing maintenance costs.

In reality this was not reflected in the bids received. DET had set its current school buildings specifications as the minimum requirement, and this was met. DET’s specifications detail the required school facilities - including size requirements, finishes, number of power points etc. - room by room.

DET sees these specifications as ensuring that the provision of school facilities remains equitable. They are subject to regular reviews to achieve efficiency in design, innovation and cost effectiveness. They also provide greater certainty in relation to the final product.

But there was little in the way of innovative design that could be attributed to the PFP approach. Also, the value of the design risk transferred to the contractor was relatively low, given the designs have been used to deliver other schools and are subject to continuous improvement by DET in consultation with stakeholders.
Was the process sufficiently competitive?

3.5 Development of the public sector comparator

We found that development of the public sector comparator had provided added competitive tension, particularly in the final stages of negotiation with the successful proponents. To the extent that the Government had already committed to fund the schools through DET’s capital works program, the public sector comparator presented a realistic alternative.

**Apparent savings**

The result was that in each case the cost of the public sector comparator exceeded the net present cost of the private sector bid.

The results of the analysis for the first contract gave a range of public sector comparator costs from a ‘worst case’ of $152.6 million to a ‘best case’ of $134.3 million with the ‘most likely’ or ‘mean’ outcome being $141.8 million. This included a ‘cost’ of $10 million for risk assessed to have been transferred to the private sector. The cost of the public sector comparator exceeded the net present cost of the winning bid, which was $131.4 million (including a ‘saving’ of $3.2 million due to revenue from childcare centres).

The results of the analysis for the second contract gave a range of public sector comparator costs from a ‘worst case’ of $203.3 million to a ‘best case’ of $185.5 million with the ‘most likely’ or ‘mean’ outcome being $193.8 million. This included a ‘cost’ of $18 million for risk transferred to the private sector. This exceeded the net present cost of the winning bid, which was $148.7 million (not including a ‘saving’ of $3.1 million from the childcare centres).
Was the process sufficiently competitive?

<table>
<thead>
<tr>
<th>Notional savings against public sector comparator</th>
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<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Contract 1</td>
</tr>
<tr>
<td>Contract 2</td>
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</tbody>
</table>

In each case the ‘saving’ is accomplished with the help of the estimated cost of risk transferred to the private sector, as shown by the following table.

<table>
<thead>
<tr>
<th>Notional savings compared to estimates of risk transfer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saving ($m)</td>
</tr>
<tr>
<td>Contract 1</td>
</tr>
<tr>
<td>Contract 2</td>
</tr>
</tbody>
</table>

NSW Treasury oversaw development of the public sector comparator and provided key economic assumptions, including the discount rates. As the evaluation of the PSC was significantly affected by assumptions and estimates, we looked to see if these were reasonable.

The public sector comparator is very sensitive to the assumptions that are made. We found that, whilst the assumptions in the public sector comparator on the whole seemed reasonable, some of the assumptions could reasonably be questioned. The assumptions are often subjective and can vary significantly between estimating teams and contracts.

For example the PSC:

- relied significantly on maintenance costs that had to be estimated in the absence of comparable historical costs. DET maintenance is largely reactive and schools are not fully maintained to the level assumed
- did not include efficiencies from the bundling of 9 new schools, packaging of the facilities management services and letting of long-term facilities management contracts that would likely have lowered its cost
- did not include the sale or lease of school land for third party use, such as childcare centres, which would have further lowered its cost. DET considered that the Education Act 1990 would have prevented it purchasing land for this purpose and, in any case, it was not in the business of sourcing third party income opportunities, but more focused on the delivery of education. There are indications that this view is changing, as long as commercial activities do not compromise educational activities.

The assumption that the efficiencies of bundling new schools could not otherwise be achieved by DET make it unlikely that the public sector comparator would ever be lower than the private sector’s PFP bid. Government guidelines require that a PSC is based on the most efficient likely method of providing the defined output currently available to the public sector. However, DET considered that this was not feasible on the basis that it would have exceeded the level of funding available using traditional means.
Was the process sufficiently competitive?

We also noticed a significant increase in the cost of the public sector comparator from PSC1 at $141.8 million to PSC2 at $193.8 million, each of which was for 9 similar schools. Whilst the construction costs were similar in each estimate, the allowances for operating costs and transferred risk had increased by more than 80 percent. DET attributed these increases to:

- higher market volatility when preparing capital cost estimates and pricing in the services sector
- now projecting wage growth at 4% pa, not 2.5% pa as in PSC1
- higher risks associated with site investigation, surveys, contamination studies, council negotiations for the sites included in PSC2
- increased scope - eg. PSC1 included only 50% of utilities costs, PSC2 has 100%; the number of demountables is higher for PSC2; PSC1 did not allow for replacement roofs after 20 years, even though the manufacturer’s warranty would have expired - so DET allowed an additional $1m per school or $9m in PSC2. Note that the contracts do not require the roofs be replaced, only that they be maintained
- a considerable increase in insurance costs.

Limitations

The NSW Government’s Working with Government - Guidelines for Privately Financed Projects observes that the PSC has inherent limitations because:

- it requires costs (and revenues) to be forecast over the life of the proposed concession. It is difficult, even for the most skilled experts, to make accurate estimates over such a long time-frame
- estimating the impact of risks on costs (and revenues) over the life of an asset is a complex and often subjective exercise.

Despite these limitations in assessing future costs and revenues and risks, the public sector comparator appears to be sufficiently precise to be a useful tool for assessing alternative procurement routes. Its accuracy in relation to school facilities is likely to improve with use.

Recommendation

DET needs to use the information and method of the public sector comparator, appropriately updated or modified, to assist in accurately comparing the costs, benefits and risks of different approaches.
4. Are performance standards adequately established and monitored?
Are performance standards adequately established and monitored?

At a glance

We looked for adequate performance monitoring and incentives.

We found that:

- the incentives for performance are clearly designed to encourage good performance by the contractor, with appropriate benchmarks. Some of these incentives were strengthened in the second contract.
- the reporting and monitoring system has been thoroughly prescribed and seems appropriate for the task. However, as it is largely reliant on self-monitoring by the contractor, DET will need to carefully oversee and regularly audit the effectiveness of the system.
- there are adequate contract mechanisms that DET can use to make changes to school facilities, or to intervene as necessary - such as in the case of poor contractor performance.
- DET has not as yet completed work on a Contract Administration manual to identify what needs to be done by whom and when.

4.1 What we looked for

Performance measurement is critical to PFPs because the Government is procuring a service of specified quantity, quality and availability. The Government needs to be in a position to confirm that the private party is performing according to the output specifications in the contract. If this is not the case, the Government will need to take corrective measures.

We looked at whether:

- the incentives for performance are appropriate and have appropriate benchmarks.
- there are appropriate payment deductions for sub-standard performance.
- the reporting and monitoring system is appropriate for the task.
- there are adequate processes if conditions change markedly from that envisaged.
- there was assurance that DET’s resources would be adequate for the task.

4.2 Incentives for performance

We found that the incentives for performance are clearly designed to encourage good performance by the contractor, with appropriate benchmarks. Some of these incentives were strengthened in the second contract.

The incentives for performance stem primarily from the payment mechanism, which is designed to:

- ensure that payment is made only to the extent that the service meets the desired standard; no payment is made until a school is built and operating.
- provide incentives for the contractor to meet the standards by placing payments to the contractor at risk for failure to meet those standards.
- provide incentives for the contractor to correct any failures as rapidly as possible and to avoid repeated failures by the use of defined rectification periods and the escalation of charges.
Are performance standards adequately established and monitored?

The starting bases for calculating each month’s ‘monthly net fee’ are ‘monthly service fees’ for each school, which are payable if the contractor fully complies with all of DET’s specifications and other requirements for the operational services.

These fees are adjusted each quarter in line with CPI less an ‘efficiency’ reduction. These fees will also be adjusted up or down every five years to reflect the results of ‘bench marking’ and ‘market testing’ exercises.

Each of the contractor’s monthly net fees may be reduced by:

- any failure by the contractor of the school facilities to comply with availability standards set out in the contract
- any other failures by the contractor to provide its operational services to standards set out in the contract
- any repetition of an availability or performance failure leading to three or more occurrences in any three-month period
- reporting failures.

By the end of 2005 payment deductions had amounted to around half a percent of the monthly service fee, most likely reflecting the newness of the facilities and good performance by the contractor.

Simplifying payment deductions

A workshop for Treasury’s and DET’s Post Implementation Review found that the payment deductions in the first contract were complex and could be limited in a number of ways, potentially proving ineffective in the case of repeated poor performance. Despite this, we found that the payment mechanism in the first contract appeared to be working effectively — although the contract is in its early stages.

We found that the second contract had adopted a simpler scheme, taking into account the lessons learnt from the first contract. The payment deductions in the second contract had also been strengthened, particularly in terms of discouraging continued failures.

We found that DET had learnt from their experience with the payment system and made improvements, but that both systems were workable and suited to their purpose.

4.3 Performance standards

We found that there had been a considerable up-front effort to define performance requirements.

Contracts clearly specify performance standards. For example:

- toilets and wash/shower areas to be completely clean and free from odours, stains, dirt, mould, limescale and dry germ. A streak and smear free finish is required
- roofs and awnings must be free of noticeable distortion and remain weathertight
- paint work must remain of uniform colour, with no chalking or lifting of the coating
- ventilation services should perform at required rates and not leak
- grassed areas should remain free of weeds and litter, with no lifting of turf
- prevent theft and physical damage to the school facilities; respond to fire, intruder, security alarms within 30 minutes.
Performance failures must be rectified within set times. For example in the second contract:

- matters that give rise to an immediate risk or fault to the health and safety or security of persons or property require a response within 30 minutes and permanent rectification before the start of the next school day

- matters that inhibit the ability to effectively carry out education functions require a response within 1 hour and permanent rectification before the start of the next school day (if cleaning and waste management and janitorial services) or 3 days (if maintenance and other services)

- other matters require a response within 2 hours and permanent rectification within 10 days.

Payment deductions apply if the failures are not rectified within the set times. For example in the second contract:

- for matters that give rise to an immediate risk or fault to the health and safety or security of persons or property, the deduction would be $300 a day for a science laboratory

- for matters that inhibit the ability to effectively carry out education functions, the deduction would be $150 a day for a general learning space

- for other matters the deduction would be $60 a day for a public reception area.

These payment deductions can be significant. For example if an area is water damaged and the contractor has 10 days to fix it, but takes 12, the deduction applies to the whole 12 days.

There is a Help Desk and fault logging system and each school has an on-site manager employed by the private sector operator. The Help desk system creates work orders and generates 'help desk activity reports' (detailing date, item, originator, job no., priority, and completion).

In our view the performance requirements and help desk procedures are well specified.

### 4.4 Performance reporting

We found that the reporting and monitoring system has been thoroughly prescribed and seems appropriate for the task. However, as it is largely reliant on self-monitoring by the contractor, DET will need to carefully oversee and regularly audit the effectiveness of the system.

The reporting and monitoring system works like this.

The contractor must monitor and report on its performance in delivering its operational services in accordance with detailed monitoring procedures, record-keeping requirements, notification requirements, "help desk” requirements and routine monthly reporting requirements set out in the contract. Payments are reduced if performance falls short of standards or if parts of the school are not available for use.

The reporting requirements shift the burden of reporting and compliance monitoring from the State onto the contractor. This represents a major change from traditional procurement, where monitoring and reporting is a State responsibility.
Are performance standards adequately established and monitored?

The hydrotherapy pool at Tallowood special needs school has specific maintenance requirements

**Planned programs**

The contractor must also prepare a number of plans and manuals that require agreement and oversight by DET.

- The Management Plans required for each school site are an Occupational Health and Safety Plan, an Environmental Management Plan, a Project Quality Plan, a Construction Management Plan and a Project Cost Plan. All have to satisfy criteria set out in the contract.

- The Operation Manuals required for each school site are an Asset Management Plan, an Operation Plan, a Maintenance Program, an Environmental Management Plan, requirements for an Operation, Maintenance and Repair Register and a plan for a survey of asset conditions which must be conducted several years prior to the end of the contract.

- The Operation Manuals must, for example, cover monitoring, auditing and reporting procedures, quality standards, benchmarking data, staff vetting procedures, training plans, “help desks” and information management, document management, complaints and corrective action procedures, security provisions, security incident reporting systems, pest control, waste management, fire and emergency management, disaster plans, business continuity plans, staffing structures and responsibilities, costed life cycle and maintenance and replacement plans, costed maintenance programs, energy management, insurance provisions and procedures and “as built” and “as installed” drawings.

**Audits**

At least every 12 months the Contractor must have its compliance with the quality standards in its Operation Manuals independently audited by an auditor reasonably acceptable to DET. For example, the contractor must implement a planned maintenance program that includes plans for the next 5 year period (five year rolling basis). The plans must be submitted to DET for review annually.
Are performance standards adequately established and monitored?

In addition to the monitoring to be carried out by the contractor, DET may at its own expense monitor the contractor’s performance of its services and the contractor’s own monitoring and quality assurance procedures.

DET may also:

- carry out audits of any school facility, to assess whether it is being operated and maintained in accordance with the standards, but not more than twice in a calendar year for any individual school facility and giving the Contractor at least five business days’ written notice of the date on which it wishes to carry out the audit
- audit the Contractor’s compliance with the Operation Manuals at any time, giving the Contractor at least 20 business days’ notice its intention to do so.

If an audit shows a breach of the contractor’s obligations, DET must advise the contractor of the standards to be met and specify a reasonable period for rectification and the contractor must:

- carry out these works, at its own cost, within the specified period
- reimburse DET for the cost of the audit.

In summary we found that although the reporting and monitoring system is well prescribed, it is largely reliant on self-monitoring by the contractor and will require careful oversight by DET.

4.5 Additional contract safeguards

We found that there are adequate contract mechanisms that DET can use to make changes to school facilities, or to intervene as necessary - such as in the case of poor contractor performance.

These contract mechanisms work like this.

**Changes**

The contracts contain detailed procedures and payment mechanisms for changes.

For example, there is uncertainty about future school demand and capacity. Demand risk is borne by DET. If additional learning spaces are required at a school facility, DET must give the contractor at least three months’ notice. If the contractor proposes to use DET demountable units to provide some or all of the additional learning spaces, DET must deliver the requested units. The contractor will be fully responsible for installing, commissioning and providing operational services for any demountable classrooms. The contractor will be paid for its provision of the additional learning spaces and associated services through the normal monthly payment arrangements.

But the post implementation review found that some minor changes had been made using an "overs-and-unders" system - offsetting potential cost increases against decreases. The contract had not envisaged such a system. The review recommended that future contracts anticipate the need for such a system and support it with clear Government authorisation procedures at both the agency and Treasury level. We agree.
Are performance standards adequately established and monitored?

The contracts also include safeguards against unsatisfactory performance. The most important of these is that the State has the right to 'step-in' to solve any contractor default (subject to rights of the project financiers).

'Step-in' occurs when government elects to assume all or some of the service delivery obligations of the private party for a period of time. Situations in which government may exercise its contractual rights to step-in include:

- preventing or mitigating a serious risk to the environment, public health, the safety of people or property
- guaranteeing continuity of a service
- discharging a statutory duty
- otherwise dealing with a default by the private party under the contract.

If the contractor fails to perform any of its obligations, the State may perform these obligations itself or procure their performance by others. If the State does so, the contractor must pay its costs upon demand.

This general right of the State to remedy the contractor’s breaches is in addition to its more specific remedy and 'step-in' rights following:

- an emergency or a perceived need to take action to discharge a public duty during the project’s operational phase
- breaches by the contractor.

'Contractor events of default’ are defined in the contract and include:

- any failure by the contractor to provide substantially all of its operational services for 15 consecutive business days, unless this is permitted under the terms of the contract
- any unavailability of any particular school facility for a total of ten days or more in any three-month period
- any unavailability of a "critical area” (such as an examination hall) during any particular "critical period” (such as an examination period), as notified to the contractor by DET for two or more days in total, if a suitable alternative area is not available at the school
- any ‘persistent breach’ of the contract by the contractor.

If the State needs to terminate the contract (such as in the case of contractor events of default or contractor insolvency, where the contract financiers have not exercised their rights to step-in) and compensation is payable it may either:

- re-tender the provision of the services and pay-out the contractor, less its costs, or
- require an expert determination to determine the fair value of the contract and then pay-out the contractor.
Are performance standards adequately established and monitored?

**Dispute resolution** The contract sets out procedures to be followed whenever there is a dispute between the State and the contractor including:
- either party may refer a dispute for resolution by a committee comprising a representative of DET and a representative of the contractor
- if the committee fails to resolve the dispute it must refer the dispute to binding expert determination or arbitration
- if the committee fails to meet, fails to make a referral, cannot agree on whether to make such a referral or cannot agree on the expert or arbitrator to be appointed, DET or the contractor may ask the President of the Institute of Arbitrators and Mediators Australia to choose a process for resolving the dispute and nominate a panel of at least three experts or arbitrators.

**End of contract** Additionally, schools must be handed over to DET in a pre-determined condition at the end of the contract. The contracts provide for a retention account to fund any shortfall. Several years prior to the end of the contract, DET may arrange an independent survey of the school facilities to:
- assess whether the facilities have been and are being maintained as required under the contract
- determine the amount of money that will need to be spent or reserved, during the rest of the contractor’s operating term to ensure there will be no life cycle failure or expiry, during the six years following the end of the operating term.

**Residual risks** The adequacy of these controls was supported by an assessment conducted by DET’s internal audit division. In 2004 internal audit conducted a risk assessment of the first contract of the New Schools PFP project. The report involved the identification and evaluation of risks associated with the project and the controls in place to mitigate those risks. The report was satisfied that all key risks have been appropriately managed and that any residual risks were so low that no mitigation activities were recommended. This would appear to also apply to the second contract, as the controls are generally the same or in some cases strengthened.

In our view the contract mechanisms are adequate, but require that DET closely oversight contractor performance so it can take timely action where necessary.

**4.6 Contract administration and oversight**

Contract administration and oversight is about anticipating and managing risk.

Savings and other benefits do not automatically flow from a PFP. Whatever the estimated value for money of such a contract when it is first signed, subsequent poor management can result in higher costs, wasted resources, impaired performance and public concern.

We examined the arrangements for:
- what needs to be done by whom and when
- how the Government’s role will be performed.
Are performance standards adequately established and monitored?

We found that DET has established a dedicated team to be responsible for the day-to-day management of the contract and liaison with the schools when necessary. The team liaises closely with school principals in the new schools. The DET finance area handles the payment of monthly invoices.

**Contract Administration Manual**

However, we found that DET had not as yet completed work on a Contract Administration Manual.

In 2003 DET’s advisors recommended that it prepare a Contract Administration Manual to:

- specifically identify the Government resources and roles needed for contract monitoring
- specify the actions needed to ensure that the Contractor’s reporting obligations were fulfilled
- ensure the performance monitoring and reporting strategy for the project is properly implemented and coordinated with overall contract administration.

The advisors also recommended that other tasks should be undertaken to supplement this and provide early warning of potential problems. For example, external information such as news articles and publicly available financial information on the consortium members should be used to supplement the reporting obligations of the contractor. The purpose is to identify early negative circumstances that could potentially impact on the financial health of the project, management quality, service performance and Government’s relationship with the contractor.

**Recommendation**

DET needs to expedite completion of the Contract Administration Manual. The Manual also needs to be regularly reviewed and updated during the 30 year life of the New Schools Privately Financed Project.

**Project Management Steering Committee**

The post implementation review noted that the contract has a 30 year term, with a 6 year trailing hand-over liability period. It noted that it is reasonable to expect future changes of both a minor and potentially major nature and that Government needs to be well placed to deal with these changes. It recommended that a cross-agency Project Management Steering Committee be formed with the aim of ensuring that corporate knowledge of the contract is retained across a range of agencies.

**Recommendation**

DET and Treasury need to ensure that the cross-agency Project Management Steering Committee can oversight and report on whether the New Schools Privately Financed Project continues to offer value for money.

**Review process**

We would also expect that there would be an appropriate process of review, removed from the day-to-day function of contract administration. Our audit has been limited to establishing whether the contracts were established and let in a way that maximises their potential for delivering value for money. But, as these are in effect open contracts that will extend over several decades, the outcomes are difficult to predict. Many changes could occur and unforeseen circumstances arise. The project will need to be carefully managed to ensure that benefits are realised, and that costs do not escalate beyond expectations.

**Recommendation**

DET needs to work with Treasury to design an appropriate evaluation process to review whether the project continues to provide value for money.
Are performance standards adequately established and monitored?

| Guidelines for Privately Financed Projects | The New Schools Privately Financed Project was the first project delivered under the NSW Government’s Guidelines for Privately Financed Project. These were released in 2001 and based much more extensive guidance material published by Partnerships Victoria. The project also benefited from considerable involvement by Treasury that may not be available to every PFP application in NSW. |
| Recommendation | Treasury needs to update and expand its Guidelines for Privately Financed Project in order to continue to ensure a consistent, transparent and accountable approach to PFPs in NSW. |
### Appendix 1 Terms used in this report

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contractor</td>
<td>A term used generally in this report to refer to the PFP service provider. Usually for a PFP a consortium of private sector interests establishes a special purpose company to make the bid. Typically each consortium comprises financiers, construction and facilities management companies.</td>
</tr>
<tr>
<td>DET</td>
<td>NSW Department of Education and Training</td>
</tr>
<tr>
<td>Discounted</td>
<td>In general, people value $1 received today more highly that $1 received at a future date. To reflect this in project costings and appraisals, amounts due to be paid or received at future dates are discounted to provide a present equivalent value expressed as a single sum.</td>
</tr>
<tr>
<td>Preferred bidder</td>
<td>A point is reached in the contract bidding process where one bidder emerges as best qualified to meet DET’s requirements in terms of its educational, financial, legal, technical and facilities management criteria. At this stage it is nominated as preferred bidder and negotiations continue with it alone until the deal is concluded.</td>
</tr>
<tr>
<td>Privately Financed Project (PFP)</td>
<td>A form of public-private partnership. PFPs involve the creation of an asset through private sector financing and ownership control for a concession period. They also involve the delivery of some services associated with the asset for a defined, but typically very long, period.</td>
</tr>
<tr>
<td>Public Private Partnership (PPP)</td>
<td>A general term for projects involving both the public and private sectors (with varying levels of involvement and responsibility). PFP is one variant of a PPP.</td>
</tr>
<tr>
<td>Public sector comparator (PSC)</td>
<td>The hypothetical risk-adjusted whole-of-life cost of government delivering the project output specifications. The PSC includes an adjustment for competitive neutrality and is used as the benchmark for assessing the potential Value for Money of private party bids in PFP projects.</td>
</tr>
<tr>
<td>Risk allocation</td>
<td>The agreement between the parties to a public/private finance deal or concession which defines which parties or party is responsible for minimising the chance that a particular adverse event should arise, for mitigating the impact of that event, and for bearing the financial or other consequences of that event occurring.</td>
</tr>
<tr>
<td>Risk transfer</td>
<td>The passing of risk normally borne by the customer to the service provider.</td>
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<tr>
<td>Traditional procurement</td>
<td>The traditional procurement approach adopted by DET uses individual school construction contracts and multiple short-term service and supply contracts. Such projects are generally for a short period.</td>
</tr>
<tr>
<td>Value for money</td>
<td>The achievement of the combination of cost over the whole life of a project and quality that best meets an organisation’s requirements.</td>
</tr>
</tbody>
</table>
Appendix 2  About the audit

Objective

Our objective was to determine if the processes for awarding the first privately financed schools contracts were adequate to maximise the potential for value for money.

Our aim was to not duplicate other work, such as the agency’s own post implementation review, but focus on the potential for such partnerships to deliver better value for money (in terms of cost, quality and risk) than traditional public sector delivery models.

Scope and focus

The audit scope and focus involved the Department of Education and Training’s New Schools Privately Financed Project – specifically the work leading up to the award of the first contract for 9 schools, the experience with that contract, the experience of similar work delivered through traditional public sector delivery, and the work leading up to the second contract for 9 schools. Other agencies included NSW Treasury and the Department of Commerce.

The audit did not seek to:

- duplicate internal reviews already conducted by the agencies in relation to this topic
- question the merits of Government policy objectives
- separately review the probity arrangements.

Criteria

We looked to see whether:

- there was a clear understanding of how the DET chose this project ahead of other possible uses of its resources and what its objectives were in doing this
- alternative delivery options had been identified and their costs and benefits properly evaluated including alternative financing options
- the processes for awarding the first privately financed partnership schools contract were sufficiently competitive and transparent
- DET properly evaluated all aspects of the bids received and then chose as preferred bidder that which offered it best value
- the incentives for performance are appropriate and have appropriate benchmarks
- there are appropriate standards and reduced payment for sub-standard performance
- the reporting and monitoring system is appropriate for the task
- there are renegotiation processes if conditions change markedly from that envisaged.
Audit approach

We acquired subject matter expertise through:

- interviews and examination of relevant documents including guidelines, reports, studies, strategies and reviews relating to the project
- discussions with relevant staff as required, including staff of supporting agencies
- discussions with representatives as required of key stakeholders such as principals and the school community
- comparisons where appropriate with other States and countries, such as the UK Schools Private Finance Initiative
- discussions with other audit offices, including the Victorian Audit Office
- government and best practice guidelines relevant to the above.

This was supplemented with assistance from an external subject matter expert - Dr Michael Regan of the Australian Centre for Public Infrastructure, School of Enterprise, The University of Melbourne - who reviewed the audit plan, scope and criteria, overall findings and draft report.

Cost of the audit

Including printing and all overheads, the estimated cost of this audit is $150,000.

Acknowledgements

We gratefully acknowledge the co-operation and assistance provided by representatives of the Department of Education and Training and the NSW Treasury. In particular, we would like to thank the Principals of Glenwood High School, Kellyville PS and Tallowood SSP for their assistance to the audit. We also wish to acknowledge the benefit of discussion with the NSW Teachers Federation.

Audit team

Chris Yates was our team leader for this performance audit. Sean Crumlin provided direction and quality assurance.
Performance Audits by the Audit Office of New South Wales
Performance Auditing

What are performance audits?
Performance audits are reviews designed to determine how efficiently and effectively an agency is carrying out its functions.

Performance audits may review a government program, all or part of a government agency or consider particular issues which affect the whole public sector.

Where appropriate, performance audits make recommendations for improvements relating to those functions.

Why do we conduct performance audits?
Performance audits provide independent assurance to Parliament and the public that government funds are being spent efficiently and effectively, and in accordance with the law.

They seek to improve the efficiency and effectiveness of government agencies and ensure that the community receives value for money from government services.

Performance audits also assist the accountability process by holding agencies accountable for their performance.

What is the legislative basis for Performance Audits?
The legislative basis for performance audits is contained within the Public Finance and Audit Act 1983, Part 3 Division 2A, (the Act) which differentiates such work from the Office’s financial statements audit function.

Performance audits are not entitled to question the merits of policy objectives of the Government.

Who conducts performance audits?
Performance audits are conducted by specialist performance auditors who are drawn from a wide range of professional disciplines.

How do we choose our topics?
Topics for performance audits are chosen from a variety of sources including:

- our own research on emerging issues
- suggestions from Parliamentarians, agency Chief Executive Officers (CEO) and members of the public
- complaints about waste of public money
- referrals from Parliament.

Each potential audit topic is considered and evaluated in terms of possible benefits including cost savings, impact and improvements in public administration.

The Audit Office has no jurisdiction over local government and cannot review issues relating to council activities.

If you wish to find out what performance audits are currently in progress just visit our website at www.audit.nsw.gov.au/

How do we conduct performance audits?
Performance audits are conducted in compliance with relevant Australian standards for performance auditing and operate under a quality management system certified under international quality standard ISO 9001.

Our policy is to conduct these audits on a "no surprise" basis.

Operational managers, and where necessary executive officers, are informed of the progress with the audit on a continuous basis.
What are the phases in performance auditing?

Performance audits have three key phases: planning, fieldwork and report writing.

During the planning phase, the audit team will develop audit criteria and define the audit field work.

At the completion of field work an exit interview is held with agency management to discuss all significant matters arising out of the audit. The basis for the exit interview is generally a draft performance audit report.

The exit interview serves to ensure that facts presented in the report are accurate and that recommendations are appropriate. Following the exit interview, a formal draft report is provided to the CEO for comment. The relevant Minister is also provided with a copy of the draft report. The final report, which is tabled in Parliament, includes any comment made by the CEO on the conclusion and the recommendations of the audit.

Depending on the scope of an audit, performance audits can take from several months to a year to complete.

Copies of our performance audit reports can be obtained from our website or by contacting our Office Services Manager.

How do we measure an agency’s performance?

During the planning stage of an audit the team develops the audit criteria. These are standards of performance against which an agency is assessed. Criteria may be based on government targets or benchmarks, comparative data, published guidelines, agencies corporate objectives or examples of best practice.

Performance audits look at:
- processes
- results
- costs
- due process and accountability.

Do we check to see if recommendations have been implemented?

Every few years we conduct a follow-up audit of past performance audit reports. These follow-up audits look at the extent to which recommendations have been implemented and whether problems have been addressed.

The Public Accounts Committee (PAC) may also conduct reviews or hold inquiries into matters raised in performance audit reports. Agencies are also required to report actions taken against each recommendation in their annual report.

To assist agencies to monitor and report on the implementation of recommendations, the Audit Office has prepared a Guide for that purpose. The Guide, Monitoring and Reporting on Performance Audits Recommendations, is on the Internet at www.audit.nsw.gov.au/publications/better_practice/better_practice.htm

Who audits the auditors?

Our performance audits are subject to internal and external quality reviews against relevant Australian and international standards. This includes ongoing independent certification of our ISO 9001 quality management system.

The PAC is also responsible for overseeing the activities of the Audit Office and conducts reviews of our operations every three years.

Who pays for performance audits?

No fee is charged for performance audits. Our performance audit services are funded by the NSW Parliament and from internal sources.

For further information relating to performance auditing contact:

Stephen Horne
Assistant Auditor-General,
Performance Audit
(02) 9275 7278
email: stephen.horne@audit.nsw.gov.au
# Performance Audit Reports

<table>
<thead>
<tr>
<th>No</th>
<th>Agency or Issues Examined</th>
<th>Title of Performance Audit Report or Publication</th>
<th>Date Tabled in Parliament or Published</th>
</tr>
</thead>
</table>
| 78 | State Rail Authority (CityRail)  
State Transit Authority | Fare Evasion on Public Transport | 6 December 2000 |
| 79 | TAFE NSW | Review of Administration | 6 February 2001 |
| 80 | Ambulance Service of New South Wales | Readiness to Respond | 7 March 2001 |
| 81 | Department of Housing | Maintenance of Public Housing | 11 April 2001 |
| 82 | Environment Protection Authority | Controlling and Reducing Pollution from Industry | 18 April 2001 |
| 83 | Department of Corrective Services | NSW Correctional Industries | 13 June 2001 |
| 84 | Follow-up of Performance Audits | Police Response to Calls for Assistance  
The Levying and Collection of Land Tax  
Coordination of Bushfire Fighting Activities | 20 June 2001 |
| 86 | Follow-up of Performance Audits | The School Accountability and Improvement Model (May 1999)  
The Management of Court Waiting Times (September 1999) | 14 September 2001 |
| 87 | E-government | Use of the Internet and Related Technologies to Improve Public Sector Performance | 19 September 2001 |
| 90* | Intellectual Property | Better Practice Guide  
Management of Intellectual Property | 17 October 2001 |
| 91 | University of New South Wales | Educational Testing Centre | 21 November 2001 |
| 92 | Department of Urban Affairs and Planning | Environmental Impact Assessment of Major Projects | 28 November 2001 |
| 93 | Department of Information Technology and Management | Government Property Register | 31 January 2002 |
| 94 | State Debt Recovery Office | Collecting Outstanding Fines and Penalties | 17 April 2002 |
| 95 | Roads and Traffic Authority | Managing Environmental Issues | 29 April 2002 |
| 96 | NSW Agriculture | Managing Animal Disease Emergencies | 8 May 2002 |
| 97 | State Transit Authority  
Department of Transport | Bus Maintenance and Bus Contracts | 29 May 2002 |
| 98 | Risk Management | Managing Risk in the NSW Public Sector | 19 June 2002 |
## Performance audit reports and related publications

<table>
<thead>
<tr>
<th>No</th>
<th>Agency or Issues Examined</th>
<th>Title of Performance Audit Report or Publication</th>
<th>Date Tabled in Parliament or Published</th>
</tr>
</thead>
<tbody>
<tr>
<td>99</td>
<td>E-Government</td>
<td>User-friendliness of Websites</td>
<td>26 June 2002</td>
</tr>
<tr>
<td>100</td>
<td>NSW Police Department of Corrective Services</td>
<td>Managing Sick Leave</td>
<td>23 July 2002</td>
</tr>
<tr>
<td>101</td>
<td>Department of Land and Water Conservation</td>
<td>Regulating the Clearing of Native Vegetation</td>
<td>20 August 2002</td>
</tr>
<tr>
<td>102</td>
<td>E-government</td>
<td>Electronic Procurement of Hospital Supplies</td>
<td>25 September 2002</td>
</tr>
<tr>
<td>103</td>
<td>NSW Public Sector</td>
<td>Outsourcing Information Technology</td>
<td>23 October 2002</td>
</tr>
<tr>
<td>104</td>
<td>Ministry for the Arts Department of Community Services Department of Sport and Recreation</td>
<td>Managing Grants</td>
<td>4 December 2002</td>
</tr>
<tr>
<td>105</td>
<td>Department of Health Including Area Health Services and Hospitals</td>
<td>Managing Hospital Waste</td>
<td>10 December 2002</td>
</tr>
<tr>
<td>106</td>
<td>State Rail Authority</td>
<td>CityRail Passenger Security</td>
<td>12 February 2003</td>
</tr>
<tr>
<td>107</td>
<td>NSW Agriculture</td>
<td>Implementing the Ovine Johne’s Disease Program</td>
<td>26 February 2003</td>
</tr>
<tr>
<td>108</td>
<td>Department of Sustainable Natural Resources Environment Protection Authority</td>
<td>Protecting Our Rivers</td>
<td>7 May 2003</td>
</tr>
<tr>
<td>109</td>
<td>Department of Education and Training</td>
<td>Managing Teacher Performance</td>
<td>14 May 2003</td>
</tr>
<tr>
<td>110</td>
<td>NSW Police</td>
<td>The Police Assistance Line</td>
<td>5 June 2003</td>
</tr>
<tr>
<td>111</td>
<td>E-Government</td>
<td>Roads and Traffic Authority Delivering Services Online</td>
<td>11 June 2003</td>
</tr>
<tr>
<td>112</td>
<td>State Rail Authority</td>
<td>The Millennium Train Project</td>
<td>17 June 2003</td>
</tr>
<tr>
<td>113</td>
<td>Sydney Water Corporation</td>
<td>Northside Storage Tunnel Project</td>
<td>24 July 2003</td>
</tr>
<tr>
<td>114</td>
<td>Ministry of Transport Premier’s Department Department of Education and Training</td>
<td>Freedom of Information</td>
<td>28 August 2003</td>
</tr>
<tr>
<td>115</td>
<td>NSW Police NSW Roads and Traffic Authority</td>
<td>Dealing with Unlicensed and Unregistered Driving</td>
<td>4 September 2003</td>
</tr>
<tr>
<td>116</td>
<td>NSW Department of Health</td>
<td>Waiting Times for Elective Surgery in Public Hospitals</td>
<td>18 September 2003</td>
</tr>
<tr>
<td>118</td>
<td>Judging Performance from Annual Reports</td>
<td>Review of Eight Agencies’ Annual Reports</td>
<td>1 October 2003</td>
</tr>
<tr>
<td>No.</td>
<td>Agency or Issues Examined</td>
<td>Title of Performance Audit Report or Publication</td>
<td>Date Tabled in Parliament or Published</td>
</tr>
<tr>
<td>-----</td>
<td>--------------------------</td>
<td>------------------------------------------------</td>
<td>----------------------------------------</td>
</tr>
<tr>
<td>119</td>
<td>Asset Disposal</td>
<td>Disposal of Sydney Harbour Foreshore Land</td>
<td>26 November 2003</td>
</tr>
<tr>
<td>121</td>
<td>Department of Health NSW Ambulance Service</td>
<td>Code Red: Hospital Emergency Departments</td>
<td>15 December 2003</td>
</tr>
<tr>
<td>122</td>
<td>Follow-up of Performance Audit</td>
<td>Controlling and Reducing Pollution from Industry (April 2001)</td>
<td>12 May 2004</td>
</tr>
<tr>
<td>123</td>
<td>National Parks and Wildlife Service</td>
<td>Managing Natural and Cultural Heritage in Parks and Reserves</td>
<td>16 June 2004</td>
</tr>
<tr>
<td>124</td>
<td>Fleet Management</td>
<td>Meeting Business Needs</td>
<td>30 June 2004</td>
</tr>
<tr>
<td>125</td>
<td>Department of Health NSW Ambulance Service</td>
<td>Transporting and Treating Emergency Patients</td>
<td>28 July 2004</td>
</tr>
<tr>
<td>126</td>
<td>Department of Education and Training</td>
<td>School Annual Reports</td>
<td>15 September 2004</td>
</tr>
<tr>
<td>127</td>
<td>Department of Ageing, Disability and Home Care</td>
<td>Home Care Service</td>
<td>13 October 2004</td>
</tr>
<tr>
<td>128*</td>
<td>Department of Commerce</td>
<td>Shared Corporate Services: Realising the Benefit including guidance on better practice</td>
<td>3 November 2004</td>
</tr>
<tr>
<td>129</td>
<td>Follow-up of Performance Audit</td>
<td>Environmental Impact Assessment of Major Projects (2001)</td>
<td>1 February 2005</td>
</tr>
<tr>
<td>130*</td>
<td>Fraud Control</td>
<td>Current Progress and Future Directions including guidance on better practice</td>
<td>9 February 2005</td>
</tr>
<tr>
<td>131</td>
<td>Follow-up of Performance Audit Department of Housing</td>
<td>Maintenance of Public Housing (2001)</td>
<td>2 March 2005</td>
</tr>
<tr>
<td>133</td>
<td>Follow-up of Performance Audit Premier’s Department</td>
<td>Management of Intellectual Property (2001)</td>
<td>30 March 2005</td>
</tr>
<tr>
<td>134</td>
<td>Department of Environment and Conservation</td>
<td>Managing Air Quality</td>
<td>6 April 2005</td>
</tr>
<tr>
<td>135</td>
<td>Department of Infrastructure, Planning and Natural Resources Sydney Water Corporation Sydney Catchment Authority</td>
<td>Planning for Sydney’s Water Needs</td>
<td>4 May 2005</td>
</tr>
<tr>
<td>136</td>
<td>Department of Health</td>
<td>Emergency Mental Health Services</td>
<td>26 May 2005</td>
</tr>
<tr>
<td>137</td>
<td>Department of Community Services</td>
<td>Helpline</td>
<td>1 June 2005</td>
</tr>
<tr>
<td>138</td>
<td>Follow-up of Performance Audit State Transit Authority Ministry of Transport</td>
<td>Bus Maintenance and Bus Contracts (2002)</td>
<td>14 June 2005</td>
</tr>
</tbody>
</table>
## Performance audit reports and related publications

<table>
<thead>
<tr>
<th>No</th>
<th>Agency or Issues Examined</th>
<th>Title of Performance Audit Report or Publication</th>
<th>Date Tabled in Parliament or Published</th>
</tr>
</thead>
<tbody>
<tr>
<td>139</td>
<td>RailCorp NSW</td>
<td>Coping with Disruptions to CityRail Passenger Services</td>
<td>22 June 2005</td>
</tr>
<tr>
<td>140</td>
<td>State Rescue Board of New South Wales</td>
<td>Coordination of Rescue Services</td>
<td>20 July 2005</td>
</tr>
<tr>
<td>141</td>
<td>State Budget</td>
<td>In-year Monitoring of the State Budget</td>
<td>28 July 2005</td>
</tr>
<tr>
<td>142</td>
<td>Department of Juvenile Justice</td>
<td>Managing and Measuring Success</td>
<td>14 September 2005</td>
</tr>
<tr>
<td>143</td>
<td>Asset Management</td>
<td>Implementing Asset Management Reforms</td>
<td>12 October 2005</td>
</tr>
<tr>
<td>144</td>
<td>NSW Treasury</td>
<td>Oversight of State Owned Electricity Corporations</td>
<td>19 October 2005</td>
</tr>
<tr>
<td>145</td>
<td>Follow-up of 2002 Performance Audit</td>
<td>Purchasing Hospital Supplies</td>
<td>23 November 2005</td>
</tr>
<tr>
<td>146</td>
<td>Bus Transitways</td>
<td>Liverpool to Parramatta Bus Transitway</td>
<td>5 December 2005</td>
</tr>
<tr>
<td>147</td>
<td>Premier’s Department</td>
<td>Relocating Agencies to Regional Areas</td>
<td>14 December 2005</td>
</tr>
<tr>
<td>148</td>
<td>Department of Education and Training</td>
<td>The New Schools Privately Financed Project</td>
<td>March 2006</td>
</tr>
</tbody>
</table>

* Better Practice Guides

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If you have any problems accessing these reports, or are seeking older reports, please contact our Office Services Manager on (02) 9275 7116.