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Victorian Auditor-General's Office

Market-led Proposals

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Independent assurance report to Parliament

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The Hon Shaun Leane MLC
President
Legislative Council
Parliament House
Melbourne

The Hon Colin Brooks MP
Speaker
Legislative Assembly
Parliament House
Melbourne

Dear Presiding Officers

Under the provisions of the *Audit Act 1994*, I transmit my report *Market-led Proposals*.

Yours faithfully

Andrew Greaves
Auditor-General

27 November 2019

Contents

Acronyms

AFP	Australian Federal Police
BCR	benefit-cost ratio
CBA	cost-benefit analysis
CBD	central business district
DEDJTR	Department of Economic Development, Jobs, Transport and Resources
DJPR	Department of Jobs, Precincts and Regions
DoT	Department of Transport
DPC	Department of Premier and Cabinet
DTF	Department of Treasury and Finance
ESTA	Emergency Services Telecommunications Authority
HPFV	higher productivity freight vehicles
HVHR	high value high risk
IDC	interdepartmental committee
IRP	Independent Review Panel
MLP	market-led proposal
NGTSM	National Guidelines for Transport System Management
NPV	net present value
PPP	public-private partnership
PSC	Public Sector Comparator
SOE	state-owned enterprise
SSP	Shared Service Provider
VAGO	Victorian Auditor-General's Office
VFM	value for money
VPC	Victoria Police Centre
VPPSS	Victorian Police Physical Security Specifications
WACC	weighted average cost of capital
WGT	West Gate Tunnel
WTC	World Trade Centre

Audit overview

Context

What is a market-led proposal?

In a market-led proposal (MLP), the private sector makes an unsolicited approach to government for support to deliver infrastructure or services through direct negotiation rather than a competitive procurement process. The private sector usually asks the government for financial support, but may also ask for regulatory or other forms of assistance.

The state has considered many MLPs since early 2015, with 14 progressing beyond the second assessment stage and four successfully advancing through the entire process to contract award.

How they are assessed

In early 2015, the government established a new guideline and five-stage process for considering MLPs and gave commitments:

- that proposals must meet a series of important tests and be in the public interest to proceed
- that proposals will only proceed if they represent a genuinely unique idea or proposition, deliver on government objectives, provide benefits to the community and achieve value for money (VFM) outcomes
- to uphold the highest levels of integrity and transparency when assessing MLPs.

The Department of Treasury and Finance (DTF) has a key role in overseeing the MLP guideline and the application of the assessment process. It leads Stage 1 and Stage 2 of proposal assessment in consultation with relevant departments. During Stages 3, 4 and 5, the government-approved lead department, which can also be DTF, undertakes the assessment. When another department or agency leads an assessment, DTF provides support.

The Treasurer is the responsible minister for the MLP guideline. DTF or the Treasurer approves the Stage 1 assessment outcome. The government approves the assessment outcome at Stage 2 and at each subsequent stage. DTF briefs an interdepartmental oversight committee and the Treasurer throughout the assessment process.

Why this audit is important

DTF receives a steady flow of unsolicited MLPs seeking exclusive negotiations with the state, so the government needs a rigorous and transparent process for assessing these proposals to promote new infrastructure and service ideas, and ensure fairness for proponents and value for the community.

It is important that the MLP process works well so that taxpayers can be confident that decisions by government to engage with a proponent in a non-competitive way is in taxpayers' best interests and beyond reproach.

Objective and scope

The objective of this audit was to determine whether MLPs are assessed in accordance with government requirements. To address this, we examined the assessment of two MLPs that the government awarded contracts to—the West Gate Tunnel (WGT) and the Victoria Police Centre (VPC). We did not examine implementation of these projects. We also examined the assessment of one alternative proposal received for the WGT and two alternative proposals received for the VPC.

Our original audit scope also included the development of a unique disease surveillance system and production of disease prevention products for Victoria. The MLP for this was submitted in June 2017 and rejected at the end of Stage 2 in June 2018. We did not evaluate this in depth, because our initial inquiries indicated that DTF assessed the proposal in accordance with the MLP guideline and process.

The departments and agencies involved in assessing these proposals were DTF, the Department of Premier and Cabinet (DPC), the Department of Transport (DoT), the West Gate Tunnel Project, Victoria Police and the Department of Jobs, Precincts and Regions (DJPR).

Conclusion

DTF and Victoria Police documented the required assessments of the WGT and VPC proposals and obtained the required government approvals. However, their advice to government could have been more transparent by fully explaining the implications of their assessment approaches, and providing greater assurance about key inputs underpinning the assessments. Not doing this meant decision makers lacked relevant information to fully inform their decisions for significant state projects procured outside a competitive process.

DTF reasonably determined that an element of Transurban's proposal for the WGT was unique. However, DTF and Victoria Police did not clearly demonstrate that the aspects they assessed as unique in the Cbus/Australia Post proposal for the VPC could not have been obtained in the marketplace within an acceptable time frame.

In DTF's assessment of VFM for the WGT, their use of particular revenue assumptions, different approaches to discounting different revenue streams and use of a state benchmark range without a single best point estimate, all had impacts on the assessment outcomes. Given this, we expected DTF's advice to the government to clearly explain why certain assessment approaches were taken and how they impacted the results. We also expected that DTF would have undertaken more checking and sensitivity analysis, commensurate with the WGT project's significance, to better assure themselves of the comprehensiveness of their VFM assessment and advice.

For the VPC, while the proposal met the VFM benchmarks set by the government, this was achieved because the state retained significant risk. Increases to the size and lease term of the VPC increased the risk and whole-of-life costs of the proposal for the state. DTF and Victoria Police did not convey the impacts of these changes clearly enough in their assessments and advice to government.

Findings

Uniqueness of the proposals

It is not sufficient for lead agencies to only demonstrate the presence of unique characteristics in an MLP. They must demonstrate that these characteristics provide value and other benefits for government that could not be achieved through a standard competitive process outside of the guideline within acceptable time frames.

There was competition in the market to deliver a WGT and VPC, evidenced by alternative proposals from Cintra Developments Australia (Cintra) for the WGT and from the World Trade Centre (WTC) and another property developer for the VPC.

DTF and Victoria Police advised the government that the WGT and VPC proposals were unique, based on a funding source and security, respectively.

West Gate Tunnel

DTF's advice to government that the Transurban proposal satisfied the uniqueness test was primarily based on Transurban's capacity to access, escalate and extend toll revenues on its existing CityLink concession.

To be commercially viable, the Transurban proposal needed revenue to flow from four sources—an upfront payment from the government, tolling revenue on the new WGT road, additional increases to tolls from its existing CityLink concession, and an extension of that concession for another 10 years. These funding sources were contingent on government actions and Parliamentary support.

The MLP guideline recognises ownership of strategic assets, including rights under an existing contract, as a unique characteristic. DTF reasonably assessed the CityLink escalation funding source as unique because, under the existing CityLink concession, no party other than Transurban could access and increase tolls on CityLink prior to 2035.

DTF advised that funding from the CityLink escalation source was sufficiently material to justify proceeding as an MLP. This funding source made up between 14 and 18 per cent of the total funding sources the state and Transurban identified and estimated for the project.

DTF also determined that revenue from the 10-year extension on the CityLink concession given to Transurban by government was unique. The 10-year CityLink extension made up around 31 percent of the total funding sources the state identified and estimated for the Transurban project.

DTF identified that as revenue from the CityLink concession extension does not begin flowing until 2035, parties other than Transurban may have had challenges raising project finance tied to this funding source on a VFM basis, due to the timing and uncertainty of these cash flows. However, DTF's assessment of uniqueness regarding the extension did not include substantive analysis of granting another private operator access to the CityLink extension or the state taking on the tolling of CityLink itself from 2035.

DTF's assessment of the Transurban proposal as unique, even if considering only the CityLink escalation funding source, is consistent with the MLP guideline. However, the guideline provides no detail on the level of materiality that unique characteristics should possess. Further, DTF did not transparently assess the value of this source of uniqueness to the state compared to the next best alternative available to government such as a competitive process with additional government guarantees.

Victoria Police Centre

DTF and Victoria Police justified the Cbus/Australia Post proposal to build a new police headquarters at 311 Spencer Street, in Melbourne's central business district (CBD), as unique based on the security and co-location benefits provided by the site. The site is next to the City West Police Complex at 313 Spencer Street, with rail lines at its rear which provide security benefits—including perimeter standoff and natural surveillance—that are unlikely to be built out.

However, DTF and Victoria Police did not satisfy the MLP guideline requirement to show that these benefits could not be achieved through a standard competitive process within acceptable time frames. With the expiry of the current lease in July 2020, there was no time pressure in 2015 that called for sole negotiations with a single proponent. There was ample time for Victoria Police to undertake a competitive process and clear evidence of other options for locating a new Victoria Police headquarters.

Advice obtained by Victoria Police clearly identified other sites that could meet its security needs, and its claims of co-location benefits with the City West Police Complex were only superficially specified.

The Stage 2 MLP assessment led by DTF indicated that Cbus/Australia Post were expected to respond to any competitive market process to provide accommodation for Victoria Police after July 2020.

The potential for other proponents to respond to the service need was demonstrated by the state receiving two alternative MLPs to provide a new headquarters for Victoria Police before it signed the lease agreement with Cbus/Australia Post in January 2017.

Service need and benefits

The 2015 interim MLP guideline criteria required proposals to meet a service or project need that is aligned with government policy objectives and priorities and provides benefits to Victorians.

The assessments of the VPC and WGT proposals clearly demonstrated both met a service need.

West Gate Tunnel

The WGT proposal met a need to reduce traffic congestion arising from high population growth.

The government sought to test the merits of the WGT as a standalone project, without regard to the potential involvement of Transurban, by requesting the former Department of Economic Development, Jobs, Transport and Resources (DEDJTR) develop a business case for the project.

We assessed DEDJTR's business case against DTF's Investment Lifecycle and high value high risk (HVHR) guidelines and found the following deficiencies:

- As also expressed by both the peer reviewer appointed by DEDJTR and the Independent Review Panel appointed by DPC to review the business case, it lacked a reasonable justification for including the Monash Freeway widening works in the WGT project scope, and this scope element improved the benefit-cost ratio (BCR).
- It showed a marginal value proposition for the WGT project on its own and lacked transparency regarding the sensitivity of the BCR for the WGT project scope element. The business case provided to the government only included sensitivity testing results for the combined Monash Freeway upgrade and the WGT project scope. DTF's advice to the government on the business case did not highlight the lack of sensitivity analysis in relation to the WGT project scope element.
- It did not examine a range of alternative project solution options in sufficient depth and therefore did not provide the government with sufficient information to select the right investment option.
- It did not have a sufficiently transparent cost-benefit analysis (CBA), limiting assurance that the risks of double counting or overstating benefits had been addressed. The collective value of 'other related benefits' were not transparently justified in the business case—such as congested travel time savings and higher productivity freight vehicle (HPFV) benefits. That these benefits were greater than the 'core travel time savings', which typically make up most estimated road project benefits, suggests that this risk was present.

Victoria Police Centre

The VPC proposal met a need to accommodate Victoria Police's headquarters in a secure facility following the expiry of their existing lease at the WTC from July 2020.

DTF's Stage 2 assessment of the VPC proposal identified that Victoria Police did not consider their current facility at the WTC a viable option for police headquarters beyond the existing lease term and were updating an options analysis for a new one.

Value for money

The 2015 interim MLP guideline required VFM assessments to compare the final proposal's cost to a state benchmark, either a public sector comparator or a realistic alternative.

West Gate Tunnel

For the WGT proposal to proceed, Transurban needed to be confident that the sum of the project's estimated future revenues would at least equal the sum of its estimated future costs, in present value terms, while delivering a commercial rate of return.

DTF's VFM assessments compared the Transurban proposal to a state benchmark range that was derived by applying a discount rate range to DTF's estimates of the nominal cost and revenue cash flows for the WGT project.

DTF's assessment and advice to the government that the WGT proposal was VFM did not adequately test and disclose the sensitivity of discount rate assumptions and calculations that underpinned the reliability of its assessment. This and limited analysis of alternative funding options means DTF's advice to the government was not sufficiently comprehensive.

Costs

More than 93 per cent of Transurban's design and construction-related costs were tendered out to the market in a competitive process so the VFM risk to the state for this side of the transaction was relatively low.

Revenues

Transurban's revenue estimates valued potential tolls from the new WGT road, additional increases to tolls from its existing CityLink concession and an extension of that concession. These revenue estimates by themselves were not enough to make the project viable for Transurban. It also needed the state to make an up-front contribution.

For the state to assess the WGT proposal as VFM, it needed to be confident about two key things:

- Estimates of tolling revenue—the state needed to compare Transurban's tolling revenue estimates with its own tolling estimates to make sure Transurban's estimates were reasonable. Without knowing this, the state risked paying too much for its up-front contribution, and it risked escalating and extending the tolls on CityLink by more than necessary.
- There were no better alternatives than Transurban's proposal to fund and finance the project.

Analysis of funding options

DTF did not comprehensively assess other approaches to funding and financing the project, such as:

- borrowing through securitisation of future CityLink tolls
- monetising future CityLink tolls through a competitive process.

DTF's assessment approach deprived the government of critical information to support its decisions on whether, and how, to progress the proposal.

DEDJTR's business case for the project did not assess the difference between the costs and benefits of raising funds from tolls on CityLink compared to other state sources of funding such as taxes and charges, borrowing or other monopoly concessions.

Tolling revenue estimates

Transurban and DTF knew that the valuation of the tolling revenue was critical for the proposal to succeed, because those estimates influenced not only the size of the state's contribution but also the respective size and extent of the CityLink toll escalation and extension.

From Transurban's perspective, demonstrating VFM for the state was a balancing act. Transurban had a commercial incentive to undervalue its tolling estimates to strengthen the argument to escalate and extend the CityLink concession. Conversely, if Transurban's tolling estimates were higher than the state's, then this would reduce the state's contribution to the project, making the proposal attractive to the state.

Transurban also faced a real risk that the state would not proceed with the proposal if the state assessed Transurban's forecast tolling revenues as unrealistic and not providing VFM against state benchmarks.

Reliability of the state VFM benchmark

A large proportion of the reported VFM benefits to the state in Transurban's proposal arose from the differences between Transurban's and the state's valuations of future tolling revenue.

DTF rightly obtained its own estimates of revenues to develop its VFM benchmark range.

At the Stage 4 assessment, the state's lower CityLink escalation toll revenue estimate was the major contributor to the overall difference of $272 million in net present value (NPV) between the Transurban proposal and the midpoint of the state's VFM benchmark range. This was because the state's low estimate had the effect of dropping the bottom end of the benchmark range.

Transurban had little incentive to overstate revenue and may have had better information than the state about the traffic flows underpinning its revenue estimates on CityLink. DTF's Stage 3 assessment report noted that Transurban's ownership and operation of the CityLink concession provided it with in-depth knowledge of the revenue, costs and risks that no other party had.

Where Transurban's estimates were higher than the state estimates, DTF's assessment and advice would have been more comprehensive had it used the Transurban estimates as a sensitivity test and shared the results with government. It did not.

Traffic demand forecasts

The forecasts of traffic demand and the selection and application of discount rates drove the differences in the two valuations of future tolling revenue.

Those differences were most noticeable in the valuations of the CityLink escalation revenues.

The lower end of the state's benchmark range for the CityLink escalation revenues was 65 per cent less than Transurban's estimate, driven by an assumption that 6 to 7 per cent of traffic would be diverted off CityLink. DTF's Stage 4 assessment did not discuss the possibility that the state benchmarks undervalued the CityLink escalation revenue.

Discount rates

Discount rates are important because, like interest rates, they express the value of money at a particular time. Organisations use them in discounted cashflow analyses as a method of valuing a project. To determine the NPV of a project in today's dollars, its estimated future cashflows, revenues and costs are discounted at a rate, the discount rate, that represents the cost of funding.

DTF applied different discount rates to its estimates of the WGT project revenues and costs to derive a benchmark range against which it could assess the VFM of Transurban's proposal. However, DTF did not explain in the Stage 4 VFM assessment why it applied the discount rates differently for the CityLink escalation revenue. Specifically, it did not explain why the nominal CityLink escalation revenue figures used in the state benchmark were discounted using the reverse of the discount rates they applied to all other revenue estimates. Not explaining this was an omission because the state VFM benchmark was sensitive to the CityLink escalation revenue low-traffic scenario.

Discount rate sensitivity of VFM state benchmark range

DTF's commercial adviser discounted a single set of nominal cashflows using a 'high scenario' discount rate and a 'low scenario' discount rate provided by an investment bank engaged by DTF. This produced a 'high scenario' NPV and a 'low scenario' NPV for each stream of nominal cashflows, which determined the range for the state's VFM benchmarks.

DTF advised that the discount rate range reflected uncertainty around the true commercial rate of return appropriate for this project that was largely caused by the risk and uncertainty involved in forecasting the future toll revenues. However, it is unusual to express discount rates solely as ranges, without also determining a best single point estimate within the range. Adopting this approach meant it was unclear whether all points in the range were equally likely and understanding this would have been useful given the Transurban proposal did not represent VFM at all points in the range. DTF advised that the uncertainty in estimating project toll revenues meant that a best single point estimate would have been inherently unreliable.

Most of the WGT project's design and construction costs occur in the first five years of the project, but the revenues are spread over the 29-year life of the project. A slight change in the discount rate applied to estimated future revenues annually over 29 years makes a significant difference to the present value of those cashflows.

This means that the state's VFM benchmark range was highly sensitive to the discount rate range and any discount rate changes.

Transurban used its estimate of the weighted average cost of capital (WACC) as its discount rate. The WACC represents the weighted average expected return to debt and equity investors.

The discount rates that informed the state's VFM benchmark range were generally higher than the rate Transurban used, so the state estimated higher commercial rates of return than those adopted by Transurban.

In an investment of this scale, where the discount rate was so influential to the outcome, the reasons why the state's assumed required commercial rates of return was generally higher than Transurban's should have been set out explicitly and unambiguously in the VFM assessment by DTF. They were not.

DTF should have performed a sensitivity analysis to challenge key assumptions underpinning the state's VFM assessment, and to support the state securing the best possible outcome. We have not seen evidence that this testing and challenge occurred.

Issues with the state contribution

Transurban's proposal involved a state contribution of $1.96 billion in present value terms, mostly towards design and construction costs.

Transurban calculated the size of the state contribution in its proposal as the nominal amount needed to ensure the project achieved an NPV of zero after delivering its required expected commercial rate of return for the project. Transurban derived this figure using a discount rate reflecting its commercial rate of return that it applied to all other cashflows in its proposal.

The VFM assessment adopted the nominal state contributions proposed in Transurban's final offer. These nominal state contribution cash flows were then discounted in the VFM assessment using the state's estimates of a commercial rate of return.

A commercial rate of return was not the right discount rate for the non-commercial risks associated with the part of the design and construction costs funded by state contributions to the project. There was no commercial risk to Transurban for the $1.389 billion of nominal state contributions towards design and construction costs that the state had agreed to pay. The discount rate for this part of the project should have been a risk-free rate, which was far lower than the commercial rate of return adopted in the VFM assessment. Applying the correct discount rate to the state contributions cash flows related to design and construction costs would have reduced the VFM of the Transurban proposal.

Lack of transparency over basis and reasonableness of assumptions underpinning the state's discount rate estimates

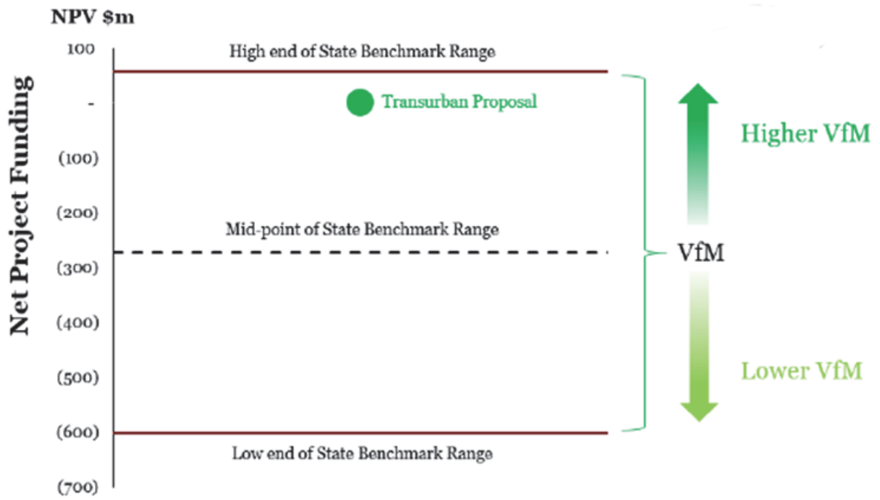
The discount rates used in the state's VFM assessment were highly sensitive to assumptions and calculations DTF's investment bank made about them, such as the rate of return equity investors require in commercial toll roads. The basis for these assumptions is not clear and it was not possible to determine whether those input assumptions are reasonable.

DTF provided us with evidence that it had interactions with its investment bank about the discount rate issues. However, the extent of scrutiny DTF applied to the investment bank's assumptions was unclear from the material DTF provided.

Advice to the government

DTF's advice to the government on the Stage 4 VFM assessment results showed the Transurban proposal as having an NPV of zero dollars. The figure below shows how DTF presented Transurban's proposal to the government.

Figure A
Presentation of Stage 4 VFM assessment results to the government



Source: DTF.

DTF's presentation approach showed the Transurban proposal falling within the range provided by the state's VFM benchmarks and meeting the VFM assessment criterion that it needed to be above the midpoint of these benchmarks.

We note that:

- the state's commercial adviser responsible for developing the VFM assessment provided no indication of the likelihoods attached to the 'high' and 'low' state VFM benchmark scenarios and did not express any opinion on the most likely benchmark outcome
- it was probably not the case that any point within the range was equally likely
- the upper and lower bounds of the range were driven very materially by the state's discount rate range, and we have raised questions about the lack of review and transparency over the basis for and reasonableness of assumptions underpinning the discount rate estimates used in the state's VFM assessment.

The VFM assessment analysis and advice to the government would have been more useful and transparent if DTF had provided a single point best estimate of the state VFM benchmark as well as the benchmark range shown in Figure A. The single point estimate should have reflected DTF's best view on the cost to the government of delivering the project itself. The government could have used this estimate as the key comparison point for the Transurban proposal.

Victoria Police Centre

DTF's SSP delivers office accommodation and property management services for Victorian Government leased and owned properties including accommodation suitability assessment and selection.

In early 2015, Victoria Police discussed plans for a competitive process to obtain new accommodation with the Shared Service Provider (SSP) business unit within DTF and would have run an expression of interest in the absence of the VPC proposal from Cbus/Australia Post.

In November 2016, the government authorised the Treasurer and Minister for Police to approve the VPC proposal and lease agreement. This was based on DTF and Victoria Police advice that the proposal provided VFM, including meeting the VFM benchmarks set by the government. The lease agreement commits the state to a 30-year lease with a starting total lease cost of $44.6 million a year.

The 30-year lease is unusually long for a government tenancy and the lease agreement is $14.8 million a year more than the annual lease costs Victoria Police pays for its accommodation at the WTC. Victoria Police plans to recoup some of these costs from sub-tenants.

The increased cost reflects a 30 per cent increase in the accommodation space available when compared to the WTC, to accommodate potential subtenants. In November 2016, none of the proposed subtenants had provided a binding commitment to take up space in the VPC.

The interdepartmental committee (IDC), DTF and the SSP challenged whether the VPC proposal represented VFM for the state throughout the assessment process. These challenges prompted ongoing negotiations with the proponents on key commercial terms and led to changes in the offer.

The government's VFM benchmarks for the VPC specified annual rental costs in total and on a per-square-metre basis, rather than as whole-of-life costs. Victoria Police and DTF provided accurate advice to government on the Stage 4 assessment that the government VFM benchmarks were met. However, the factors that most significantly contributed to this outcome were the:

- increase of the lease term from 20 to 30 years
- increase of the building size from about 42 000 square metres in net lettable area to more than 60 000 square metres to accommodate potential, unconfirmed subtenants.

These adjustments increased the risk and whole-of-life costs of the VPC proposal for the state. Two of the three proposed subtenants withdrew after the state signed the lease agreement. This has left the state exposed to meeting any shortfall in rental costs for the entire VPC building.

Victoria Police continues to work with the SSP to seek other tenants. Actual achievement of the VFM benchmarks is contingent on Victoria Police recouping some of the lease costs from sub-tenants. There is also a risk that other tenants will diminish the security benefits sought by Victoria Police.

Alternative proposals

While the 2015 interim MLP guideline includes the government objective of ensuring a transparent and fair process, it does not include a process that explains how lead agencies should fairly assess 'competing' MLPs for the same project.

The state received two alternative proposals while it considered the VPC proposal from Cbus/Australia Post, one from the owners of the WTC and one from another property developer. The government rejected both at Stage 1—the WTC proposal in November 2016 and the other proposal in January 2017.

The government rejected the WTC proposal based on DTF's assessment and advice that the proposal could not meet Victoria Police's critical security requirements and was unlikely to offer VFM for the state.

While the IDC identified the need for DTF and Victoria Police to assess the WTC and the VPC proposal against the same requirements, Victoria Police did not provide the WTC proponents with the same information on its security specification as it provided to the VPC proponents.

The government also received an alternative proposal for the WGT project from Cintra in October 2015. DTF's assessments of this proposal at Stage 1 and Stage 2 were comprehensive in addressing the requirements and intent of the MLP guideline. In December 2015, the government approved DTF's recommendation that the proposal not progress to Stage 3.

Meeting MLP process requirements

DTF and Victoria Police largely met the MLP guideline requirements for due diligence, probity, governance and approval, consultation and public disclosure for the WGT and VPC proposals.

There were two exceptions.

The only significant non-compliance identified for the WGT proposal was DTF's decision to not publicly disclose details of the Cintra proposal for an alternative WGT project after the Stage 2 assessment of this proposal and decision not to progress it to Stage 3 in December 2015.

The MLP guidelines require public disclosure of summary details of proposals at the end of Stage 2 in the MLP process. DTF advised the government that it would publicly disclose details of the Cintra proposal, but then determined that it would not do so on the basis that it wished to maintain competitive tension with Transurban. DTF disclosed the Cintra proposal on the MLP website in September 2019.

Public officials involved in assessing the MLPs examined in this audit did not document declarations that they had no conflicts of interest during the assessment process. DTF took the view early in the MLP process that departmental and agency staff only needed to complete conflict of interest declarations where there was an actual or potential conflict and did not require a 'positive' declaration of no conflict.

This approach was inconsistent with the conflict of interest declaration form included in DTF's Probity Plan requirements that applied at the time, which provided for positive declarations. DTF advised us that it acknowledges there was inconsistency between the requirements of the plan and the attached conflict of interest form, but confirmed its view that the Probity Plan for Stages 1 and 2 assessments did not require 'positive declarations of no conflict'.

DTF later amended the MLP process to make it clear that public officials need only complete conflict of interest declarations if involved in Stage 2 assessments and beyond, in its updated Probity Plan for Stage 1 and Stage 2 assessments in August 2018.

Improving and supporting the MLP guideline

DTF has actively supported the MLP process by improving the specificity and rigour of the guidance and underlying assessment process since the government first established it in 2014.

The current MLP guideline could be further enhanced to provide guidance on ensuring equity and procedural fairness when assessing 'competing' MLPs for the same project.

Recommendations

We recommend that the Department of Treasury and Finance:

1. documents the assumptions and calculations underpinning advice it presents to decision-makers about market-led proposals, including advice provided by third parties
2. undertakes sensitivity analyses to test key assumptions of value for money assessments for market-led proposals
3. clarifies the market-led proposals guidance about:
    a. the nature and weighting of primary and secondary sources of uniqueness
    b. how material uniqueness benefits need to be to support exclusive negotiations
    c. whether agencies should measure uniqueness benefits against a state benchmark or other private providers
    d. whether agencies should demonstrate the merits of market-led proposals against a value for money range and/or a point estimate
    e. how agencies should assess concurrent alternative market-led proposals.

Responses to recommendations

We have consulted with DPC, DTF, DoT, Victoria Police and DJPR, and we considered their views when reaching our audit conclusions. As required by the *Audit Act 1994*, we gave a draft copy of this report to those agencies and asked for their submissions and comments.

The following is a summary of those responses. The full responses are included in Appendix A:

- DPC and DJPR noted the report and provided no substantive comments.
- DTF did not support the findings in the report and did not accept the recommendations. We have written to DTF's Secretary outlining our concerns with this response.
- DoT supported DTF's response to the report in relation to the WGT MLP.
- Victoria Police did not accept the report findings on the VPC MLP and supported DTF's response in relation to the VPC.

1

Audit context

In an MLP, the private sector makes an unsolicited approach to government for support to deliver infrastructure or services through direct negotiation rather than a competitive procurement process. The private sector usually asks the government for financial support but may also ask for regulatory or other forms of assistance.

The government issued a new guideline and established a five-stage process for considering MLPs in early 2015 and declared that MLPs would only succeed if found to be unique, VFM and in the public interest.

1.1 Why this audit is important

This audit considers the WGT project and the new VPC. The government procured both projects, which involve significant public expenditure, through MLPs.

MLPs do not result from standard government investment planning and evaluation processes and are not fully tested in a competitive market. While the MLP process may elicit innovative solutions, governments must take care to ensure they do not overspend in what is a non-competitive process.

Given these risks, DTF and relevant agencies must rigorously assess MLPs against the guideline requirements to give confidence to the government and the community that successful proposals are genuinely unique and provide VFM.

1.2 The MLP assessment and approval process

DTF first issued guidelines for unsolicited proposals, now called MLPs, in February 2014. DTF's amendments to the guidelines later that year addressed our recommendation that proposals of more than $100 million be subject to HVHR requirements.

In February 2015, the government replaced the guidelines with the *Market-led Proposals Interim Guideline*. It updated this document in the *Market-led Proposals Guideline November 2015.* The current version of the guideline is the *Market-led Proposals Guideline November 2017.*

Current five-stage process

The current MLP guideline specifies the five-stage assessment and award process outlined in Figure 1A. A proposal must pass each step to proceed to the next.

Figure 1A
Current MLP five-stage assessment and award process

Stage		Action
1	Preliminary assessment	Assess sufficiency and relevance of information. Assess whether the proposal is within the scope of the guideline.
2	Due diligence and strategic assessment	Assess proposal against assessment criteria. If suitable to proceed, consider whether it should be through exclusive negotiation or a competitive tender process.
3	Procurement preparation	Agree with the proponent on: • terms of the exclusive negotiation, or • approach to a competitive tender process. Undertake further due diligence.
4	Exclusive negotiation or limited competitive process	Evaluate and benchmark a final offer for government consideration. Assess affordability, value for money, expected benefits, and scope. Recommend whether to award contract.
5	Contract award	Enter binding contractual arrangements. Agree governance structure and publish project summary and executed contract.

Source: Market-led Proposals Guideline November 2017, Diagram 1: Market-led proposal assessment process, page 4.

This assessment process has been in place and broadly consistent since February 2015.

The process does not rule out competitive delivery. However, it allows for situations where an innovative idea or competitive advantage means awarding a contract to a private party without competition.

The guidelines emphasise that, wherever possible, a proposal should incorporate competitive downstream tendering to ensure VFM outcomes.

The government bases its decision on whether procurement should be through exclusive negotiation or a competitive process on advice from DTF and lead agencies.

1.3 Key assessment criteria for MLPs

The MLP guideline includes the government's key criteria for assessing proposals. Proposals must:

- have unique characteristics resulting in outcomes that are not likely to be obtained using standard competitive processes within acceptable time frames and therefore justify exclusive negotiations with government
- meet a service or project need that is aligned with government policy objectives
- represent VFM for Victorians
- have significant social, environmental, economic or financial benefits for Victorians
- be affordable in the context of budget priorities
- be commercial, feasible and capable of being delivered.

Proposals need to satisfy these criteria to proceed under the MLP guideline.

Uniqueness and VFM are critical criteria.

Unique characteristics

For a proposal to be considered outside of the usual competitive process, it must have 'unique characteristics'. Figure 1B shows how the approach to determining whether a proposal is unique has evolved in iterations of the MLP guideline.

Figure 1B
Evolution of uniqueness criterion in the MLP guideline

	February 2014	February and November 2015	November 2017
Preliminary assessment (Stage 1)	Assessed in Stage 2	Potential to demonstrate a level of uniqueness Minimum information requirements for a detailed description of the unique characteristics	Potential to have unique characteristics resulting in outcomes not likely to be obtained using standard competitive processes, within acceptable time frames
Key assessment criteria (to justify exclusive negotiation) (Stage 2)	Proponent may have a unique idea or intellectual property, be in a unique position, or have ownership of strategic assets integral to delivery	Government cannot reasonably engage another party to: • deliver the proposal or an equivalent outcome if a standard competitive process was pursued • achieve similar benefits (including VFM, policy/service delivery outcomes, reduced delivery time frames or risks not borne by government) if a standard competitive process was pursued In assessing uniqueness, the government will consider whether: • unique characteristics are present, verifiable, and enforceable • proposal provides value to government compared with alternatives • proponent is in a unique position to deliver the desired outcome for government	Has present, verifiable and enforceable unique characteristics Provides value to government compared with alternatives Proponent is in a unique position to deliver the desired outcome to government Note: may be assessed holistically or have additional uniqueness test applied if uniqueness is still not determined

Note: The dark blue circle represents more comprehensive assessment guidance, lighter blue circle represents limited assessment guidance, and uncoloured circle represents no assessment guidance.
Source: VAGO, based on DTF's MLP guideline.

Before November 2017, the MLP guideline required proponents to demonstrate uniqueness by the end of Stage 2 to justify further exclusive negotiations with the government.

Under the current MLP guideline, a proposal that may not meet all of the uniqueness characteristics specified in the guideline may still be assessed as unique when considered holistically. If a proposal is not assessed as unique at the end of Stage 2, it will only progress to Stage 3 if an additional uniqueness test has been undertaken and the government has approved progressing with a limited competitive process.

Value for money

VFM is a key assessment criterion under the MLP process, and therefore critical to a proposal's success. The MLP guideline indicates that VFM is informed by multiple factors, including the proposal's risk and the reasonableness of costs to government to achieve promised benefits.

DTF's guidance on how to determine whether a proposal represents VFM for Victorians has evolved over time, as shown in Figure 1C.

VFM is assessed in two parts: a quantitative assessment of the proposal and a qualitative assessment of the value of the proposal.

The quantitative assessment includes comparing the proposal's cost to a state benchmark for the proposal, either a public sector comparator or a realistic alternative. The qualitative assessment involves assessing the proposal as a whole, including benefits and any commercial principles underpinning the proposal, including risk allocation.

The current MLP guideline considers VFM at each of the first four MLP assessment stages in varying degrees of detail.

Figure 1C
Evolution of VFM criterion in MLP guideline

	February 2014	February 2015	November 2015	November 2017
Preliminary VFM Assessment (Stage 1)		Proposal is required to address expected VFM (but no specific assessment criteria).	Assesses VFM as one of five key criteria.	
Assessment of potential VFM (Stage 2)	Prescriptive guidance. Suggested steps.	Assesses risk and reasonableness of costs to government.	Assesses likelihood of affordability given required investment.	Now informed by scope, time lines and risk allocation.
VFM Qualitative Assessment (Stage 2)			Includes CBA and documentation of risks to achieving identified benefits.	
VFM Quantitative Assessment (Stage 2)				Now informed by scope, time lines and risk allocation.
Consideration of VFM in assessing uniqueness (Stage 3)			Asks whether VFM is improved compared to other approaches.	
Process for determining VFM (Stage 3)		Only requires that the formal agreement includes the process for determining VFM.		Public-sector comparator or realistic alternative may be developed.
VFM Qualitative Assessment (Stage 4)		Assess proposal as a whole and individual value drivers.	Document risks to achieving benefits identified in qualitative assessment. CBA included.	

Figure 1C
Evolution of VFM criterion in MLP guideline—*continued*

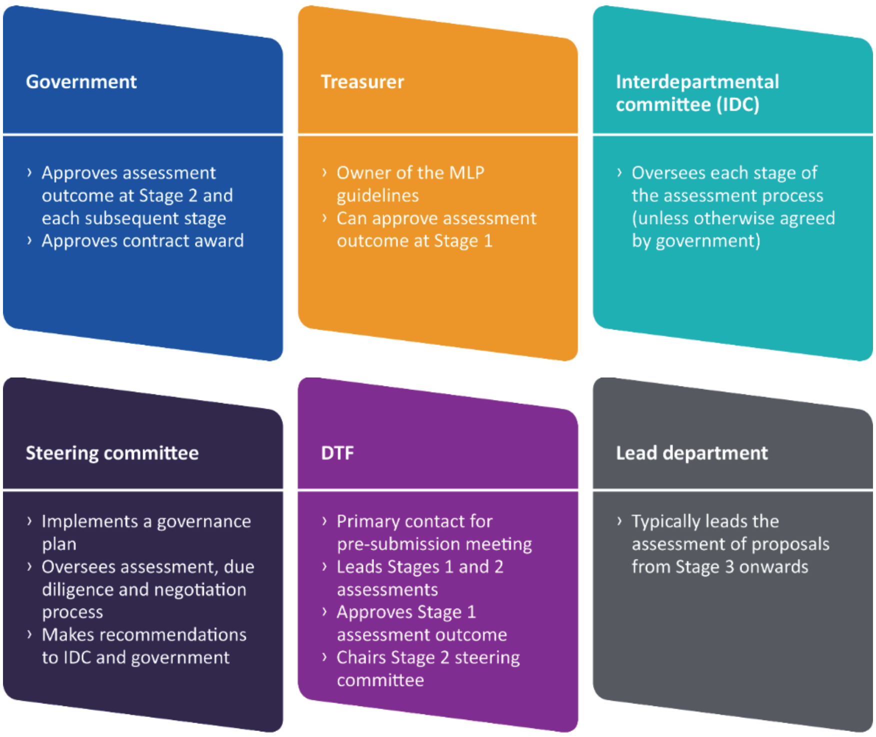
	February 2014	February 2015	November 2015	November 2017
VFM Quantitative Assessment (Stage 4)		Compare final proposal's cost to State Benchmark.		Finalise comparator or realistic alternative estimate.

Note: The dark blue circle represents more comprehensive assessment guidance, lighter blue circle represents limited assessment guidance, and uncoloured circle represents no assessment guidance.
Source: VAGO, based on DTF's MLP guideline.

1.4 MLP process governance and approvals

The MLP guideline specifies governance and approval arrangements for each stage of the assessment process. Figure 1D outlines the stakeholder responsibilities within these arrangements.

Figure 1D
Stakeholder responsibilities



Source: VAGO.

1.5 MLP process probity and disclosure

Each version of the MLP guideline includes a government commitment to uphold the highest levels of integrity and transparency in assessing proposals and specifies requirements for probity and disclosure.

The November 2017 MLP guideline enhanced disclosure and probity requirements to ensure the framework upholds this commitment. It:

- makes DTF responsible for coordinating disclosure and advising the Treasurer when information is disclosed
- requires that the proponent and the public sector specify probity requirements, including the plans put in place at each stage.

Figures 1E and 1F outline the disclosure and probity requirements of the MLP assessment process.

Figure 1E
Disclosure requirements during MLP assessment process

Stage/time		Disclosure details	Published on
1	At any time	DTF reserves the right to disclose details of a proposal if a proponent has not complied with its probity requirements and the circumstances set out in the guideline*.	Guideline does not specify
2	During	Where a proposal is subject to an additional uniqueness test, the desired outcomes and/or key elements the proposal seeks to deliver.	Victorian Government Tenders website
	End	Proposal including: • Name of proponent • Proposal title and description • Reasons for progressing/not progressing.	DTF website
3	Start	Stage 3 Probity Plan.	DTF website
	End	Detailed proposal description, covering: • Proposal overview • Proposed scope • Proposed benefits • Reasons an exclusive negotiation or limited competitive process is being pursued.	DTF website
4	Start	Stage 4 Probity Plan.	DTF website
	End	Update of previously disclosed detailed proposal description.	DTF website
5	Within 60 days of close**	• Project summary • Contract.	DTF website Victorian Government Tenders website

Note: *In the Guideline Appendix: Terms and Conditions.
** Within 60 days of contractual or financial close.
Source: VAGO, from DTF's MLP guideline.

Figure 1F
Probity requirements during MLP assessment process

Stage	Proponent	DTF	Lead agency	Government	Comments
Submission	Must declare any conflicts of interest.				
1		Assesses proposal in accordance with DTF Probity Plan for Stage 1 Assessment.			
2	Signs formal commitment at start of stage covering confidentiality, communication protocols and conflicts of interest.	Assesses proposal in accordance with DTF Probity Plan for Stage 2 Assessment. Prepare Stage 3 Probity Plan.		Approves Stage 3 Probity Plan.	
3	Must appoint a probity adviser for Stages 3 and 4 to advise and represent them on any probity issues that arise. Agrees Stage 4 Probity and Process Deed with lead department.		Assess proposal in accordance with Stage 3 Probity Plan. Agree terms of Stage 3 Probity and Process Deed. Agrees Stage 4 Probity and Process Deed with proponent.	Approves Stage 4 Probity and Process Deed if the proposal progresses to Stage 4.	Interactions between the public sector and proponents are guided by the Stage 3 or Stage 4 Probity and Process Deed. This includes agreeing the process for any cost reimbursement.
4			Exclusive negotiations to be based on Stage 4 Probity and Process Deed. Assess proposal in accordance with Stage 4 Probity Plan.		

Source: VAGO based on DTF's MLP guideline.

1.6 MLP process application: three examples

This audit examined whether DTF and lead agencies assessed the following MLPs in accordance with the MLP guideline:

- WGT Project: Transurban submitted a proposal in March 2015, with a contract finalised in December 2017.

- VPC: Cbus/Australia Post submitted a proposal in May 2015, with a contract finalised in January 2017.
- Development of a unique disease surveillance system and production of disease prevention products for Victoria: proposal submitted in June 2017 and rejected in June 2018.

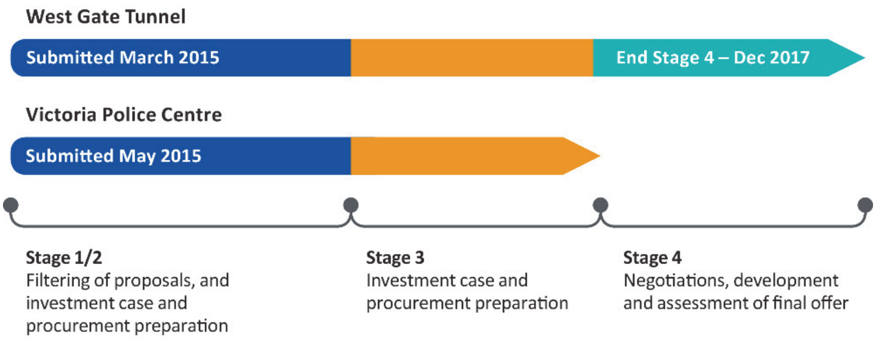
The audit focused on the application of the MLP process. This included examining alternative proposals received for both the WGT and VPC.

The audit did not examine delivery of the approved proposals.

Relevant guidelines

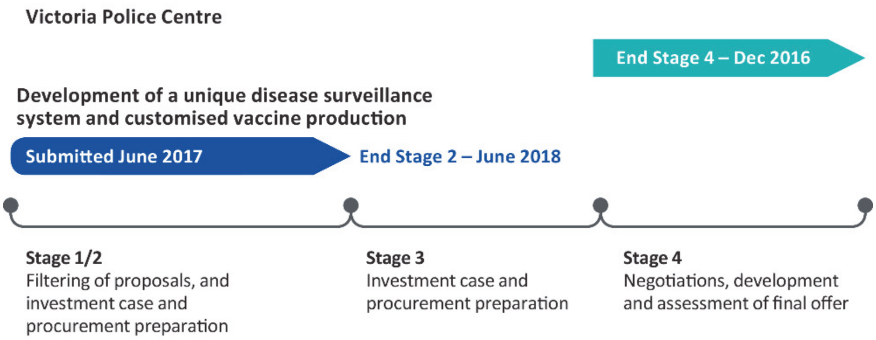
Figures 1G and 1H shows the MLP guideline versions that DTF and lead agencies used to assess the three proposals across the four assessment stages.

Figure 1G
MLP Interim Guideline (February 2015) proposals



Source: VAGO.

Figure 1H
MLP Guideline (November 2015) proposals



Source: VAGO.

1.7 Gateway Review and HVHR process

The Gateway Review and the HVHR processes are project assurance mechanisms overseen by DTF to review and improve project selection, management, delivery and outcomes.

The Gateway Review Process involves short, intensive reviews by a team of reviewers independent from the project at six critical points or 'gates' in the project life cycle. The reviews check that projects are on track before continuing to their next stage and are intended to support project owners.

The Gateway Review Process has been mandatory for all high risk projects since 2003, and for projects that are considered high risk or high value (over $100 million) since 2011. The onus has been on departments and agencies to opt in to the Gateway Review Process.

The government's HVHR project assurance framework was introduced in 2010. DTF performs HVHR reviews for the Treasurer. The HVHR process aims to achieve greater rigour in investment development and oversight, increasing the likelihood of timely project delivery and benefits realisation for Victorians.

A project is classified as HVHR if it is a budget-funded project that is:

- considered high risk using DTF's risk assessment tool, the Project Profile Model
- considered medium risk using the Project Profile Model tool and has a total estimated investment of between $100 million and $250 million
- considered low risk using the Project Profile Model tool but has a total estimated investment over $250 million, or
- identified by the government as warranting the rigour applied to HVHR investments.

The HVHR has linked gateway reviews to key project approval points and mandated that projects costing over $100 million and/or assessed as high risk must be reviewed at all six gates.

1.8 Prior reviews relevant to this audit

Applying the High Value High Risk Process to Unsolicited Proposals

In our 2015 audit we found that, in some instances, when DTF applied the HVHR process to unsolicited proposals there was inadequate:

- assurance about the deliverability of the proposal's benefits
- assessment of the alternative funding options
- engagement with stakeholders about the likely impacts.

East West Link Project

This audit, also published in 2015, found that the business case for the East West Link project did not provide a sound basis for the government's decision to commit to the investment.

1.9 Who this audit examined

This audit examined whether DTF and lead agencies assessed the selected MLPs in accordance with government requirements.

Department of Treasury and Finance

DTF is responsible for the MLP guideline and process, and:

- receives all proposals and does not progress any until the Deputy Secretary, Commercial Division or the Treasurer approves the Stage 1 assessment
- leads the assessment of proposals at Stage 1 and Stage 2 of the guideline in consultation with relevant departments
- is responsible for chairing the IDC to oversee assessment of proposals
- provides support when another department or agency leads an assessment, by contributing to the assessment as required (this varies depending on the nature of the proposal) and providing advice to the lead department or agency regarding application of the MLP Guideline requirements
- briefs the Treasurer throughout the assessment process.

DTF is required to consult with relevant portfolio agencies and IDC members to undertake the strategic assessment of all proposals. This consultation feeds into the recommendations provided to government on whether to pursue the proposal and, if so, how it will be procured.

Lead agencies

During Stages 3, 4 and 5, the government-approved lead department, which can also be DTF, undertakes the MLP assessment. When another department or agency leads an assessment, DTF provides support. DTF and relevant departments and agencies brief the MLP IDC throughout the assessment process

The former Department of Economic Development, Jobs, Transport and Resources

DEDJTR (now DoT and DJPR) was represented on the IDC and involved in assessing the MLPs for the WGT project and the development of a unique disease surveillance system.

The government-operated Pig Services Centre at Epsom, near Bendigo, then part of DEDJTR's Agriculture Policy branch (now within DJPR) was involved in assessment of the unique disease surveillance system.

Department of Premier and Cabinet

DPC is represented on the IDC and was part of the steering committees established to oversee the assessment of the WGT project.

DPC also engaged an independent review panel to examine the Stage 2 assessment of the WGT proposal and the business case for the WGT project.

West Gate Tunnel Project

West Gate Tunnel Project is a project office within the Major Transport Infrastructure Authority in DoT. It is responsible for the delivery of the WGT project. It was previously known as the Western Distributor Authority and more recently the West Gate Tunnel Authority.

Victoria Police

Victoria Police provided input into the Stages 1 and 2 assessments of the VPC proposal and led negotiations with the proponents from Stage 3 onwards. Victoria Police also developed the Stages 3 and 4 assessment reports on the VPC in consultation with DTF.

1.10 What this audit examined and how

This audit analysed whether DTF and lead agencies assessed MLPs in accordance with government requirements. We examined whether DTF and lead agencies:

- complied with the MLP guidance and other relevant process and review requirements when assessing selected proposals
- applied the MLP process rigorously and comprehensively to provide assurance on the merit of selected proposals and a sound basis for government decisions on whether and how these proposals should proceed.

We also assessed whether DTF and lead agencies:

- met the due diligence, probity, governance and approval, consultation and public disclosure requirements in the MLP guideline
- complied with other applicable oversight, assurance and review mechanisms such as the HVHR and Gateway Project Assurance frameworks.

Our original audit scope also included the development of a unique disease surveillance system and production of disease prevention products for Victoria.

The MLP for this was submitted in June 2017 and rejected in June 2018. We did not evaluate this in depth because our initial inquiries indicated there were no significant issues with the MLP process.

We conducted our audit in accordance with the *Audit Act 1994* and ASAE 3500 Performance Engagements. We complied with the independence and other relevant ethical requirements relate to the assurance engagements. The cost of this audit was $1 115 000.

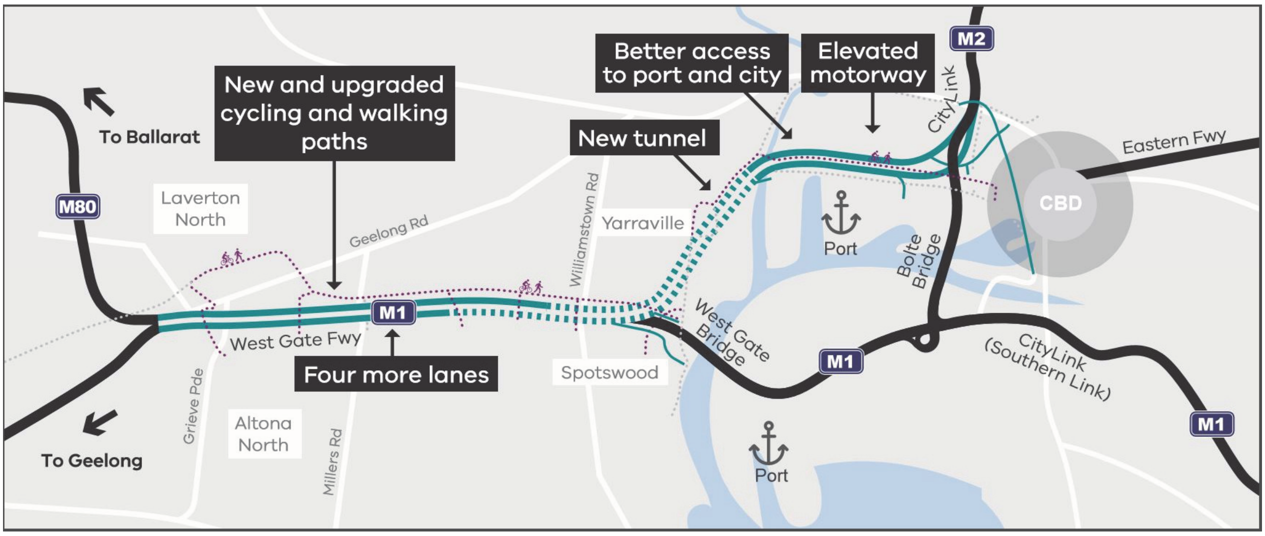
1.11 Report structure

The remainder of this report is structured as follows:

- Part 2 examines the uniqueness assessment for the WGT MLP and the business case, including options assessment and cost benefit analysis.
- Part 3 examines the VFM assessment for the WGT MLP.
- Part 4 examines the assessment of the VPC MLP.
- Part 5 examines the assessment of alternative proposals for the VPC.

2

West Gate Tunnel project: uniqueness, options and benefits



Source: http://westgatetunnelproject.vic.gov.au.

After discussions with the government in late 2014 and early 2015, Transurban submitted its proposal for what became known as the WGT project in March 2015. DTF and lead agencies assessed the proposal through all five stages of the MLP process between March 2015 and December 2017 using the February 2015 version of the MLP guideline.

DTF and the relevant agencies assessed Transurban's WGT proposal as meeting the key MLP assessment criteria. DTF advised the government in December 2017 that Transurban's final offer was unique and represented good VFM, meaning it satisfied the Stage 4 MLP guideline criteria to proceed to Stage 5—awarding a contract.

The government signed a public-private partnership (PPP) contract with Transurban on 11 December 2017. The WGT will give road users an alternative to the West Gate Bridge. The WGT component of the project involves:

- the construction of a road tunnel
- widening of the West Gate Freeway
- an elevated motorway that will link the West Gate Freeway to the CityLink tollway and the Port of Melbourne.

Under the contract, Transurban must design, partially finance and construct the WGT, then operate, toll and maintain it until January 2045, when it will transfer responsibility back to the state. The contract also requires Transurban to manage Stage 1 of the Monash Freeway upgrade and deliver improvement works at Webb Dock, a port facility at Fishermans Bend.

In this Part, we examine whether DTF and the former DEDJTR (now DoT) assessed the MLP for the WGT in accordance with relevant MLP guideline requirements concerning uniqueness. We also examine the quality of the business case in justifying project scope, assessing options and estimating benefits compared to costs.

2.1 Conclusion

DTF and lead agencies advised the government that Transurban's proposal met the requirements for uniqueness primarily based on Transurban's capacity to access, escalate and extend toll revenues on its existing CityLink concession.

DTF assessed the CityLink escalation and extension funding source as unique because no party other than Transurban could access revenue from increasing tolls on CityLink prior to 2035, and no other party could access revenue from an extended concession until after 2035. Identifying the CityLink escalation funding source as unique was consistent with the MLP guideline. The uniqueness of the extension funding is less clear, as the possibility for the state or another provider to take up this funding source existed.

The MLP guideline is silent on the level of materiality unique characteristics should represent. Together, these funding sources made up almost 50 per cent of the total funding sources identified and estimated by the state for the project.

The uniqueness assessment and project business case lacked a comprehensive analysis of the costs and benefits of adopting alternate funding options for delivering the project. DTF's advice to the government would have been more comprehensive if it had included such analysis.

Since the community will pay for the WGT project whichever funding source is adopted, we question whether funding should have been considered the defining unique characteristic to exclude a competitive procurement process.

In addition, the business case did not adequately justify the inclusion of the Monash Freeway upgrade in the project scope. The inclusion of this scope element improved the project BCR. There was also a lack of transparency in the CBA that limited assurance that the risks of overstating benefits had been addressed.

2.2 Uniqueness

Assessment

The February 2015 MLP Interim Guideline defined unique characteristics as including proponents being in a unique position or owning strategic assets to deliver desired outcomes, including having:

- rights under an existing contract
- ownership of land, technology or software, or
- exclusive access to, or control over, strategic assets integral to delivering the proposal or improved outcomes for the government.

In December 2015, DTF advised the government that Transurban's proposal satisfied the MLP guideline uniqueness test and provided material benefits to the state that could not be achieved through a standard competitive process.

DTF assessed the proposal as unique based on Transurban's capacity to access toll revenue from:

- its existing concession on the Melbourne CityLink
- escalated and extended CityLink tolls.

That is, the assessment of uniqueness was based primarily on Transurban's funding model for the project. The Transurban proposal relied on revenue from four sources—an upfront payment from the government, tolling revenue on the new WGT road, additional increases to tolls from its existing CityLink concession and an extension of that concession for another 10 years. These funding sources were contingent on government actions and parliamentary support.

Adequacy of the assessment

Our examination of the uniqueness assessment process identified three key issues:

- The assessment was not balanced by examination of other possible providers and funding sources.
- The MLP guideline does not specify a threshold or approach to assessing the materiality of the uniqueness.
- The MLP guideline does not specifically deal with primary and secondary unique characteristics.

In addition, not all funding sources cited were uniquely deliverable by Transurban and there was uncertainty around these funding sources when awarding the WGT proposal contract. Transurban could not have secured or delivered the funding sources identified by DTF as unique without direct government policy decisions and parliamentary support.

Funding sources and balance of uniqueness assessment

Transurban's position as the operator of CityLink is certainly unique as it is the only entity that can access CityLink tolling and escalation revenue.

Transurban …	However …
Was the only party with the right to operate and toll the existing CityLink to 2035	Transurban did not have any existing rights or capacity under the Concession Deed to: • access revenue from escalating CityLink tolls by more than the consumer price index • extend the CityLink concession.
Included access to the CityLink toll revenue stream beyond the 2035 expiry of its existing concession in its proposal	The DTF advice to government at Stage 4 recommending that it sign the contract with Transurban made it clear that access to this funding source was not certain, as it relied on parliamentary support.

Source: VAGO.

DTF's advice to government on the Stage 4 assessment correctly noted that:

- if the government could not secure the relevant legislative changes and parliamentary support to deliver the funding sources, the primary unique characteristic in the Transurban proposal would be eliminated
- other parties could not access the CityLink toll revenue streams without government support
- Transurban also required government support to secure revenue from its CityLink toll escalation and extension
- these funding sources were not certain because they relied on the actions of a future parliament.

DTF's assessment and subsequent advice to the government focused on funding sources and advised that the CityLink escalation and extension funding source was uniquely accessible by Transurban.

The uniqueness assessment would have been more comprehensive if DTF had also:

- demonstrated why the proposed funding sources provided more beneficial outcomes than other options available, by valuing the relative benefits of Transurban's ability to access this funding compared to other market participants
- examined whether other entities could offer the same project outcomes and benefits in a similar time frame. To do so would have been more consistent with the MLP guideline.

While Transurban's access to CityLink escalation revenue was unique, it is less clear that extension revenue is unique. The right to operate the CityLink concession after Transurban's concession deed expired in 2035 could have been granted to a state-owned tolling company or a different private sector operator.

DTF rightly identified that because this revenue cannot begin flowing until 2035, parties other than Transurban may face challenges in raising project finance tied to this funding source on a VFM basis. However, DTF's assessments of the uniqueness of the Transurban proposal did not include any substantive analysis of the option to grant another private operator access to the CityLink extension as a source of revenue.

Materiality of uniqueness characteristics

The MLP February 2015 guideline specifies that:

> 'It is not sufficient to only demonstrate the presence of unique characteristics in a proposal. It must also be demonstrated that these characteristics provide value for money and other benefits for government that could not be achieved through a standard competitive process outside of the guideline within acceptable time frames'.

It is appropriate to estimate the size of any claimed unique benefits of a proposal. However, the guideline does not specify an approach or threshold for assessing how material uniqueness benefits need to be to support exclusive negotiations and is unclear about whether benefits should be measured against a state benchmark or other private providers.

The CityLink escalation funding source made up between 14 and 18 per cent of the total funding sources identified and estimated by the state and Transurban for the project. DTF advised us that this was sufficiently material to justify proceeding as an MLP.

It is less clear whether the 10-year extension CityLink concession the government gave to Transurban was unique. This made up around 31 per cent of the total funding sources the state identified and estimated for the Transurban project.

Primary and secondary uniqueness factors

As shown in Figure 2A, DTF's Stage 4 assessment of the Transurban proposal introduced a distinction between two levels of uniqueness.

Figure 2A
Levels of uniqueness in the Stage 4 assessment

Level of uniqueness	Type of factor
Primary	Funding sources
Secondary	Related to potential for Transurban to realise operational synergies and economies of scale from: • operating the WGT together with the existing CityLink toll road • taking on the interface risks in relation to accessing and disrupting CityLink to deliver the connection between the two roads.

Source: VAGO.

The MLP guideline does not refer to primary and secondary uniqueness factors. It is unclear how DTF weighed the significance of the primary and secondary factors and how each factor impacted the assessment.

DTF updated the MLP guideline in November 2017 to refer to a holistic assessment of uniqueness, including consideration of other factors that may be considered material to demonstrate a unique proposal. DTF can further enhance the guideline by providing additional information and guidance about assessing the materiality of unique characteristics including primary and secondary uniqueness factors.

2.3 Service need and benefits

Business case

The government approved the outcome of the Stage 2 assessment of Transurban's proposal in April 2015. Parallel to the Stage 3 assessment, it asked DEDJTR to develop a business case, with support from DTF, to examine the project's merits, irrespective of the delivery method and potential involvement of Transurban.

A business case should clearly establish service need and project scope, examine solution options and demonstrate project benefits.

The DEDJTR business case for the project was provided to the government in October 2015 and:

- did not reasonably explain the inclusion of the Monash Freeway widening works in the WGT project scope, which improved the BCR
- showed a marginal value proposition for the WGT project on its own but had limited transparency regarding the sensitivity of the BCR for the WGT project scope element
- did not examine a range of alternative project options in sufficient depth
- did not have a fully transparent CBA, meaning the user of the advice could not be assured that benefits had not been overstated.

Inclusion of Monash Freeway upgrade in project scope

The justification for including the Monash Freeway widening works in the WGT project scope lacked a convincing rationale and was inconsistent with DTF's guidelines on separate business cases for multiple related projects and the findings of independent reviews.

Business case scope

The government's commitment in late 2014 to construct a West Gate Distributor project did not include any works on the Monash Freeway east of Toorak Road. Similarly, the project scope in Transurban's initial proposal in March 2015 did not include these works.

DTF's Stage 1 and Stage 2 assessments of Transurban's proposal and related advice to the government in April 2015 did not refer to Monash Freeway upgrade works as part of the project scope for the state's reference project or in any other context.

Given this, it is reasonable that the project scope for the business case would be largely consistent with the scope of Transurban's proposal.

However, DTF's advice to the government in August 2015 indicated that the state's base scope for the project included Monash Freeway upgrade works. DTF indicated that these works could deliver additional user benefits along the M1 corridor, but did not provide a clear rationale for combining this scope item with the Transurban proposal.

Figure 2B shows the geographic and preferred investment scopes outlined in the October 2015 Western Distributor business case. This proposed investment scope covered a wide geographic area and comprised several distinct key project scope elements.

Figure 2B
October 2015 Western Distributor business case scope

Geographic Scope	Preferred Investment Scope
• M1 Corridor • Its adjoining economic precincts stretching from Geelong through to the Latrobe Valley	• Widening of West Gate Freeway • New Western Distributor connecting the West Gate Freeway to the Port of Melbourne and CityLink • Port of Melbourne (Swanson Dock) access • Port of Melbourne (Webb Dock) access • Monash Freeway Capacity Improvement Project

Source: VAGO from Western Distributor Business Case, October 2015.

The works proposed as part of the Monash Freeway upgrade were:

- around 15 kilometres away from the core WGT project scope at their closest point (Toorak Road)
- over 60 kms away at the farthest point.

These works and related benefits were unrelated to the WGT works.

The inclusion of the Monash Freeway upgrade in the Western Distributor business case was not consistent with DTF's Investment Lifecycle and HVHR guidelines. These guidelines allow for a single master plan, or program business case covering outcome-focused investments that bring together multiple projects under a single coordinating structure. While not mandatory, the guidelines state that agencies should prepare separate business cases for the major projects that are part of the master plan or program.

Both the peer reviewer appointed by DEDJTR and the Independent Review Panel (IRP), appointed by DPC to review the business case, pointed out the need to better justify the inclusion of the Monash Freeway upgrade works in the business case.

Independent Review Panel findings

The IRP review:

- identified that the Monash Freeway scope element contributed a significant proportion of overall project benefits
- did not agree that the two projects should be combined into a single business case
- recommended separate business cases for the WGT and Monash Freeway upgrade because it saw very limited overlap between the problems and the benefits.

DTF did not accept this IRP recommendation, and was transparent about this in the relevant advice to the government. However, DTF's advice that this recommendation could be addressed by simply strengthening the justification for presenting two separate works packages in a single business case did not fully address the issues raised by the IRP. DTF provided the government with an option to separate the business cases, noting that this option would delay the finalisation of the business case. The government approved the retention of a single business case approach in October 2015.

The IRP also recommended that the business case present the results of the CBA for both the WGT and the Monash Freeway upgrade separately. DTF asked the government to determine the response to this recommendation. The government agreed that the final business case show separate BCR results for the WGT and Monash Freeway upgrade and a BCR for the combined project scope.

Transparency of BCR analysis

In August 2015, the government determined that the WGT project would not proceed unless the business case demonstrated that it had a positive BCR, meaning 1.0 or above.

The CBA in the business case provided to the government in October 2015 used a discount rate of 7 per cent and showed a marginal value proposition for the WGT project and a strong value proposition for the Monash Freeway upgrades. Figure 2C shows these BCRs.

Figure 2C
Final business case BCRs

Project	BCR
Monash Freeway upgrade and the WGT (combined project)	1.3
Monash Freeway upgrade (solo project)	4.2
WGT (solo project)	1.1

Source: VAGO, from Western Distributor Business Case, October 2015.

A **sensitivity analysis** shows how the viability of a project changes if some variables deviate from expected values.

The analysis is useful when projects involve uncertainty as it can demonstrate whether the preferred solution option would be still worthwhile pursuing if key assumptions were incorrect.

The business case only included sensitivity analysis results for the combined project scope.

The sensitivity analysis showed the impacts of applying a higher and lower discount rate and different assumptions about project costs. Applying a discount rate of 10 per cent to reflect greater uncertainty or project risk reduced the BCR for the combined project scope to 0.8. This meant that the present value for project costs exceeded the present value of project benefits. Applying a discount rate of 4 per cent increased the BCR for the combined project scope to 2.3.

The sensitivity results were included in the business case provided to the government. However, DTF's advice to the government summarising the key results of the business case did not highlight the lack of sensitivity analysis in relation to the WGT project scope element.

Options assessment

A business case should:

- define a set of problems
- explore a range of options for addressing the problems
- include an options assessment to identify a preferred way forward which is VFM, affordable, feasible and deliverable.

The October 2015 business case did not meet the requirements in DTF's Investment Lifecycle and HVHR 'Prove' guidelines to examine a range of alternative project solutions to reach a preferred investment option. As shown in Figure 2D, these guidelines require two distinct stages of options assessment.

Figure 2D
Options assessment requirements

Options assessment stage	Required steps/outcomes
First stage	Explore high-level potential options (strategic options), including both asset and non-asset options.
	Select a preferred 'strategic response' based on a qualitative assessment of strategic options that also considers the potential to package strategic options (for example, an asset upgrade combined with a policy targeted at consumer behaviour).
Second stage	Develop detailed options (solution options) that are all a subset of the preferred strategic response.
	Assess and rank the solution options, either through an economic evaluation or a broader integrated assessment if there are significant, difficult to monetise, socio-economic costs or benefits that need to be evaluated, to determine the preferred solution.

Source: VAGO, from Investment Lifecycle and HVHR guidelines.

The approach taken in the business case departed from these DTF requirements at both stages because it did not:

- package strategic options to determine a preferred strategic response, creating the possibility that potential elements of a solution were prematurely overlooked
- follow the process of defining solution options for the project as a whole and conduct an economic evaluation, or integrated analysis, of different solution options to reach a preferred investment option.

These issues mean the business case was not sufficiently comprehensive and so undermined one of its key purposes—to provide confidence to decision makers that they are selecting the right investment option. Instead, the approach focused on justifying a series of investments rather than using an economic evaluation to compare options and identify a preferred investment option.

DTF advised that the business case exceeded the requirement for options analysis. We acknowledge that the business case identified a range of project options, but do not agree that the analysis of these options fully addressed the requirements in the Investment Lifecycle and HVHR guidelines.

Neither the Gateway Gate 2 review nor DTF's HVHR review of the business case identified the shortcoming. However, the IRP identified the need for:

- better articulation of how possible public transport options were explored
- more information on how the investment pathways were selected from a broader range of pathway options
- further work to establish that certain elements of the project scope, such as multiple port and CBD access points, freeway braiding and additional off-ramps to Hyde Street, are positively adding to the net economic benefits of the project.

DTF's response to the IRP findings was inadequate because it did not broaden or revisit the options assessment.

In addition, DTF's summary advice to the government did not highlight that the sensitivity analysis undertaken for the CBA for the business case found that a surface road for the Western Distributor was a better value investment than a tunnel.

It is not standard practice to include alternative investment options in a CBA sensitivity analysis. Despite this, this analysis showed results for a surface road option at a BCR of 1.8 and an NPV of $2 034 million, higher than the equivalent analysis for the WGT on its own, with a BCR of 1.1 and an NPV of $217 million. The analysis did not include a transparent explanation of the surface road option's underlying costing and transport modelling.

We expected commentary on these results in advice to the government. However, the business case, economic analysis report and the various Gateway and HVHR review reports did not comment on this, and we have seen no evidence of further analysis to rule the option out.

Cost-benefit analysis

Consultants commissioned by DTF conducted two CBAs for the project. The first formed part of the business case in October 2015. The second was an updated CBA in March 2018 after the state signed the project agreement with Transurban. The consultants produced an economic assessment report and a financial model to support the CBA results reported in the business case.

Figure 2E shows the high-level approach taken by the consultants to estimating key benefit streams included in the CBA. It outlines the standard and non-standard benefits it included, where non-standard means that these benefit types are not typically included in a CBA developed under DTF's Investment Lifecycle HVHR guidance. We have excluded wider economic benefits, as these were not relevant for the BCR ratios presented to the government.

Wider economic benefits relate to economic benefits that are not typically captured in traditional CBAs and include estimates of project impacts on productivity due to improved proximity to suppliers and labour markets, the impact of transport on increasing competition and competition-related user benefits.

Figure 2E
Approach to estimating WGT benefits

Benefit category	Standard or non-standard benefit	Description
Base travel time savings from improved flow—cars	Standard	Based on transport model outputs and the National Guidelines for Transport System Management (NGTSM) monetisation factors
Travel time savings from reduced traffic congestion—cars	Non-standard	Based on transport model outputs and a methodology from the New Zealand Transport Authority
Travel time savings from improved reliability—cars	Non-standard	Based on transport model outputs and the United Kingdom Department of Transport's methodology
Vehicle operating cost savings—cars	Standard	Based on transport model outputs and NGTSM monetisation factors
Base travel time savings from improved flow—Light Commercial Vehicle and Heavy Commercial Vehicle	Standard	Based on transport model outputs and NGTSM monetisation factors
Vehicle operating cost savings—Light Commercial Vehicle and Heavy Commercial Vehicle	Standard	Based on transport model outputs and NGTSM monetisation factors
Travel time savings from improved reliability—Light Commercial Vehicle and Heavy Commercial Vehicle	Non-standard	Based on transport model outputs and the United Kingdom Department of Transport's methodology
HPFV user benefits	Non-standard	Bottom up calculation made by consultants separately to the transport model
Resilience to lane closures on the West Gate Bridge	Non-standard	Bottom up calculation made by consultants separately to the transport model
Base travel time savings from improved traffic flow—public transport users	Standard	Based on transport model outputs and NGTSM monetisation factors
Crash benefits	Standard	Based on transport model outputs and NGTSM monetisation factors
Reduced air emissions and improved amenity	Standard	Based on transport model outputs and NGTSM monetisation factors

Source: VAGO based on Western Distributor business case and supporting economic assessment, October 2015.

Risk of overstating benefits

For road infrastructure projects, travel time savings typically make up most estimated project benefits. As expected, core travel time savings made up around 76 per cent of the total estimated economic benefits of the WGT claimed in Transurban's initial proposal.

However, the CBA in DEDJTR's business case for the project valued 'other related benefits'—including congested vehicle travel time savings, estimated travel time savings from metered on-ramps to the Monash Freeway, HPFV benefits, reliability and resilience benefits—at $1.76 billion in present value terms, higher than core travel time savings from the transport model calculated at $1.63 billion.

That these other related benefits exceeded the core travel time saving benefits indicates the:

- potential for these related benefits to include some of the same travel time benefits
- need for the CBA to transparently justify both the inclusion and the additive nature of each individual benefit stream.

Overstatement may occur where benefit streams overlap and potentially capture benefits that have already been counted as part of the core travel time savings. The extent to which this is a problem depends on how the transport model treated traffic within the network, including the extent to which exceptional conditions, such as lane closures, were already incorporated into the modelled traffic conditions and therefore did not require adjustments outside the model.

The economic assessment report and CBA financial model that supported the business case did not transparently explain the basis for the material 'other related benefits' streams or demonstrate that they were distinct from and additive to the core travel time saving benefits.

An example of insufficient documentation is the inclusion in the estimated benefits of $408 million (present value) in the CBA for an item titled 'switcher Vehicle Operating Costs correction'. The business case does not specifically note or explain this item but included it within a total $880.1 million (present value) for vehicle operating costs savings. Given that the impact of this correction represented nearly half of the total vehicle operating costs savings benefits, it should have been transparently explained and justified in the business case.

In general, DEDJTR did not adequately justify in the business case their inclusion of additional non-standard benefit categories. An alternative approach would have been to incorporate these considerations into a sensitivity analysis to better inform the government's decision on the project.

This view was also supported by a peer review of the CBA in October 2015 that suggested that a number of these benefit streams should have been included in a sensitivity analysis rather than in the core analysis. DTF and DEDJTR did not address this peer review suggestion in the business case.

In some cases, the estimated benefits may be overstated. We outline examples here.

Monash managed motorway benefits

On-ramp meters, usually a basic traffic or two-section signal light together with a signal controller, manage the rate of vehicles entering a freeway in response to traffic conditions.

Additional time savings were assumed on the Monash Freeway by implementing 'managed motorway techniques'—primarily on-ramp metering. These travel time benefits, shown in Figure 2F, were aggregated into the travel time savings category in the CBA reporting, but were a standalone calculation in the CBA model.

Figure 2F
Monash managed motorway benefits

Benefit (saving)	Individual benefit
Monash managed motorway travel time	Additional 7.5 per cent travel time saving in the morning and afternoon peaks. Additional 3.5 per cent travel time saving in the period between the morning and afternoon peaks.

Source: VAGO based on information from DTF and DEDJTR.

These benefits were applied to travel times along the Monash Freeway based on the transport modelling. There are several issues with this approach:

- It applied additional travel time savings whether or not the link was performing at, or near, free flow (meaning traffic travelling continuously at or near the speed limit). In circumstances where the traffic is flowing freely, the benefits of metered on-ramps would be redundant.
- The calculation did not account for the main downside of the ramp metering relating to vehicles having to wait longer to join the freeway.
- The time saving assumed to result from ramp metering was based on a single source from the United States that referred to unspecified toll roads.
- Another source dealing with the benefits of ramp metering presented to the Australasian Transport Research Forum in 2015 suggested lower and potentially negative time savings from ramp metering.

Given that the present value of the Monash Managed Motorway benefit was significant, at $209.7 million, DEDJTR should have tested and more clearly justified the assigned benefit value. Applying the results of the Australian study would have resulted in a far more modest benefit.

Benefits from HPFVs

The CBA included $283 million in benefits from HPFVs, particularly their improved access to the Port of Melbourne. Calculating these benefits required a number of assumptions to approximate journey times, vehicle operating costs, crashes, emissions, externalities and amenity benefits. However, as noted in the economic assessment report, the Victorian road network requires multiple upgrades to enable HPFVs to operate. As a result, this benefit cannot be wholly attributed to the project, as realising it relies on other investments that are not included within the costs in the CBA.

Blended approach to transport modelling outputs

The CBA took a 'blended' approach to using the transport modelling outputs. This considers how road users will change their travel routes and patterns in response to the changed roads, using 'fixed' and 'variable' matrices.

A matrix that is …	Assumes …	So …
Fixed	Demand for the road is fixed and independent of cost	No behavioural change occurs in response to the costs of travel.
Variable	Travellers can change their travel mode or route in response to costs and network conditions	Allows for induced demand associated with new or upgraded roads.

Source: VAGO.

The CBA outputs were 'blended' using a linear profile, with outputs applied differently over time.

Year of operation	Based on Fixed Matrix	Based on Variable Matrix
First full year of operation	90%	10%
Ninth year of operation	10%	90%
Beyond the tenth year of operation	0%	100%

Source: VAGO based on Western Distributor Economic Assessment Report, 15 October 2015.

Adopting this blended approach, which initially relies on a fixed trip matrix, results in higher benefits than an approach that relies solely on a variable matrix. As such, DEDJTR should have transparently justified the reason for this approach. However, the business case and underlying economic assessment report presented no evidence to support it.

The peer review of the economic appraisal in October 2015 identified the lack of evidence as to why it was assumed that travellers will take 10 years to change their habits and stated a need for further justification of the approach. DEDJTR did not address this comment in the updated peer review.

Given the limited justification for use of the blended approach, the CBA results in the economic appraisal report should have also shown results from fully applying the variable matrix from the first year, at least as a sensitivity test. This is consistent with our previous recommendations on the need to adequately assess the significance of induced traffic for all major road projects and take account of this when forecasting traffic and estimating the economic benefits.

External review of the CBA approach and results

We expected the CBA methodology, model and results to be thoroughly reviewed and refined as part of the business case development process. However:

- the report on the combined Gateway 1 and 2 review made no comment on the CBA
- the peer review, conducted by consultants commissioned by DEDJTR, of the economic analysis underpinning the CBA (initial report on 8 October 2015 and an updated report on 21 December 2015) raised substantive issues, but there is little evidence that DEDJTR and DTF refined the CBA approach and results to address these matters
- DTF's HVHR review of the business case focused on deliverability and did not reference the CBA
- the IRP review noted that the panel did not receive the economic assessment report to inform their review, but nonetheless found that 'the economic analysis undertaken in the Business Case appears to be both robust and based on accepted methodologies'.

Of these reviews, only the peer review made substantive comments on the CBA. The updated peer review indicated that a number of issues raised in the initial peer review were either not addressed at all, or only partially addressed. These issues had a material impact on the results of the CBA. Specifically, the initial peer review:

- made it clear that the CBA scenarios within the economic appraisal referred to as 'current Victorian practice' included benefit categories not included in Victorian guidance material, such as the perceived cost of congested travel time
- suggested that, subject to sufficient justification, the perceived cost of congested travel time could be included in the core analysis but might be better referred to as part of sensitivity tests to be consistent with Victorian and Australian guidelines. The updated peer review report noted that some additional justification was provided for the inclusion of this benefit category
- suggested that it would be useful to identify which other benefit categories were included in a standard Australian or Victorian guideline, and which were 'add-ons'
- identified the need to clarify how HPFV benefits were calculated and how they related to additional investment in bridges across the state
- raised an issue with benefits relating to network resilience and redundancy, saying 'The calculation methodology and assumptions would benefit from greater supporting justification to ensure that they are robust and that there is no overlap with other benefits'. The updated peer review indicated that greater clarification was provided, but did not state whether the potential for double counting had been addressed.

The peer review did not provide an overall conclusion on whether the economic appraisal as a whole was appropriate and fair based on relevant guidance and practice.

Review of transport modelling

DEDJTR appointed a peer reviewer in mid-2015 to assess the transport modelling undertaken for the business case. This peer reviewer raised substantive issues with the modelling approach, but they were not retained long enough to assess the adequacy of responses to these issues.

There was no formal peer review process for transport modelling undertaken after the business case. This is despite this modelling representing a key input for the Environment Effects Statement process, the VFM assessment process and the state’s tolling parameters and approach.

The final VFM assessment report in December 2017 gave the impression that the outputs of the transport model had been reviewed by another adviser. However, DTF has confirmed that this was not a formal peer review and there is no documentary evidence on the outcome of this review process.

We reviewed available evidence on the transport modelling undertaken for the business case and the subsequent Environment Effects Statement with a focus on whether issues raised by the peer review were adequately acquitted.

DEDJTR used a strategic transport model to evaluate the impacts of this road project. The model largely met VicRoads validation standards for strategic models but not international standards for road project models.

The peer review raised concerns about whether technical aspects of the modelling approach used for the business case were consistent with accepted guidance and practice and the potential implications of this for the reliability of the modelling. We conducted our own review which confirmed these issues, but also found, subject to some qualifications relating to the comprehensiveness of validation and forecasting data, that:

- forecast rates of traffic growth were reasonable
- there was no indication of serious faults in the network modelling methodologies applied for the project
- the model generally reproduced the pattern of total traffic in the project area well for the business case, with a few exceptions
- model performance improved for the subsequent Environment Effects Statement process although some key roads were less well matched and the model ‘fit’ to peak traffic levels (in the peak direction) deteriorated compared with the business case
- the modelling of afternoon peak traffic was less accurate and there was limited evidence to support the estimates for commercial vehicle traffic flows.

Our review also found that the blended approach to using the transport modelling outputs for the calculating benefits in the business case was not well justified and the impacts of induced travel on project benefits were unclear.

Updated cost benefit analysis

When DTF recommended to the government in December 2017 that it proceed to award a contract to Transurban for the WGT project, the project's total cost had increased by $1.2 billion (nominal) and the state contribution had increased by more than $600 million (nominal), as shown in Figure 2G.

Figure 2G
Updated WGT project costs: 2017

	Original Business Case Cost	Total cost in 2017 (nominal)	Excluding
Total project cost	$5.5 billion	$6.7 billion	
State contribution	$2.1 billion	$2.7 billion	
Unfunded contingency			$220 million

Source: VAGO based on information from DTF.

DTF advised the government that it:

- had not updated the CBA for the project to determine a revised BCR
- expected that the BCR for the combined project comprising the WGT and Monash Freeway upgrade would be above 1.0 despite the revised scope and cost
- had instructed the state's commercial adviser to update the CBA and BCR.

Updated economic assessment report

The commercial adviser provided a draft updated economic assessment report in March 2018. DTF advised us that this report was not finalised. This report and the underlying CBA model further demonstrated the marginal value proposition for the WGT on its own.

This report updated the project cost and benefit estimates to reflect the final project scope. While it is clear that the project costs had increased, the basis for the assumed benefit increases is less apparent.

The report included new benefit categories that were not included in the original business case.

Total additional benefits	% of total NPV*	% of total increase in project benefits**
$432 million	46% ($931 million)	~40% ($1 084 million)

Note: * Total project benefits, excluding wider economic benefits, less total costs.
Note: ** Excluding wider economic benefits.
Source: VAGO from West Gate Tunnel Project, Updated Economic Appraisal draft report, March 2018.

This included benefits from:

- reduced truck incidents at the Napier Street bridge
- improved incident response time resulting from increased live monitoring of traffic
- new and upgraded walking and cycling paths

- improved access to community open space
- better noise walls along the West Gate Freeway
- opening of the Monash Freeway upgrade in 2019–20 rather than 2022–23.

Further, the updated economic assessment report applied the discount rate used in the business case of 7 per cent, but included no sensitivity analysis applying higher and lower discount rates.

The revised BCR figures reported were:

- 1.2 for the combined WGT and Monash Freeway upgrade project
- 1.0 for the WGT project on its own.

The updated economic appraisal report did not provide details on the methods used to estimate the additional benefits or a breakdown of the values of individual components within the new benefit categories.

The updated CBA has similar issues to those identified with the business case CBA, including that it did not provide detail to dispel any concerns of potential double counting of benefits. In addition, neither the updated model nor the updated report included convincing evidence to demonstrate the appropriateness of the new additional benefits included in this analysis.

As a result, the updated CBA can only reasonably be considered as a sensitivity analysis undertaken to examine whether it was possible for the project to still provide positive net benefits, despite the significant cost increases.

Figure 2H provides specific comments on three of the new additional benefits and other issues.

Figure 2H
Issues with new additional benefits in updated CBA

Additional benefit category	Audit comments
Better noise walls	• The calculation of the better noise walls benefits is highly assumption driven. It uses a 'noise externality monetary benchmark' which is commonly used in CBA, but also relies on an assumption that noise walls reduce vehicle sound impacts by 75 per cent. This assumption on the marginal impact of noise walls is not based on CBA guidance and no evidence is cited to support it. • The broader 'externality impact' benefit category in the original CBA—an output of the transport modelling included the noise externality monetary benchmark. The updated economic appraisal report does not explain why the new benefit of 'better noise walls' does not double count this reduced noise benefit.
Walking and cycling benefits	• This was a logical benefit to include within the updated CBA as the scope of active transport improvements had been clarified by this time in the project. • However, the key input used to calculate the walking and cycling benefit is a survey of the number of walkers and cyclists, along the route to be upgraded, over a two-hour morning peak period. An expansion factor of 7.21 was applied to the two-hour morning peak data to determine daily use data. This expansion factor is a figure used by Transport for New South Wales for application to Sydney roads. It implies that morning peak rates of walking and cycling along this route are sustained for over 14 hours a day. The report does not explain why this factor is applied to walking and cycling, when the equivalent Transport for New South Wales expansion factors are 3.58 for trains and 4.34 for buses. • Given this additional benefit stream totals $102 million in present value, justification of the expansion factor was warranted in the report.
Monash Freeway early opening benefits	• This benefit is not calculated within the CBA financial model. It is input as a single value, providing a benefit of $192 million NPV, with no details included in the model on how it was calculated. • DTF provided further information on this benefit during our audit that should have been highlighted in the updated economic appraisal report.
24-hour truck bans in Maribyrnong and Hobsons Bay	• Our review of the updated CBA financial model indicates that this benefit stream may have been overstated because it counts a 60-year benefit stream. The report does not explain the inconsistency with other benefit streams (with the exception of the Monash Freeway early upgrades) where benefits were profiled for 50 years.
Auxiliary traffic control room	• This has been used to calculate an additional resilience benefit relating to the Monash Freeway upgrade. However, no justification is provided to demonstrate why this benefit is wholly additive to the managed motorways benefit stream already included in the CBA.

Source: VAGO.

2.4 Public Interest Test and equity

A key feature of the preferred solution in the business case was a PPP procurement approach for the Western Distributor/WGT works, though not for the Monash Freeway and Webb Dock upgrades.

The business case stated that the purpose of the Public Interest Test was to ensure that procuring the project as a PPP was in the public interest and that, after a decision was made to procure the project as a PPP, the process be structured so that the project continued to be in the public interest.

The business case concluded that 'the Public Interest Test has determined that the public interest can be adequately protected through a PPP delivery of the Western Distributor works'. Tolling the newly constructed Western Distributor/ WGT was implicit in the preferred solution.

The Public Interest Test applied as part of the business case assessed the preferred project against eight elements set out in the *Partnerships Victoria Guidelines* and largely addressed the criteria of:

- effectiveness
- accountability and transparency
- affected individuals and communities
- equity
- public access
- consumer rights
- security
- privacy.

The Public Interest Test assessment for the equity criteria asks, 'are there adequate arrangements to ensure that disadvantaged groups can effectively use the infrastructure or access related services?'.

The assessment referred to impacts on urban amenities in the inner west and improving walking and cycling connections. However, the assessment made no reference to the potential impacts of the toll road element of the PPP on disadvantaged groups.

A comprehensive assessment of equity impacts would have also noted that it introduced a new toll road into the inner west—the WGT—while upgrading an untolled road in the south-east—the Monash Freeway. This issue was not explicitly considered in the Public Interest Test assessment.

The Public Interest Test also did not consider the implications of tolling on different user groups. Specifically, it does not consider the impacts:

- on the freight and logistics sector of tolling heavy commercial vehicles using both the new Western Distributor/WGT and the existing West Gate Bridge
- of the city access charge, which would only apply during the inbound morning weekday peak period. This tolling element may disproportionately impact commuters who live in Melbourne's west and have poor access to public transport.

The Public Interest Test assessment did not examine the distribution of costs and benefits among different categories of road users. While not specifically required by the *Partnerships Victoria Guidelines*, including analysis of this issue in the assessment would have improved its comprehensiveness by considering the equity implications of introducing a new toll road.

3

West Gate Tunnel project: value for money

The 2015 interim MLP guideline required VFM assessments for MLPs to include:

- a quantitative assessment involving a comparison of the final proposal's cost to a state benchmark, either a public sector comparator or a realistic alternative, and
- a qualitative assessment of the value of the proposal as a whole and the individual value drivers underpinning the proposal.

In December 2017, DTF advised the government, based on the Stage 4 assessment, that the Transurban WGT proposal offered VFM based on a comparison with state benchmarks for the same project funding sources.

The total project cost is $6 689 million (nominal) including the Monash Freeway upgrade and the Webb Dock access improvement. Works will be funded by:

- new tolls on users of the project, including heavy commercial vehicle tolls on the upgraded West Gate Freeway and car, light commercial vehicles and motorcycle tolls on WGT
- adjustments to various CityLink tolls during the remaining term of Transurban's existing CityLink concession, including:
  - a fixed 4.25 per cent annual toll escalation rate for 10 years from July 2019
  - a 10-year extension of the CityLink concession, from 2035 to 2045
- a state funding contribution of $2 661 million (nominal).

More than 93 per cent of Transurban's design and construction-related costs were tendered out to the market in a competitive process. Transurban will transfer the WGT back to the state in January 2045.

3.1 Conclusion

DTF's VFM assessment and advice to the government met the 2015 interim MLP guideline requirement for a quantitative assessment of the Transurban WGT proposal.

DTF advised the government that Transurban's proposal met the requirements for VFM. However, DTF's advice to the government was not sufficiently comprehensive due to:

- limited analysis of alternative funding and delivery options
- state VFM benchmarks used to compare against the Transurban proposal being expressed as a wide range without inclusion of a best estimate
- lack of sensitivity analyses to challenge discount rate assumptions in the state's VFM assessment.

In addition, DTF's presentation to the government of the VFM assessment results on Transurban's proposal did not clearly disclose the sensitivity of key assumptions and calculations which underpinned the reliability of the assessment.

3.2 Adequacy of the VFM assessment

Analysis of funding and delivery options

Transurban's proposal offered an apparent benefit to the state because Transurban intended to finance most of the project delivery itself, primarily through CityLink tolls—the unique characteristic the proposal offered. This would remove the need for the state alone to fund the build. Assessing the value of Transurban's proposal therefore required a comparison with an estimate of what it would cost if the state delivered the project or used other possible funding and delivery approaches.

Assessment and analysis process

DTF committed to the government to comprehensively assess whether Transurban's proposed approach to funding and financing the project was the best option available to the state, or whether an alternate funding and contracting approach would deliver better VFM. This analysis was to include approaches other than granting a concession extension to Transurban such as the state:

- borrowing through securitisation of future CityLink tolls
- monetising future CityLink tolls through a competitive process.

However, DTF did not meet this commitment. Neither the Stage 3 or Stage 4 reports or advice to the government provide this broader assessment. DTF's VFM assessments only compared the Transurban proposal to state benchmarks using the same funding sources. This narrow assessment approach deprived the government of critical information to support its decisions on whether, and how, to progress the proposal.

Exploration of alternative funding sources and delivery options in the business case and VFM assessments

DTF's Investment Lifecycle and HVHR 'Prove' guidelines on the development of business cases state that alternative funding sources should be considered when assessing commercial and financial issues for projects.

Given this, we expected that DEDJTR's business case for the project would include assessment of a wider set of alternative project funding options and issues such as the difference between the costs and benefits of raising funds from tolls on CityLink compared to other state sources of funding such as taxes and charges, borrowing or other monopoly concessions.

This was not the case. DEDJTR's business case included a DTF report on the approach to tolling. However, this analysis was restricted to a narrow set of toll pricing alternatives, not broader options associated with alternative mechanisms for funding the project.

We expected the VFM assessments to include assessments:

- of the risk associated with entrenching Transurban's incumbency advantage in bidding for future toll roads
- combining qualitative and quantitative analysis of the incremental costs and benefits to the state of accepting Transurban's proposal.

At Stage 2, DTF noted that the government should consider whether extending an existing concession would create an unintended monopoly advantage for Transurban in the construction and operation of toll roads. However, DTF did not, in Stages 3 or 4, advise government on whether extending the CityLink concession would create an unintended monopoly advantage for Transurban.

By accepting Transurban's proposal, the state effectively chose not to exercise the other options available to it. The business case explored whether the state should do nothing or whether a similar package of works would be of value without Transurban involvement. However, it did not examine whether the state would be better off accepting the Transurban proposal, undertaking the works on its own or seeking private sector involvement in the marketplace. This was the intended role of the VFM assessment.

The quantitative VFM assessments at Stages 3 and 4 compared Transurban's proposal to a state VFM benchmark intended to represent the costs to the state of undertaking the project without Transurban, but assuming the state could access all the same funding sources. This approach was reasonable.

However, the uniqueness and VFM assessments and advice to the government did not clearly provide the intended broader qualitative VFM assessment of the benefits and costs, including opportunity costs, of either pursuing or not pursuing the Transurban proposal.

Such an assessment would have examined the incremental benefits to the state of pursuing the Transurban proposal against alternative options of state or private sector delivery. The benefits to the state under the Transurban proposal included Transurban's capacity to fund the project by accessing CityLink toll revenues at low cost, reduced costs to manage interface issues between the project and Transurban's CityLink road and avoiding costs to set up a tolling operation. The opportunity costs of accepting Transurban's proposal would include costs associated with potentially entrenching Transurban's incumbency advantage in bidding for future toll roads.

The individual costs and benefits of accepting Transurban's proposal were, for the most part, articulated either qualitatively or quantitatively in the VFM assessments. However, these strands of analysis were not brought together in a meaningful way in the VFM assessments or advice to the government, meaning it would have been difficult to assess the benefits and costs, including opportunity costs, to the state of either pursuing or not pursuing the Transurban proposal.

Reliability of VFM benchmark inputs

The Stages 3 and 4 VFM assessments included a quantitative comparison of the Transurban proposal against state benchmarks for project costs and revenues. The VFM assessment reports refer to these benchmarks as the state-owned enterprise (SOE) or SOE delivery model benchmark. We refer to this as the 'state VFM benchmark'.

An **Availability PPP** is where the primary funding source that repays the private sector finance used to build the asset takes the form of a payment from government over the operational phase of the project to ensure the continuing availability of the asset.

State VFM benchmark (SOE)	Assumed that the state …
Project costs for construction and operation	Independently delivered the same project and scope proposed by Transurban under an Availability PPP delivery model.
Project funding solution	Collected and retained the same toll revenue streams assumed under the Transurban proposal, and that those revenues delivered a commercial rate of return.

Source: VAGO.

WACC is the rate that a company is expected to pay on average to all its security holders to finance its assets. WACC is commonly referred to as the cost of capital.

The state's VFM assessment involved discounting the estimated nominal cashflows for project costs and revenues using a range of discount rates intended to reflect a market-based WACC valuation range. This gave a range of state VFM benchmark results.

Discount rates used to reflect market-based WACC valuation range

Determined by an …	Intended to reflect …	Resulted in …	Used to compare with …
Investment bank engaged by DTF.	the state's requirement for a commercial rate of return given the commercial risk position assumed under the SOE delivery model.	a range of values for the state VFM benchmarks for each cost and revenue element in NPV terms.	corresponding elements in Transurban's proposal and presented as overall results in the VFM assessment reports.

Source: VAGO.

Estimated toll revenue and discount rate assumptions were the most important drivers of the overall determinants of the VFM assessment results presented to government.

Toll revenue estimates

The state's VFM assessment used benchmarks which included the state's estimates of the toll revenues it could raise from the WGT, the West Gate Freeway, and the CityLink escalation and extension sources.

A large proportion of the reported VFM benefits to the state in Transurban's proposal arose from the differences between Transurban's and the state's valuation of future tolling revenue. At Stage 4, the state's lower CityLink toll escalation revenue estimate was the major contributor to the overall difference of $272 million (NPV) between the Transurban proposal and the midpoint of the state's VFM benchmark. This was because the low estimate had the effect of dropping the bottom end of the benchmark range.

This difference arose because Transurban valued tolling revenues, particularly toll escalation revenue, more highly than the state did. The difference between the valuations reduced the size of the state contribution needed under Transurban's proposal. DTF rightly advised us that Transurban was prepared to accept the risk involved in achieving its higher toll revenue estimates. Transurban also faced a real risk that the state would not proceed with the proposal if the state assessed Transurban's forecast tolling revenues as unrealistic and not providing VFM against state benchmarks.

Notwithstanding this, DTF rightly obtained its own estimates of revenues to develop its VFM benchmark. However, there were clear reasons for the state to be sceptical if its own toll revenue estimates were less than Transurban's because:

- as noted by DTF in its Stage 3 and 4 assessment reports, Transurban had greater knowledge of CityLink revenues and their drivers above all other market participants
- Transurban's better knowledge means its estimates may have been more accurate than the state's
- Transurban had commercial incentive to undervalue future CityLink toll revenues in its proposal to make a case for a longer extension of the CityLink concession, higher toll escalation and a larger state contribution.

Given this, DTF should have been wary of significant differences between Transurban's and the state's tolling revenue valuations and the potential impact of those differences on the size of the state contribution and the extension and escalation of the CityLink concession.

Given that Transurban had little incentive to overstate toll revenue, and had the best information, where Transurban's estimates were higher than the state estimates, DTF's assessment and advice would have been more comprehensive had it used the Transurban estimates as a sensitivity test for its VFM benchmarks and shared the results with the government.

Estimation of CityLink escalation revenue in Stage 4 assessment

The state's forecast 'low traffic scenario' benchmark for the CityLink escalation revenue was significantly below Transurban's forecast. DTF's VFM assessments counted Transurban's higher estimate as a material source of VFM for the state. However, Transurban's knowledge about this revenue source raises questions about the reliability of the state's low estimate.

At Stage 4 both the state benchmark and the final Transurban proposal used the same toll price assumptions. Given this, differences in forecast toll revenue were driven by differences in the assumed traffic demand and/or the discount rate applied.

Figure 3A shows that the Stage 4 VFM assessment included a single point estimate for the state's benchmarks for all revenue sources, except CityLink escalation revenue, where DTF reported both a high and low benchmark.

The difference between the state's high and low CityLink escalation revenue benchmarks arose from an assumption that around 6 to 7 per cent of traffic would be diverted under a 'low traffic scenario'.

Figure 3A
Nominal project revenues as reported in the Stage 4 assessment

Project	Transurban proposal ($m)	State benchmark ($m)
WGT	1 854	2 163
West Gate Freeway	3 010	3 109
City Access	137	149
CityLink Extension	14 345	15 061
CityLink Escalation	4 758	2 893–4 788
CityLink Traffic Impact (during operation)	(210)	(300)
Total	**23 894**	**23 075–24 970**

Source: VAGO based on information from DTF.

DTF advice to the government on the Stage 4 assessment did not:

- highlight that the state benchmark's forecast 'low traffic scenario' for the CityLink escalation revenue was 65 per cent lower than Transurban's
- discuss the possibility that the state benchmarks undervalued the CityLink escalation revenue
- explore the suitability of the assumption that resulted in 6 to 7 per cent of traffic being diverted under the 'low traffic scenario'.

The differences in revenue assumptions significantly impacted the calculation of the overall project NPV. The state's low CityLink escalation revenue estimate had a material effect as it was used to estimate the Stage 4 'low' state benchmark, dropping the bottom end of the benchmark range.

This was further exacerbated by DTF reversing the discount rates applied to this revenue source, without explanation, in contrast to those applied to all other revenue estimates. In the Stage 4 assessment, for revenue sources other than the CityLink escalation revenue:

- the 'low' state benchmark was derived by applying a high discount to future revenues and costs
- the 'high' state benchmark was derived by applying a low discount rate to future revenues and costs.

Conversely, for the CityLink escalation revenue:

- the ‘low’ state benchmark was based on a low traffic scenario and a low discount rate
- the ‘high’ state benchmark was based on a high traffic scenario and a high discount rate.

Applying the discount rates this way, in the state benchmark, placed the Transurban proposal as offering comparatively better VFM (all else remaining equal). DTF did not explain, in the Stage 4 VFM assessment or related advice to the government, the nature, impact or basis for this approach. This was an omission given how sensitive the state VFM benchmark was to the CityLink escalation revenue ‘low’ traffic scenario.

DTF advised us that its approach to combining the range for CityLink escalation toll revenues with the range for the state’s discount rates was intended to reflect an inherent link between the risk profile of the two revenue forecasts and the discount rate applied to each, suggesting that the high escalation revenue estimate was considered less realistic. If that were the case, it should have been clearly explained in the Stage 4 assessment report, but it was not.

DTF’s explanations to us on this issue suggest that the treatment of the discount rates in relation to the CityLink escalation toll revenues was their way of seeking to address concerns about the plausibility of assumptions about traffic diversion that underpinned each of those forecasts. If that was the case, there would have been better approaches for addressing those concerns.

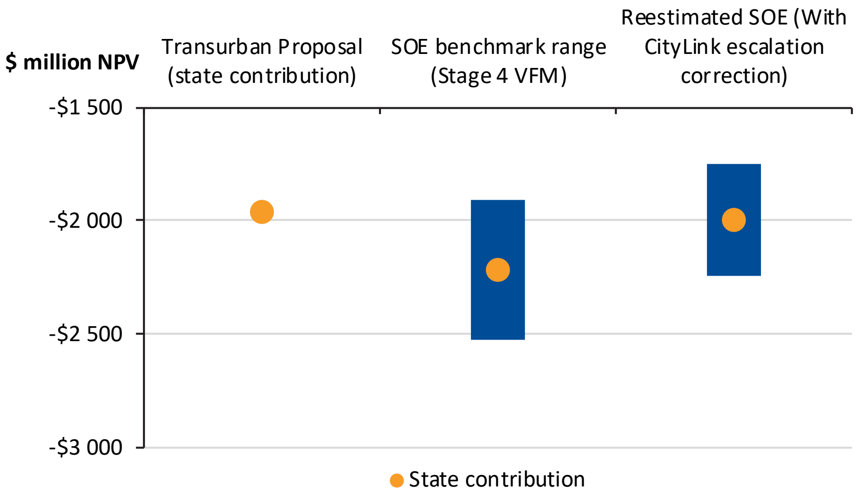
The discount rate should reflect the variability of the cash flows that are being discounted—not the degree of doubt about the plausibility of those cash flows.

If DTF was attempting to account for the high CityLink escalation revenue forecast scenario being less realistic than the low scenario, the appropriate way to address that concern would have been to probability-weight the scenarios, according to the likelihood of each of those scenarios arising. DTF argued that adopting a probability-weighted approach to deriving a best estimate of toll revenues would have introduced unnecessary subjectivity into the forecasts. However, it would have been far better to express those judgments transparently, so that the impact of those assumptions about likelihood could be scrutinised and tested.

Figure 3B shows the combined effect on the estimated range for the state’s VFM benchmark of:

- removing the low traffic scenario CityLink escalation revenue estimate
- applying discount rates to the CityLink escalation revenue consistent with those applied to other sources of revenue.

Figure 3B
Comparison of state contributions under Transurban proposal, the state benchmark from the Stage 4 assessment and our re-estimated state benchmark ($ million NPV)



Note: The middle bar represents the state VFM benchmark range as given in the Stage 4 VFM assessment. The right bar is our re-estimated benchmark range based on our adjustments.
Source: VAGO based on the DTF Stage 4 assessment report and our re-calculations.

The impact of these adjustments is that the state contribution, represented in Figure 3B by dots, under the Transurban proposal of $1.96 billion (NPV) is no longer near the top of the state benchmark but closer to the mid-point.

Discount rate issues and impacts on state VFM benchmark

The Stage 4 VFM assessment and advice to the government showed the state benchmark as a wide NPV range—positive $55 million to negative $600 million—largely because of the range of discount rates used.

DTF engaged an investment bank with experience in the financing of toll roads, including the original CityLink transaction for Transurban in the mid-1990s, to provide advice on the discount rates in the state's VFM assessment.

Relevant guidance

The MLP guideline does not advise how to determine discount rates. Therefore, it would have been necessary for the state to consider the appropriate methodology for determining discount rates for this MLP.

The state benchmark for the WGT project assumed an availability PPP to deliver the infrastructure and a state-owned entity operating the road and collecting tolls. This involved the state accepting traffic demand risk for the WGT and receiving the extended CityLink tolling concession. The state's commercial advisers used discount rates in the Stage 4 VFM assessment that were intended to reflect commercial rates of return given the commercial risk position taken on by the state under this model.

The *National PPP Guidelines* on discount rates are relevant. DTF advised that this project is akin to an economic infrastructure project, rather than a social infrastructure project and, therefore, the relevant methodology for determining discount rates is established in Appendix D of Volume 5 of the *National PPP Guidelines*, which indicates that:

- there is no valid reason that the state should seek a lower net return on its participation in economic projects than that sought by private sector participants in the same market. This means that when evaluating bids in a PPP process for economic infrastructure the Public Sector Comparator (PSC) should ordinarily be developed as an asset purchase model and the decision structure based on selecting the best value investment
- the PSC model should be developed using observed returns private sector entities are seeking for similar projects to develop the model. This will naturally include a market premium for systematic risk, since economic infrastructure cashflows are subject to such risks
- the PPP bids will include either a payment to or from the state, independent of the actual future revenue experience, and as such are devoid of systematic and project risk from the government perspective and so should be discounted by the risk-free rate. There is no need to adjust this rate since the PSC directly values the cost of systematic risk and therefore there is no differential between valuation approaches as there is in social infrastructure projects.

Public Sector Comparator

The *National PPP Guidelines* define the PSC as an estimate of the hypothetical, risk-adjusted whole-of-life cost of a public sector project if delivered by government.

The PSC is used as the financial benchmark in the quantitative VFM assessment during the PPP procurement process.

The state's investment bank adviser on discount rates used a 'bottom-up' financial model to derive the set of discount rates used in the VFM analysis. This financial model used inputs including equity internal rates of return that were benchmarked using observed rates of return for actual toll road projects. This approach was consistent with the broad requirements of the relevant part of the *National PPP Guidelines*.

Reasonableness of the discount rate range

The investment bank engaged by DTF determined a range for the rates of return on capital used in the state VFM benchmark. These rates were intended to reflect the state's need for a commercial rate of return under the SOE model assumed as part of the state's VFM benchmark.

Discount rates as ranges

DTF treated forecast cashflows and discount rates inconsistently in the state's VFM assessment.

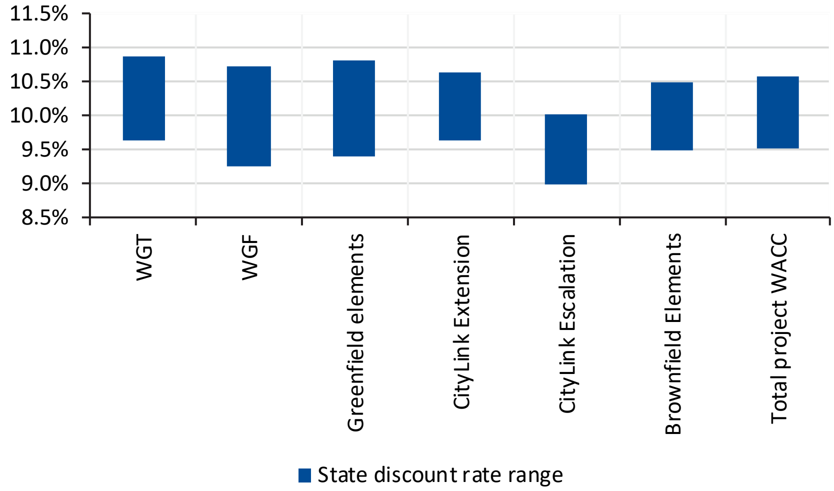
DTF's commercial adviser discounted a single set of nominal cashflows using a 'high' discount rate and a 'low' discount rate provided by the investment bank DTF engaged. This determined the range for the state's benchmarks.

The VFM financial model assessed the NPVs of cashflows from June 2017 to March 2045. This required forecasting cashflows 29 years into the future. The level of uncertainty of these cashflow forecasts is at least as significant as the uncertainty of discount rate assumptions.

Despite this uncertainty, DTF's commercial adviser formed a best view of future cashflows to be discounted and used a single scenario for forecast future cashflows. The one exception to this was CityLink escalation revenues, used to estimate the NPV of the project for the purposes of establishing the state's VFM benchmarks.

The investment bank engaged by DTF to advise on the appropriate discount rate did not provide a single point best estimate for the discount rate. Figure 3C presents the nominal discount rates used in the Transurban proposal and in the state's Stage 4 VFM assessment benchmark analysis.

Figure 3C
Discount rates used in the State Benchmark (per cent)



Source: VAGO based on information from DTF.

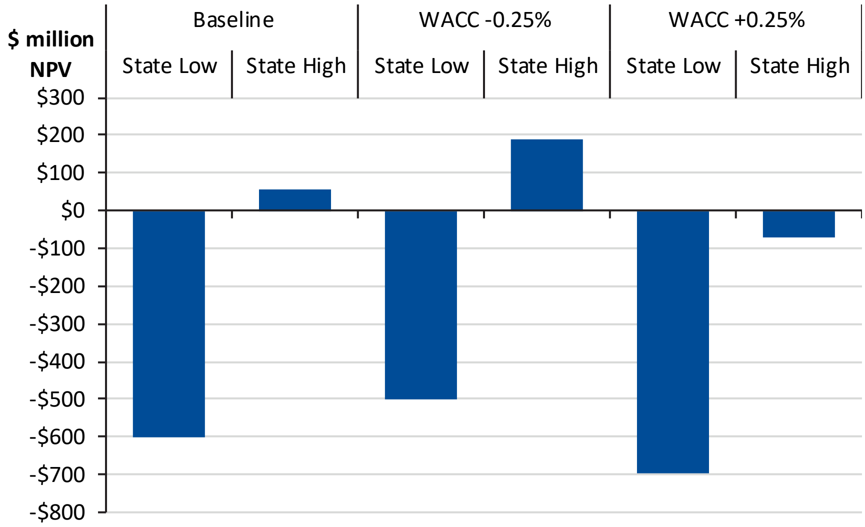
It is not unusual to express discount rates as ranges because discount rates (estimated as the WACC) are difficult to estimate with a high degree of precision.

Expressing discount rates as ranges recognises the uncertainty involved in deriving reliable estimates of the WACC and DTF advised that the discount rate range reflected uncertainty around the true commercial rate of return appropriate for this project. However, it is unusual to express discount ranges solely as ranges, and adopting this approach produced a very wide band for the state VFM benchmarks.

Figure 3D shows:

- that even the modest range in the state's discount rate resulted in a very wide range for the state VFM benchmarks of $655 million NPV
- the extent to which the state VFM benchmarks shift if the discount rate range is varied by just +/- 0.25 per cent.

Figure 3D
Sensitivity of VFM state benchmarks to changes in discount rates ($ million NPV)



Source: VAGO based on data from DTF.

The reason the VFM benchmarks are so sensitive to the discount rate relates to the timing of the project cashflows. In projects such as the WGT, where most of the costs are incurred early and most of the revenues are spread over the lifetime of the project, the longer the life of the project, the more sensitive the state's VFM benchmark range will be to the discount rate range.

Further, the upper bounds of the discount rate ranges used by the state were materially higher than the discount rate used by Transurban, suggesting the state estimated higher required commercial rates of return than that adopted by Transurban.

Transurban had better knowledge of the commercial rate of return in relation to its existing CityLink asset and the project. Transurban also had an incentive to propose the highest possible commercial rate of return, to maximise the state contribution towards the project. DTF advised that Transurban's incentives would have been dampened by the fact that the state could have chosen at any stage in the MLP process to deliver the project itself. That is, the state's ability to 'walk away' would have constrained Transurban's incentives to overstate the commercial rate of return.

Aside from Transurban's incentives, it should have been clear to the state that Transurban had adopted a rate of return that was close to the bottom end of the discount rate range that the state had adopted. There are two possible reasons why the state's estimate of the discount rate was higher than Transurban's:

- Transurban genuinely had a lower cost of capital than the SOE, in which case adopting the Transurban proposal would have provided the state with VFM, or
- the state overestimated the required rate of return.

The state should have undertaken further work to rule out the second possible explanation, because if the state had overestimated the discount rate, that would have had a material impact on the VFM assessment. DTF did not demonstrate that it had undertaken any such work. In addition, DTF advised us that it had no information to determine whether the top of the state's discount rate range was more or less likely than the bottom end of the range.

It would have been reasonable for DTF to examine and advise the government:

- whether there was any reason Transurban may have in fact had a lower required rate of return than the SOE, and
- the impact of adopting Transurban's rate of return estimate on the outcome of the VFM assessment, as a sensitivity analysis.

There may have been legitimate reasons why an SOE would need a required rate of return higher than Transurban, including assumptions about the type of finance that would be used for this investment. Given the importance of the discount rates to the outcome of the state's VFM assessment, we expected clear evidence that this question was explicitly addressed. However, the:

- VFM assessment report offered no discussion or evidence about whether the SOE faced a higher cost of capital than Transurban
- assumptions in the investment bank discount rate analysis advice and models lacked transparency in this area and while evidence provided by DTF shows ongoing interaction with the investment bank as it developed its analysis the evidence does not demonstrate substantive testing and challenge by DTF.

In an investment of this scale, where the discount rate was so influential to the VFM outcome, the reasoning behind these key inputs should have been set out explicitly and unambiguously.

The use of discount rates in the state's VFM assessment that materially exceeded Transurban's proposed rate of return was significant because the top end of the state's discount range produced the lower bound (negative $600 million) of the VFM range, while the bottom end of the state's discount rate range indicated that it would have been better VFM for the state to undertake the project (i.e. the VFM benchmark in that scenario was positive $55 million).

All points in the discount rate range are not necessarily equal

Further to the issue of using discount rate ranges, the state's VFM assessment assumed that discount rate and NPV outcome points within the state's benchmark range were equally likely to occur. However, this may not be true.

The upper and lower bounds of the state's WACC ranges were derived using a set of input assumptions. The most important of those assumptions were benchmarked using actual toll road and infrastructure projects. The projects used in the benchmarking exercise may not have shared close risk characteristics with this particular project and DTF has not provided evidence the toll road and infrastructure projects used in the benchmarking exercise were in fact appropriate comparators for that task. Therefore, the appropriate rate of return for this project may have been located closer to one end of the state's WACC range than the other.

In these circumstances, there is no certainty that the midpoint discount rate estimate is the best or most likely outcome, or that estimates above the midpoint are equally likely as estimates below the midpoint. Given this, and the fact that the VFM state benchmarks were very sensitive to the discount rates used, it would have been preferable to show sensitivity analysis using point estimates for the discount rate that represented advisers' best view of a commercial rate of return for the project. The Transurban proposal could then have been compared to the VFM benchmark derived using the state's best estimate of the required rate of return.

The discount rate ranges could have still been used to demonstrate the range of uncertainty around a point estimate. However, the ranges are better used as a cross-check or for the purposes of conducting sensitivity analysis on the VFM conclusion, rather than to drive the central result, as was the case in the state's VFM assessment of Transurban's proposal.

Determining a point estimate that represents a likely discount rate outcome is not straightforward given uncertainties and challenges in discount rate estimation. However, this should have been confronted as part of the state's VFM assessment. Alternatively, DTF should have provided the government with more transparent advice on how the VFM assessment was undertaken and its sensitivity to different assumptions.

The discount rate used for the state contribution in the VFM assessment

The VFM assessment assumed that the SOE would receive the same state contributions that would be received by Transurban. The size of the state contribution in the Transurban proposal was calculated as the nominal amount required to ensure that the project achieved an NPV of zero, while delivering Transurban an expected commercial rate of return.

The VFM assessment adopted the nominal state contributions proposed in the Transurban final offer and discounted all of those nominal state contributions using the state's estimates of a commercial rate of return for the SOE.

It was reasonable for the state contributions towards state costs and state works to be discounted using a commercial rate of return, as those cash flows had commercial risk attached to them. However, a commercial discount rate should not have been applied to the state contributions towards design and construction costs. These contributions totalled around $1.4 billion in nominal terms in Transurban's proposal.

Standard finance theory advises discounting cashflows using a rate that reflects the risk associated with those cashflows.

The state contribution towards the WGT design and construction costs had low risk attached because those payments were negotiated and agreed with Transurban and were to be reflected in the project agreement and other contractual arrangements for the project. The state was effectively agreeing to make a schedule of payments to Transurban, or the SOE in the VFM assessment, to share a portion of the design and construction costs related to WGT.

Therefore, the nominal state contribution cashflows included in the VFM assessment that related to sharing the WGT design and construction costs should have been discounted using the state's borrowing rate as a proxy for the risk-free rate, not a commercial rate of return. From the perspective of the SOE, the commitment by the state to make the scheduled payments to share these design and construction costs should have been viewed—and valued in the VFM—as a risk-free commitment by the state.

Given this, the discount rate applied in the VFM assessment to the nominal state contribution that related to sharing WGT design and construction costs should have reflected the risk of the state defaulting on its funding commitment to the project, that is, the state's borrowing rate. In early December 2017, the state's five-year borrowing rate was approximately 2.17 per cent, which is considerably lower than the commercial rate of return used in the VFM assessment.

Appendix D of Volume 5 of the *National PPP Guidelines* provides relevant guidance on this point:

> 'The PPP bids will include either a payment to, or from the state independent of the actual future revenue experience and are thus devoid of systematic and project risk, from the government perspective and hence should discounted by the risk-free rate.'

The guideline is clear that where cashflows are devoid of risk from the government's perspective (that is, the government will make a set of fixed cash flows), those cash flows should, for the purposes of the VFM assessment, be discounted at the risk-free rate. Where cash flows are subject to commercial risk from the government's perspective (that is, the cash flows to be made by government are uncertain, depending on whether or not particular commercial risks materialise), those cash flows should be discounted at a commercial rate that reflects the risk of those cash flows.

In this case, there was commercial risk attached to the WGT design and construction costs. Therefore, it was reasonable to discount those costs using a commercial rate of return in the VFM assessment. However, the portion of the state contribution towards WGT design and construction costs was essentially a risk-free commitment by the state and should have been discounted at a risk-free rate. This means that the VFM assessment undervalued (in NPV terms) the state contributions.

The state's VFM assessment sought to determine whether Transurban's delivery of the project represented better VFM than state delivery of the project. To do that, the VFM assessment should have compared:

- the net cost of the state undertaking the project itself (that is, the commercial revenues that would be generated by the project less the costs of the state building and operating the project), against
- the savings the state would realise by avoiding state contribution payments to Transurban.

If the net cost of the state undertaking the project exceeds the state contribution costs the state would avoid by delivering the project itself, then Transurban should be allowed to undertake the project. If, however, the state contribution costs that the state would avoid by delivering the project itself exceed the net costs of the state undertaking the project, then it would be better VFM for the state to self-deliver rather than allow Transurban to undertake the project.

The incorrect use of a commercial rate of return to value all of the state contributions in the VFM assessment did not affect the net cost of the state undertaking the project (that is, the revenues generated by the project less the costs of the state building and operating the project). However, as explained above, by applying a commercial rate of return rather than a risk-free rate to discount a significant portion of the nominal state contributions, the state contributions towards design and construction costs were undervalued in the VFM assessment.

Correcting this error in the VFM assessment causes the VFM of the Transurban proposal to decline, since the savings to the state from self-delivery of the project (that is, the avoided state contributions to the Transurban project) would be larger than was estimated in the original VFM assessment. This would effectively mean an upward shift in both the high and low VFM benchmarks.

DTF submitted to us that even if there had been an error in valuing the state contributions, that should have no impact on the overall VFM assessment. That is because applying a risk-free rate, rather than a commercial rate of return, to the state contribution to design and construction costs causes the value of the project to Transurban to increase. If the relevant risk-free rate were taken to be 2.17 per cent, then the NPV of the Transurban project would rise to positive $191 million.

DTF advised us that the VFM assessment should recognise that the NPV of the Transurban project has increased in line with any upward shift in the VFM benchmarks.

This is incorrect. The VFM assessment should have no regard to how Transurban values the project. All that should matter in the VFM assessment is:

- the net cost to the state of building and operating the project, and
- the value of the state contributions the state could save if it were to deliver the project instead of Transurban.

Lack of evidence of review

It is unclear whether DTF substantively tested the approach used in the WACC model that the investment bank used to derive the state's discount rate range.

The Stage 4 VFM assessment report stated that 'no review has been undertaken by the State or its advisers in reviewing the underlying assumptions and calculations in [investment bank's] WACC model'. This is despite the outcome of the state's VFM assessment depending heavily on the reasonableness of the discount rate estimates. However, the state's commercial adviser advised that the statement in the VFM assessment report is incorrect and should have stated that the commercial adviser specifically did not undertake a review, without reference to the state.

DTF, in response, advised us that:

- the engagement scope for its primary commercial adviser did not extend to reviewing the inputs to the state's VFM benchmark, such as discount rates
- it, as well as DEDJTR, engaged separate advisers to provide expert input to each benchmark element—relying on their respective specialist skills and experience—and therefore did not consider it necessary to also engage an external consultant to further review these inputs
- its general approach in relation to advice received from advisers was to workshop and challenge such advice to ensure it was understood and appropriate, including for advice received from the investment bank in relation to discount rates.

DTF has provided evidence showing that it had ongoing interaction with the investment bank as it developed the discount rate analysis and advice. However, this evidence does not demonstrate substantive testing and challenge by DTF.

Lack of clarity and specific evidence to support key assumptions

The discount rates used in the state's VFM assessment were highly sensitive to certain input assumptions made by the investment bank when deriving those rates.

The key input assumptions were about the assumed equity internal rate of return, the cost of debt, and the debt structure. However, the basis for these assumptions is not clear and it was not possible to determine, based on the very limited material provided by the investment bank, including its reports to DTF's advisers and its financial models and calculations, whether those input assumptions are reasonable.

The investment bank derived the discount rates used in the VFM assessment by benchmarking against the returns required by investors in other toll road projects—which may or may not have been directly comparable to the project proposed by Transurban. It is possible that the limitations of the data available (for example, a large enough sample of sufficiently comparable projects) meant that there was significant uncertainty over the rate of return for this project. Under these circumstances, the true rate of return could have been located near the bottom end of the discount rate range estimated by the investment bank, close to the rate of return proposed by Transurban. This should have prompted the VFM assessment to explicitly examine this possibility.

For example, a key input assumption in the discount rate calculation was the rate of return equity investors require in commercial toll roads. It appears this input assumption was derived by benchmarking the rates of return equity investors require in a sample of toll road investments. However, the investment bank's work does not disclose details of these toll roads, meaning we cannot assess whether they are comparable to the project proposed by Transurban. Given the significance of this input, the inability to check this is an issue.

We note that DTF's Stage 2 Assessment report stated that 'the CityLink toll revenues are very mature and relatively low risk compared to international toll road comparisons.'

DTF advised that due to the confidentiality of some of this information, it did not have access to the details related to some of the comparator toll roads either. It is difficult to see how DTF could have scrutinised the relevance and comparability of certain toll roads used in the benchmarking exercise if it did not know the identity of those toll roads. This is not necessarily a criticism of DTF. It is understandable that DTF may not have had full access to confidential information. However, this demonstrates the uncertainty that DTF faced around the discount rate used in the VFM.

In these circumstances, significant caution should have been exercised when interpreting the VFM results—particularly since some of the state's own discount rate scenarios suggested that acceptance of the Transurban proposal would not have provided VFM to the state.

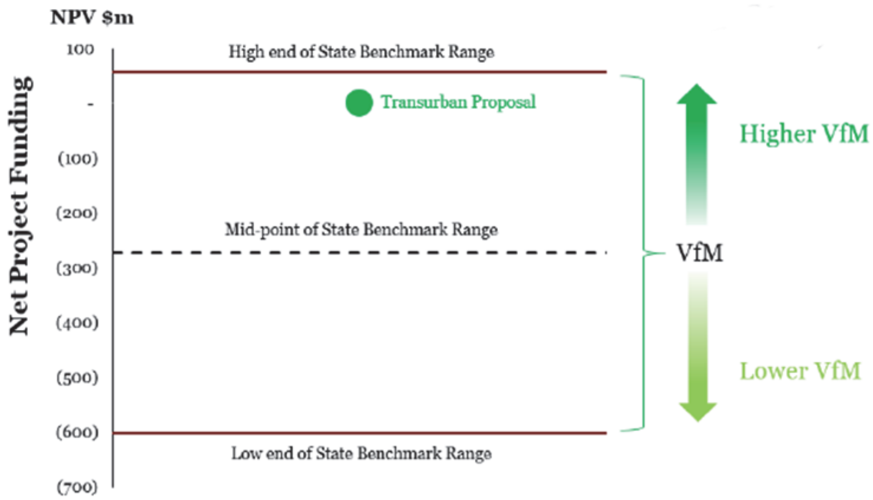
Presentation of VFM results to the government

In December 2017, DTF presented the Stage 4 VFM assessment results to the government. The DTF advice included the chart shown in Figure 3E, designed to give the government a comparison of Transurban's proposal and the alternative SOE. The advice noted that 'where the Transurban Proposal sits in the top half of the range, prima facie this suggests it represents VFM'.

This chart shows:

- the Transurban proposal with an NPV of $0, based on the inclusion of a state contribution
- a wide state VFM benchmark range of positive $55 million to negative $600 million NPV.

Figure 3E
Presentation of Stage 4 VFM assessment results to the government



Source: DTF.

The VFM assessment methodology DTF used required a comparison of the net project funding in the Transurban proposal to a state benchmark range. It did not specify or explain where in this range the Transurban proposal would need to sit to represent VFM to the state.

The presentation of the VFM assessment results in Figure 3E is not transparent because it wrongly implies that the mid-point of the state VFM benchmark is the threshold for achieving VFM. Given that the state faced significant uncertainty in developing key elements of its benchmark, such as future toll revenue estimates, the VFM total benchmark range was important and the midpoint does not necessarily represent the state's best or most likely estimate of VFM.

DTF's presentation approach showed the Transurban proposal falling within the range provided by the state's VFM benchmarks and meeting the VFM assessment criterion that it needed to be above the midpoint of these benchmarks.

We note that:

- the state's commercial adviser responsible for developing the VFM assessment provided no indication of the likelihoods attached to the 'high' and 'low' state VFM benchmark scenarios and did not express any opinion on the most likely benchmark outcome
- it was probably not the case that any point within the range was equally likely
- the upper and lower bounds of the range were driven very materially by the state's discount rate range, and we have raised questions about the lack of review and transparency over the basis for and reasonableness of assumptions underpinning the discount rate estimates used in the state's VFM assessment.

VFM benchmark range versus a single point estimate

The VFM assessment analysis would have been more useful and transparent if DTF had provided the benchmark range, together with a single point estimate. That is, a single point VFM benchmark to represent DTF's advisers' best view of the cost to the government of delivering the project itself.

The government could have used this estimate as the key comparison point for the Transurban proposal. The closer the most likely outcome—the single point estimate—for the state benchmark to the top of the state's VFM benchmark range, the less likely that the Transurban proposal would have met the VFM criterion.

A more transparent presentation of VFM assessment results

DTF's advice to the government on the VFM assessment results showed the Transurban proposal as having an NPV of zero. In this particular case, the NPV of the Transurban proposal was zero, given the way Transurban valued the state contributions it proposed.

Figure 3F shows how the high, low and midpoints were derived for the presentation to the government. It also shows the differences in estimates between the state's Stage 4 midpoint benchmarks for costs and revenues and the final Transurban proposal.

Figure 3F
Comparison of state VFM benchmarks at Stage 4 and the final Transurban proposal ($ million NPV)

	Transurban Proposal	SOE Low	SOE Mid	SOE High	Difference b/w SOE Mid & Transurban
Revenues					
Tolls	4 056	3 339	3 754	4 169	-302
State contribution	1 960	1 926	1 944	1 961	-16
Cost savings for settlement of CityLink historical claims	31	31	31	31	0
Major Maintenance Reserve account	24	24	24	24	0
Total Revenue	**6 071**	**5 320**	**5 753**	**6 185**	**-318**
Costs					
Design and construction costs contestably procured	4 221	4 148	4 188	4 227	33
Design and construction costs not contestably procured	388	311	314	317	74
State costs	854	848	851	854	3
Operations and maintenance costs not contestably procured	608	613	673	732	-65
Total Costs	**6 071**	**5 920**	**6 025**	**6 130**	**46**
Net state benchmark as presented to government	0	-600	-272	55	-272
Net state contribution	-1 960	-2 526	-2 216	-1 906	-256

Source: VAGO based on information from DTF.

DTF's VFM assessment compared the VFM benchmarks (as computed above) to the value of the Transurban proposal. However, the VFM assessment should be independent of how any other party, including Transurban, values the project. The VFM assessment should consider how the state values the project, and what savings it would make (by way of avoided contributions to Transurban) if it were to deliver the project.

DTF's advice to the government on the results of the state's VFM assessment would have been more informative if it had compared the present value of:

- costs incurred by the state if it proceeded with the Transurban proposal, that is the state contribution component, against
- the NPV of the estimated cost and revenue cashflows if the state delivered the project itself using the SOE delivery model.

Presenting the information this way would have provided clearer advice to the government to inform decisions on the WGT MLP.

Design and construction costs

The Stages 3 and 4 assessments include non-contestable design and construction costs to the state. These are Transurban's estimates of these costs, and they were not competitively tendered. While only around 6.4 per cent of the overall project costs, these costs were an area of potential VFM risk for the state given the need to rely on Transurban's representations.

The MLP interim guideline required DTF to support the Stage 4 VFM assessment by a cost reasonableness assessment including independent review and open book review of Transurban's proposed costs. DTF and the West Gate Tunnel Authority took steps to gain assurance on the reasonableness of these costs including engaging expert advisers to assess Transurban assertions on its costs and create a state benchmark for the same costs but did not gain open book access to Transurban's costings.

At the end of the Stage 4 assessment of the Transurban proposal, DTF and the West Gate Tunnel Authority were not satisfied that the Transurban proposal for non-contestable design and construction costs provided VFM for the state. However, the summary advice DTF provided to the government when seeking approval to proceed to contract close with Transurban did not raise this issue. The summary advice referred to testing Transurban's non-contestable costs but did not inform the government about the results of that testing.

Instead, the summary advice to the government communicated an overall VFM assessment rating of 'satisfied' for Transurban's final offer and stated that *'all non-contestable costs, including Transurban's rate of return, have been rigorously tested against a robust state benchmark'.*

Attachments to the summary advice revealed the actual extent of testing, but this could have been more transparently noted in the summary advice.

4

Victoria Police Centre: uniqueness and value for money

In May 2015, Cbus and Australia Post submitted an MLP to the state. They proposed to build a new Victoria Police headquarters, the VPC, on a vacant site at 311 Spencer Street in Melbourne's CBD. This site is next to the existing City West Police Complex.

The proposal was timely because Victoria Police's lease on its existing secure headquarters accommodation at the WTC expires in July 2020. Before receiving the VPC proposal, Victoria Police and DTF's SSP discussed undertaking a standard procurement process through releasing an expression of interest to the market in late 2015 or early 2016.

The government approved the VPC proposal in December 2016 and the state signed a lease agreement with Cbus/Australia Post for the VPC in January 2017. The VPC will include 39 floors and more than 60 000 square meters of net lettable area. The lease term is 30 years with options for three further term extensions of five years each. The state's total estimated nominal rental liability over the initial 30-year lease term is $1.8 billion, with a present value of $851 million.

Victoria Police advised the government that it would sublease about 32 per cent of VPC space to other government law enforcement or support agencies. At the time of VPC proposal approval, these subtenants were expected to pay about $15.6 million in total annual rental, including car parking and other costs, or 35 per cent of the total annual rental costs under the lease of $44.6 million.

In this Part, we examine the adequacy of DTF and Victoria Police assessments and advice to the government on the VPC proposal for a new Victoria Police headquarters.

4.1 Conclusion

DTF and Victoria Police assessments and advice to the government on the VPC proposal did not sufficiently demonstrate that the VPC proposal met the uniqueness criteria in the MLP guideline.

In the Stage 2 assessment, DTF and Victoria Police advised the government that the security benefits offered by the site at 311 Spencer Street were unique and could not be achieved through a standard competitive process within acceptable time frames. However, while evidence supporting the assessment found that the site had security benefits, it identified other sites that could also meet Victoria Police security needs, making the site not unique.

DTF and Victoria Police also relied on the benefits of co-locating the VPC next to the City West Police Complex when advising the government that the proposal met the uniqueness criteria. However, neither agency specified or measured these benefits in any detail, despite Victoria Police subsequently describing the co-location benefits as the primary source of uniqueness for the VPC.

There were clearly other options to obtain a new secure headquarters and Victoria Police could have achieved the benefits offered by this proposal through a standard competitive process. There was a clear expectation that Cbus/Australia Post would participate in any open-market competitive process and the receipt of two alternative proposals for the VPC indicates that an open, market-based process could have elicited competitive bids and potentially provided greater VFM.

The government's VFM benchmarks for the VPC specified annual rental costs in total and on a per-square-metre basis, rather than as whole-of-life costs. Victoria Police and DTF provided accurate advice to the government on the Stage 4 assessment that the government VFM benchmarks were met. However, the factors that most significantly contributed to this outcome were the:

- increase of the lease term from 20 to 30 years
- increase of the building size from about 42 000 square metres in net lettable area to more than 60 000 to accommodate potential, unconfirmed subtenants.

These adjustments increased the risk and whole-of-life costs of the VPC proposal for the state. Two of the three proposed subtenants withdrew after the state signed the lease agreement. This has left the state exposed to meeting any shortfall in rental costs for the entire VPC building. Victoria Police continues to work with the SSP to seek other tenants. There is a risk that other tenants will also diminish the security benefits sought by Victoria Police.

4.2 Uniqueness

Assessment

For a proposal to be considered outside a usual competitive process, it must have 'unique characteristics'. Under the 2015 MLP guideline this meant that the government could not reasonably engage another party to deliver the proposal, or an equivalent outcome, and achieve similar benefits.

Cbus and Australia Post asserted that 311 Spencer Street was the only opportunity Victoria Police would have to acquire a highly secure location in the Melbourne CBD adjacent to the existing City West Police Complex at 313 Spencer Street.

DTF assessed the VPC proposal at Stage 2 (due diligence and strategic assessment) against the February 2015 MLP interim guideline. The guideline requirements made it clear that for an MLP to progress to exclusive negotiations, the uniqueness criterion must first be satisfied.

In September 2015, DTF advised the government that the security benefits offered by the site at 311 Spencer Street, combined with the benefits of co-locating with the City West Police Complex, were unique. DTF recommended, and the government agreed, that the proposal proceed to Stage 3 (procurement preparation) of the MLP process in an exclusive negotiation.

Adequacy of the assessment

DTF and Victoria Police did not sufficiently demonstrate that the VPC proposal met the uniqueness test in the MLP guideline:

- Evidence supporting the uniqueness assessment clearly indicated that other sites could meet Victoria Police's security needs.
- Victoria Police could have achieved the outcomes offered by the proposal through a standard competitive process.
- With expiry of the current lease five years away, there was no time pressure in 2015 that called for sole negotiations with a single proponent.

The IDC, the body overseeing the MLP assessment process, agreed with the recommendation to the government that the proposal proceed to Stage 3 in an exclusive negotiation. Our review of IDC meeting documentation found that DTF and the IDC initially expressed doubts about whether the Cbus/Australia Post proposal satisfied the uniqueness criteria and obtained additional information and advice on this.

Security characteristics

The SSP advised DTF in June 2015 that Victoria Police needed to clearly document the security specifications for the police headquarters to be able to determine whether there were alternative sites that could meet the desired security attributes. Victoria Police did not finalise the security specification until October 2016.

However, without specified security needs, Victoria Police obtained advice from a property consultant in mid-2015 about potential sites, which it used in the Stage 2 assessment.

There is little doubt that the site at 311 Spencer Street has security benefits due to its shared boundaries with the City West Police Complex to the north and rail lines to the west, and it would be difficult to identify a site with the same characteristics in the CBD. However, Victoria Police's property consultant identified other sites that could potentially meet its security and other service requirements.

The search by the property consultant was limited and at that point there was no policy decision that the location needed to be a greenfield, purpose-built facility. A less restricted search may have identified more options.

The terms of reference limited the search to properties that were …		**This meant that the search …**
Site type	**Timing**	
Vacant and cleared or easily clearable	Able to be procured by the end of 2016, and redeveloped by the end of 2019	Did not include existing buildings that may have been be able to accommodate Victoria Police requirements. Only identified sites that were known to the market or currently for sale (due to their immediate development potential). Did not identify 'unknown' sites, existing buildings or leased premises that may be offered if the market was approached with a request for interest or tender process to meet the service need.

Source: VAGO from information provided by Victoria Police.

The site search was followed by an assessment of the security characteristics of the five 'short listed' site options by consulting engineers with security expertise. The criteria for the security assessment focused on 17 areas of physical security controls under five threat categories including terrorism, crime and civil disturbance. These were generic physical security control characteristics and not a security specification prepared by Victoria Police for its headquarters.

Figure 4A shows the information and advice resulting from the search and security assessments.

Figure 4A
Property search and security assessment advice

Source	Identified/assessed	Recommendations
Report from a property consultant based on site requirements specified by Victoria Police	165 possible sites Narrowed to five site options, including 311 Spencer Street	In initial advice, the five 'short listed' sites were not ranked In subsequent advice, 311 Spencer Street was ranked first
Report from consulting engineers with security expertise based on generic physical security control characteristics	Assessed top five options as identified by the property consultant 311 Spencer Street: • scored highest overall, but • did not score higher than all other sites in any specific security attributes cited by Victoria Police, indicating it was not uniquely secure in any of these areas	

Source: VAGO, from information provided by Victoria Police.

In July 2015, the IDC considered an initial draft Stage 2 assessment report and advice that DTF and Victoria Police did not agree on whether the proposal should proceed to Stage 3. Discussion centred on the availability of comparable CBD sites and the evidence to support the uniqueness criteria. The IDC agreed to Victoria Police further investigating available sites and reporting back to the IDC on a comparative site assessment and commercial strategy to achieve an affordable outcome relative to current costs.

In August 2015, Victoria Police gave DTF and the IDC its summarised interpretation of the site search and security assessment. Victoria Police advice stated that the property:

> "… analysis indicated that the site offered by Cbus/Australia Post is the most suitable for Victoria Police particularly with regard to security and proximity to existing Victoria Police key infrastructure at 313 Spencer Street".

and claimed that the security assessment identified the 311 Spencer Street site as:

> "… particularly unique with regard to its extensive natural surveillance capabilities, ability of territorial reinforcement, limited oversight by neighbours, diversified utilities and vehicular access".

This advice from Victoria Police was important evidence in persuading DTF and the IDC that the proposal met the MLP uniqueness criteria. However, it was inaccurate and insufficient as:

- proximity to existing Victoria Police infrastructure was not in the consultant's property search criteria
- the security assessment did not identify the 311 Spencer Street site as unique

- Victoria Police did not advise DTF that the security assessment also gave two other sites positive scores across all evaluation criteria.

While Victoria Police did provide DTF and the IDC with the detailed property consultant and security assessment reports, it appears that the contradictory information in the underpinning reports was either not noticed or not discussed.

The IDC accepted Victoria Police's advice and DTF's updated Stage 2 assessment report and agreed that:

- the Stage 2 assessment report would recommend proceeding to Stage 3 in exclusive negotiation, subject to achieving assurance on VFM by the end of October 2015.
- Victoria Police should continue to develop an expression of interest in conjunction with the SSP, concurrent to the exclusive negotiations with the proponents, so that it would be ready to go to market in November 2015 if exclusive negotiations failed.

Victoria Police advice to the SSP on its requirements in September 2015

Security was the primary factor cited by Victoria Police during mid-2015 when arguing that the Cbus/Australia Post proposal met the uniqueness criteria in the MLP guideline. However, other evidence indicates that security was not necessarily the paramount consideration for Victoria Police at the time.

In August 2015, the SSP sought details from Victoria Police on its specific requirements for a new headquarters to inform development of an expression of interest document if exclusive negotiations with Cbus/Australia Post did not proceed.

Victoria Police's response to this request in September 2015 did not detail any specific security concerns or requirements and indicated that:

- security was important, but not a paramount consideration
- they would be satisfied with CBD fringe locations near public transport and major roads
- they did not require sole occupancy.

We found no evidence that Victoria Police and the SSP further developed the expression of interest document after September 2015. The SSP advised us that it received verbal advice from Victoria Police in late September 2015 to stop further development of the document.

Co-location benefits

DTF and Victoria Police advice to the government at the Stage 2 and Stage 3 assessments indicated that the VPC proposal would deliver benefits that were unique and could not be achieved through a competitive tender process.

This advice emphasised the co-location benefits offered by the site at 311 Spencer Street due to its shared boundaries with the City West Police Complex. However, this advice:

- included superficial untested assertions from Victoria Police about the basis for claimed co-location benefits
- did not specify or quantify the claimed benefits in any detail.

Further, when responding to the SSP request for its requirements for an expression of interest in September 2015, Victoria Police did not mention the need for co-location with other police facilities.

The content of DTF's Stage 2 assessment report to support the existence of material co-location or integration benefits is largely a direct copy of advice Victoria Police provided to DTF on 25 August 2015. That Victoria Police advice comprises superficial references to relevant literature and high-level assertions about benefits that could eventuate from co-locating the VPC next to the City West Police Complex. The advice indicated that such benefits were difficult to quantify, but made no effort to demonstrate the benefits in any detail.

There is no evidence that DTF tested the accuracy or reliability of Victoria Police's advice before including it in the Stage 2 assessment report and claiming that the integration benefits of co-locating with City West Police Complex were material. This report was part of advice provided to the government supporting the assessment of the proposal as unique.

We examined the literature referenced by Victoria Police and DTF to support their claims about co-location benefits and found that this material:

- does not provide unqualified endorsements of co-location
- clearly suggests the need for more work on identifying and measuring co-location benefits than was undertaken by Victoria Police or DTF.

Victoria Police confirmed that it did not undertake any detailed analysis to quantify the potential savings and other benefits expected from co-locating the VPC with the City West Police Complex.

In addition, maintaining the claimed co-location and security benefits associated with situating the VPC next to the City West Police Complex for the full 30-year term of the proposed VPC lease would involve extending the City West Police Complex lease. However, DTF and Victoria Police did not examine and provide advice to the government on the cost implications of extending the City West Police Complex lease.

Timelines

The MLP guidelines include 'time frame' as a relevant factor when assessing uniqueness.

The SSP had discussed a competitive market approach with Victoria Police in early 2015. In 2015 there was no time pressure on the state that warranted exclusive negotiations with a single proponent for this proposal. Victoria Police's lease at the WTC was not due to expire until July 2020.

The IDC directed Victoria Police to continue to work with the SSP during 2015 and 2016 to keep the competitive market approach open as a viable alternative.

However, in October 2015, the government noted advice from DTF that alternative end of lease options would be developed if the exclusive negotiations with Cbus/Australia Post did not demonstrate VFM by the end of 2015.

Other options

DTF's Stage 1 assessment of the VPC proposal noted it had potential to meet the uniqueness criteria for an MLP subject to further investigation on alternative locations, given the competitive market for property development.

In June 2015, the SSP advised DTF that, given the competitive nature of property development in Melbourne, it was very possible that the state could achieve better VFM at other sites if it pursued a competitive approach.

However, DTF and Victoria Police advice to the government in the Stage 2 and Stage 3 assessments did not sufficiently emphasise that:

- other sites that could potentially meet Victoria Police's security and other requirements had been identified
- further sites may emerge in response to a competitive approach
- there was a clear expectation that Cbus/Australia Post would participate in any open-market competitive process for the provision of office accommodation to Victoria Police after July 2020
- there was clear potential for other proponents to meet Victoria Police's service needs in response to a competitive procurement process.

The potential for other proponents to respond to the service need was demonstrated by the state receiving two alternative MLPs to provide new headquarters for Victoria Police before it signed the lease agreement with Cbus/Australia Post in January 2017.

Both alternative proposals claimed the potential to meet Victoria Police's service need and security requirements but were rejected at Stage 1 of the MLP process.

Advice to government on uniqueness

DTF's October 2015 advice to government on the outcomes of the Stage 2 assessment of the uniqueness attributes of the Cbus/Australia Post proposal did not make a convincing case for the uniqueness of the proposal.

The DTF and Victoria Police advice to the government on the outcomes of the Stage 3 (February 2016) and Stage 4 (November 2016) assessments indicated:

> 'that the proposal maintains unique benefits of a secure site and integration with the existing City West Police Centre that are not substitutable and cannot be achieved through market competition'.

The Stage 3 and Stage 4 assessments continued to emphasise the same security and other benefits identified at Stage 2 without adding any evidence to demonstrate these benefits. These assessments also gave no emphasis to other information that raised doubts about the validity of the claimed benefits.

For example, the report obtained by Victoria Police examining the security attributes of alternative site options as part of the Stage 2 assessment did not assess or raise the potential for heightened security risks arising from concentrating critical Victoria Police resources at a single location at 311 and 313 Spencer Street.

In August 2016, Victoria Police obtained further expert advice on security risks for the new police precinct comprising the VPC and City West Police Complex. This advice clearly indicates that security risks to the new police headquarters are increased as a result of integration with the City West Police Complex. The adviser reported that the combined precinct represented a highly visible and desirable target for threat actors, noting that the risks could be mitigated.

4.3 Service need and benefits

In 2015, with approximately five years left on its lease at the WTC, Victoria Police needed to secure ongoing accommodation for its headquarters.

Victoria Police considered its existing headquarters at the WTC to be deficient due to the spread of personnel across multiple towers and security vulnerabilities due to its location and design. There was also credible information suggesting an increased security threat level for police resources.

DTF and Victoria Police's assessments clearly demonstrated that the VPC proposal met a service need given the impending WTC lease expiry and that it offered potential security and other benefits.

The VPC proposal's initial 2019 commencement date was based on Cbus/Australia Post's stated assumption that the state would exercise its early termination provisions in the WTC lease, which was otherwise due to expire on 31 July 2020. It is unclear how the proponents knew that the WTC lease allowed lease termination at 31 July 2019.

The Stage 2 assessment of the VPC proposal established the service need for a replacement headquarters and identified that Victoria Police:

- did not consider the WTC a viable option beyond the existing lease term
- did not have a current options analysis or business case for new headquarters but that previous work was being updated
- already had an intention to reduce their space at the WTC, with potential to further reduce this if it could relocate to a new custom-designed facility.

The Stage 3 assessment report on the VPC proposal confirmed the service need and placed greater emphasis on Victoria Police's advice that the WTC accommodation did not meet its key security requirements.

The VPC proposal allowed for approximately 42 000 square metres of net lettable area, which would meet Victoria Police's requirements and allow for modest growth in workforce and operational requirements.

In addition, there were related parties that were interested in, or could be approached, about co-locating:

- The Australian Federal Police (AFP) had interest in co-locating with Victoria Police to increase collaboration across jurisdictions to improve responses to issues such as organised crime. The AFP had indicated interest in about 10 000 square metres of net lettable area.
- The Emergency Services Telecommunications Authority (ESTA) occupied part of the WTC and could be approached to take space in the VPC.

Figure 4B shows the space requirements identified in the assessment.

Figure 4B
Identified space requirements

Location	Requirements	Net lettable area (m^2)
WTC	Current (in 2015)	48 000
	Intended (reduced) requirement	42 000
	Potential (reduced) requirement	35 000–37 000
VPC	Proposed requirement	42 000
	Potential co-locator requirements	AFP: 10 000
		ESTA: not defined

Source: VAGO, from information provided by Victoria Police.

4.4 Value for money

Public sector agencies usually seek VFM outcomes when buying or leasing office accommodation by approaching the market in an open competitive process. Initially, this was also the case for the proposed new Victoria Police accommodation. In early 2015, Victoria Police discussed plans for a competitive process to obtain new accommodation with the SSP and would have run an expression of interest in the absence of the VPC proposal from Cbus/Australia Post.

In November 2016, the government authorised the Treasurer and Minister for Police to approve the VPC proposal and lease agreement. This was based on DTF and Victoria Police advice that the proposal provided VFM, including meeting the VFM benchmarks set by the government. The lease agreement commits the state to a 30-year lease with a starting total lease cost of $44.6 million a year.

Adequacy of assessment

VFM benchmarks and assessments

Figure 4C shows the quantitative VFM benchmarks that the government set for the MLP assessment of the VPC proposal.

Figure 4C
VFM benchmarks for the VPC proposal

Timing	Context	Benchmark: Annual rental costs for the VPC should not exceed …
October 2015 (Stage 2)	The government indicated it was not willing to provide Victoria Police with significant budget supplementation to meet annual lease costs for new headquarters	The comparable annual rental costs of remaining at the WTC
February 2016 (Stage 3)	The government endorsed the VPC proposal progressing to Stage 4 of the MLP process (exclusive negotiation)	\$424 per square metre—reflecting the outcome of Stage 3 negotiations with the proponents

Source: VAGO.

Victoria Police prepared the Stage 4 assessment report in consultation with DTF. In November 2016, Victoria Police advised the government that the VPC proposal provided VFM and met the government's VFM benchmarks.

Figure 4D shows the information Victoria Police and DTF provided to the government as part of their Stage 4 assessment advice on:

- costs for Victoria Police and its proposed subtenants under the negotiated VPC lease terms
- estimated VFM benchmark comparator costs of remaining at WTC.

Figure 4D
Stage 4 assessment: Advice to the government on WTC and VPC lease costs

	VFM benchmark WTC costs 2020	VPC lease costs				
		Victoria Police	AFP	ESTA	Other subtenant	Total for VPC
Leased area (m^2)	46 784	41 423	15 411	1 739	2 211	60 784
Lease costs (\$/m^2)	408	418	530	429	461	445
Base annual rental costs (\$ million)	19.1	18.4	8.9	0.8	1.1	29.2
Parking and storage costs (\$ million)	2.7	3.6	1.2	0.0	0.2	5.0
Other 'outgoing' costs including cleaning (\$ million)	8.0	7.0	2.7	0.3	0.4	10.4
Total annual lease costs (\$ million)	**29.8**	**29.0**	**12.8**	**1.1**	**1.7**	**44.6**

Note: The other subtenant was another law enforcement agency.
Source: VAGO, based on information from Victoria Police and DTF.

The information provided to the government indicated that the cost outcome negotiated by Victoria Police bettered the government's VFM benchmarks in terms of total annual rental costs and rental rate per square metre.

Reliance on subtenants

During Stage 3 negotiations with the MLP proponents, Victoria Police explored the potential for other government law enforcement agencies to take space in the VPC. The proponents were open to this and agreed to amend the building size and design to accommodate them.

Victoria Police advised the proponents that it wanted to sign a single lease agreement for the entire building to maintain control over other tenancies for security purposes.

The proponents accepted this position. They may have seen commercial advantages in the arrangement, as it meant signing a 30-year lease with a single government tenant. Risk relating to subtenants rested with Victoria Police and the state.

The advice to the government acknowledged that VFM relied on all expected VPC subtenants committing to leasing space in the VPC building before it was completed. This was significant because Victoria Police had committed to covering the cost shortfall for any subtenancies that did not eventuate. The proposed AFP subtenancy was the most significant and DTF emphasised the importance of obtaining a binding commitment from this agency.

DTF and Victoria Police's advice to the government at Stage 3 indicated that the main risk was gaining formal commitment from the AFP and another proposed law enforcement agency subtenant to take space in the VPC. The advice expressed this as a very low risk and that Victoria Police would meet the additional costs, estimated at up to $2.5 million per year, if the proposed subtenants did not commit. At that point the estimated annual rental cost for the space allocated to these proposed subtenants was $10.3 million.

In November 2016, none of the proposed subtenants had provided a binding commitment to take space in the VPC. Figure 4E shows Victoria Police's advice on costs and comparisons with and without tenants.

Figure 4E
Annual costs to Victoria Police with and without sub-tenants

	Annual costs to Victoria Police of …		
	Remaining at the WTC	Moving to the VPC	Government benchmark
Total lease cost with subtenants	$29.8 million	$29 million	$29.8 million
Total lease cost without subtenants	$29.8 million	$44.6 million	$29.8 million
Lease costs with subtenants		$418/m^2	$424/m^2

Figure 4E
Annual costs to Victoria Police with and without sub-tenants—*continued*

	Annual costs to Victoria Police of …		
	Remaining at the WTC	Moving to the VPC	Government benchmark
Lease costs without subtenants		$445/m^2	$424/m^2

Source: VAGO, based on information from Victoria Police and DTF.

Without tenants, the first-year lease costs would be $14.8 million more than the relevant VFM benchmark.

At Stage 4, Victoria Police and DTF's advice to the government stated that:

- Victoria Police planned to lease out more than 30 per cent of the floor space in the VPC to subtenants at higher rental rates than it would pay
- the annual lease cost for the entire building was about 50 per cent more than the advised annual lease costs for Victoria Police.

Victoria Police had significantly increased risk to the state associated with accepting the VPC proposal. However, the advice provided continued to indicate only a low risk that proposed subtenants would not commit to leases. It advised that this risk could be mitigated at little cost to the state by:

- reducing floor space or fit-out requirements
- identifying other Victoria Police units or state government tenants to take up the space.

Victoria Police's Stage 4 assessment report indicates that it liaised with the SSP to identify suitable potential state government tenants for the VPC building and that the SSP identified multiple leases terminating between 2019 and 2021.

The advice to the government on the Stage 4 assessment should have clearly informed the government about the extent to which the VFM benchmarks for Victoria Police would be breached if one or more of the proposed subtenants did not sign on.

Since November 2016, only one subtenant has committed to take space in the VPC. This tenant will pay about $1.7 million of the $44.6 million payable by the state in the first year of the lease. Victoria Police is currently working with the SSP to secure replacement tenants for the building.

VFM implications of co-locating with 313 Spencer Street

Victoria Police and DTF's advice to the government on the Stage 4 assessment emphasised the benefits of the VPC at 311 Spencer Street co-locating with the City West Police Complex at 313 Spencer Street. However, it did not examine, or provide advice on, the VFM implications of fully aligning the lease terms.

The rental of $534 per square metre that Victoria Police were paying for the City West Police Complex was about 28 per cent higher than proposed VPC costs. The annual rental escalation rate of 4 per cent at the City West Police Complex was also higher than the 3.65 per cent negotiated for the VPC.

It is also significant that the lease terms for the two organisations overlap but do not fully align. The VPC 30-year lease begins in 2020 and expires in 2050 while the City West Police Complex 20-year lease began in April 2015 and expires in 2035. Victoria Police will need to renew the City West Police Complex lease for a further 15 years to deliver the claimed co-location benefits.

If Victoria Police do not exercise lease renewal options for the City West Police Complex, the claimed co-location benefits will only be realised for half of the 30-year VPC lease term.

Given the intention to align the lease terms and prolong the claimed co-location benefits, DTF and Victoria Police should have examined the cost implications of extending the City West Police Complex lease and provided advice to government accordingly.

Reliability of the WTC benchmark comparator

In February 2016, the owners of the WTC submitted an MLP to offer Victoria Police a new lease on the WTC for between $360 and $385 per square metre.

In October 2016, when DTF reviewed the draft Stage 4 assessment report, it recognised the importance of the 'remain option' costs. That is, the estimated annual lease costs if the Victoria Police stayed at the WTC.

DTF asked the SSP to review the Victoria Police estimate of these costs.

The Victoria Police estimate of total annual lease costs at the WTC in 2020 was about $5.6 million or 23 per cent higher than the SSP's estimate of the same lease costs. The SSP agreed with Victoria Police's calculation of the WTC VFM benchmark comparator following discussions on specific assumptions adopted by Victoria Police. These assumptions included increased rental charges to reflect expected refurbishments, and increased costs for security and car parking.

However, the highest end of the WTC owner offer in their earlier MLP was about 6.5 per cent lower than Victoria Police's estimate of the WTC rental rate.

Challenges to VFM estimates

Throughout the assessment process, the IDC and DTF, including the SSP, challenged whether the VPC proposal represented VFM for the state. These challenges prompted ongoing negotiations with the proponents on the VFM of key commercial terms and led to changes in the offer.

IDC oversight, input and issues raised

There is clear evidence that the IDC highlighted concerns about the extent to which the Cbus/Australia Post proposal represented VFM.

Date	The IDC …
August 2016	• Noted delays in finalising negotiations with the VPC proponents • Noted the 30-year lease term created an obsolescence risk for the state
September 2016	• Noted that negotiations were still continuing with the VPC proponents • Noted that DTF had concerns with the proposed 30-year lease term and 'fit for use' obligations in the lease (these issues related to the risk that Victoria Police could not reliably assess whether the building would continue to meet its service needs for a 30-year period)
October 2016	Discussed a draft Stage 4 VFM assessment report and raised the following concerns: • the potential that Victoria Police's rent would be cross-subsidised by the proposed subtenants • the need for formal written commitments from proposed subtenants, as verbal commitments were not sufficient to proceed • a lack of transparent assumptions in Victoria Police's commercial adviser's draft VFM assessment report • whether Victoria Police could secure the Valuer-General report and relevant approvals in time for the scheduled advice to government in October 2016

Source: VAGO based on information from DTF.

The IDC sought additional advice, information and assurances from Victoria Police to address their concerns. Victoria Police responded and the IDC subsequently supported the recommendation to the government that the proposal proceed to Stage 5, subject to resolution of specific issues raised by the Valuer-General.

SSP input and issues

When DTF requested feedback on a draft Stage 2 assessment report and a range of specific questions in June 2015, the SSP's responses raised some important issues:

- Potential for the state to achieve better value for money at an alternative site—this was very possible particularly at more fringe CBD locations such as Docklands or West Melbourne that could also meet Victoria Police's service and locational needs
- Market rental comparison—the rental in the VPC proposal appeared to be within the range ($400 to $550 per square metre exclusive of fit-out) for equivalent accommodation but the SSP cautioned that a valuation would be required to more accurately determine whether the proposal reflected current market levels
- WTC rent comparison—the proposed VPC rent was about $4.5 million higher than at the WTC but the WTC premises were 20 years old and required updating and renovation

- Cbus' performance in completing the City West Police Complex at 313 Spencer Street on time and on budget—the City West Police Complex project was delivered on time, but Victoria Police and Cbus made alterations to the building and fit-out design, which meant the final net lettable area was larger than that agreed to by the state and approved by the Minister. These changes meant the final rental commitment exceeded the amount allowed under the lease agreement, requiring a Deed of Variation. As a result, ministerial approval had to be sought retrospectively for changes that had already occurred.

Response to issues: changes in key terms

During 2015 and 2016, Victoria Police negotiated changes to key parameters of the proposed leasing arrangement with the VPC proponents. This was in response to issues raised by the IDC, DTF and the SSP and aimed to deliver outcomes that met the government's VFM requirements.

The main changes were increasing the lease term from 20 to 30 years and meeting the proponents' proposal for an upfront capital contribution from the state by building this into the annual lease charges.

Figure 4F shows advice given to the government at the various stages of the MLP assessment process. It covers lease costs to Victoria Police under the Cbus/Australia Post proposal and the final outcome for the state based on the lease agreement signed with the proponents.

Figure 4F
Summary of advice to the government on lease costs

Item	Stage 2 Victoria Police costs	Stage 3 Victoria Police costs	Stage 4 Victoria Police costs	Outcome for the state at June 2019
Initial term (years)	20	30	30	30
Office space (m^2)	41 392	41 392	41 423	60 784
Net effective rent ($/$m^2$)	455	424	418	445
Rental cost total ($ million/year) (including car parking and storage costs but excluding outgoings and cleaning)	22.2	21	22	34.2
Annual rent escalation rate (%)	4.0	4.0	3.75	3.65
Up-front fit-out contribution ($ million)	75.0	0	0	0
Total annual lease costs ($ million) (inclusive of outgoings and cleaning)	**27.4**	**26.9**	**29.0**	**44.6**

Source: VAGO, based on information from DTF and Victoria Police.

The key changes negotiated with the proponents did not demonstrably improve the whole-of-life VFM of the proposal for the state and created additional risk for the state, but contributed to Victoria Police meeting the government's VFM benchmarks, which were only specified in terms of annual costs.

DTF, the IDC and the government agreed to these changes, which means that, in substance, the state will finance the construction and maintenance of a purpose-built asset, but not obtain ownership of the asset at the end of the lease period.

Lease term

Increasing the lease term from 20 to 30 years lowered the rental costs (annual and per square metre) and improved the risk profile of the development for the proponents. However, the SSP advised us that lease terms of 10 to 15 years are standard for government-occupied buildings. Longer-term leases are generally avoided because they limit the tenant's flexibility.

The SSP said that where a longer lease term, such as 30 years, is needed, the preferred approach is to use renewal options. That is, 10+10+10 years or 15+15 years. Multiple shorter renewal options enable better risk management than a fixed single lease term because they:

- keep pressure on the landlord to ensure the premises remain fit for purpose by undertaking required upgrades/renovation
- enable the tenant to reassess and renegotiate their accommodation size and configuration requirements based on changing business needs
- give the tenant an option to end the lease and move to new premises if business needs change
- increase the tenant's leverage to renegotiate the lease in line with market levels over shorter periods of time.

Up-front state capital contribution

The VPC proponents' initial proposal included options on the configuration of key commercial terms. This included the length of the lease and rental costs with and without a provision for the state to make an up-front capital contribution towards building fit-out costs in exchange for lower annual rental charges.

If the state …	Then the cost would be …
Funded fit-out costs of $75 million with an up-front capital contribution	$580/m^2, inclusive of all fit-out costs
Agreed to a 30-year rental term	$550/m^2, inclusive of fit-out costs
Agreed to a 30-year rental term and funded $75 million estimated fixed tenant costs	$435/m^2

Source: VAGO, based on information from Victoria Police and DTF.

During Stage 3 negotiations, the requirement for the state to make an up-front capital contribution towards fit-out costs was taken out of the proposed lease terms. However, this did not eliminate the cost from the overall costs to the state. Instead, the fit-out contribution was incorporated into the annual rental charges, meaning it will be escalated annually as part of the rent.

DTF's advice to the government on the Stage 3 assessment pointed this out, noting that this approach was potentially less cost-efficient for the state because it allowed the capital contribution to increase as part of the lease's annual rental increases. However, DTF did not provide a comparative analysis in NPV terms of the costs of paying the fit-out contribution in an up-front payment or as part of the annual lease payments.

Advice to government on MLP assessment stages

Outcomes of MLP Stage 2 assessment

DTF's Stage 2 assessment report and advice to the government in October 2015 recommended that the VPC proposal proceed to Stage 3 in an exclusive negotiation. It also proposed that the Stage 3 negotiations with the proponents focus on determining if VFM could be demonstrated.

However, there were some issues with DTF's advice on the VFM of the VPC proposal.

The Stage 2 advice …	But this advice …
Stated that the VPC proposal had "… potential to provide value for money as the proposed commencing rent is within the benchmarked range ($400–$550 m^2 exclusive of fit-out rates) for equivalent accommodation to the proposed VPC as identified by DTF Shared Service Provider"	Did not include the qualifications the SSP attached cautioning that a valuation was needed to confirm VFM. Did not disclose relevant advice from the SSP on the potential for the state to obtain better VFM at alternative locations.
Indicated that Cbus/Australia Post completed the development of the City West Police Complex at 313 Spencer Street on budget	Was inconsistent with the SSP's earlier advice to DTF that Victoria Police and Cbus had increased the net lettable area on the City West Police Complex development in breach of the terms agreed by the state and relevant Minister, resulting in additional rental costs to the government and the need for a variation to the lease.
Noted that the proponents had identified project risks and were accepting most of these risks	Included little other substantive commentary on risks despite the MLP guideline identifying risk as a key consideration when examining VFM.

Source: VAGO.

Outcomes of MLP Stage 3 assessment

DTF and Victoria Police prepared the Stage 3 assessment report and in February 2016 recommended to the government that the proposal proceed to Stage 4 in an exclusive negotiation.

The advice indicated that negotiations with the proponents had achieved an outcome that met the government's VFM benchmark. This was accurate but relied on:

- the lease term of 30 years
- proposed subtenants taking space in the VPC.

Without the 30-year lease and subtenants, the costs to Victoria Police would have exceeded the VFM benchmark.

However, as shown below, there were some issues with the revised VPC proposal and the advice given to the government.

The Stage 3 advice (on the revised VPC proposal) …	**But this advice …**
Showed the annual lease costs to Victoria Police as below the costs of remaining at the WTC	Did not make sufficiently clear that the total lease costs had increased to cover the fact that the state would not make an up-front capital contribution of $75 million for fit-out costs.
Showed that the government's VFM benchmark of not exceeding WTC annual rental costs was achieved by increasing the lease term from 20 to 30 years	Did not transparently discuss the potential risks associated with a 30-year lease.
Indicated that the negotiations reduced the original offer by 18 per cent	Did not transparently explain the basis for the claimed 18 per cent cost saving. Victoria Police calculated the saving with reference to the 'initial offer' for the VPC proposal but used a different and higher cost variant of the initial offer than it had used when advising the government at Stage 2. • At Stage 2, it presented the initial offer to the government with a total annual cost of $27.4 million based on a 20 year lease, annual rent of $\$455/m^2$ plus an upfront state contribution to fit-out costs of $75 million and claimed that this was about 12 per cent higher than the WTC benchmark annual lease costs • At Stage 3, when calculating the cost saving, it compared the Stage 3 offer that was based on a 30-year lease term and therefore a lower annual rental rate of $\$424/m^2$, to a variant of the initial offer that was based on a 20 year lease and annual rent of $\$580/m^2$ due to no up-front state contribution to fit-out costs. This resulted in a total annual cost of $33.4 million for the initial offer, which was about 37 per cent higher than the WTC benchmark. The different assumptions on lease term and up-front contribution to fit-out costs drove the annual cost saving.
Indicated that the revised offer was effectively a cap on costs going forward	Was unrealistic because Victoria Police subsequently expanded the size and overall lease costs for the VPC development to accommodate subtenants that had not provided binding commitments.
Indicated that the rental costs under the VPC proposal were consistent with market benchmarks and represented VFM because the SSP was consulted and verified benchmarking data used in the assessment	Not sufficiently comprehensive because the SSP had not verified all of the market rental cost benchmarking data relied on in the Stage 3 assessment report.
	Not sufficiently comprehensive because the benchmarking information relied on was not 'like-for-like'. Rather, it comprised market rental comparisons against Melbourne CBD projects with 10 to 15-year lease terms Unsurprisingly, the lease costs for shorter-term leases were higher than would be expected for a 30-year lease term, given the advantages of such a long lease to the landlord.

Source: VAGO.

Outcomes of MLP Stage 4 assessment

DTF and Victoria Police advice to government on the outcomes of the Stage 4 assessment in November 2016 indicated that the proposal demonstrated VFM. This was on the basis of three key measures:

- independent opinion—the Valuer-General had independently verified VFM
- achievement of the government's lease cost benchmark ($424 per square metre)—under the proposed VPC lease, Victoria Police's net rental was $418 per square metre, less than the benchmark set by the government at Stage 3
- risk allocation—under the proposed VPC lease the risk allocation was better than a standard state accommodation lease.

Despite advising the government that VFM had been demonstrated, DTF and Victoria Police did not recommend that the proposal proceed to contract approval. This was because Victoria Police first needed to address issues raised by the Valuer-General as well as addressing subtenancy issues including:

- negotiating a commitment from the AFP to co-locate at the VPC
- negotiating with the proponents on issues relating to subtenancy areas and costs
- obtaining commercial advice on the appropriateness of proposed rental charges for subtenants.

Given these unresolved issues, DTF and Victoria Police recommended that the government authorise the Treasurer and Minister for Police to approve the proposal to move to Stage 5 (contract award), subject to the resolution of all outstanding issues to the satisfaction of DTF. The government agreed.

A detailed Stage 4 assessment report completed by Victoria Police in consultation with DTF supported this advice. The report referenced supporting evidence in appendices including the Valuer-General advice, commercial advice and a business case. However, DTF and Victoria Police did not provide these appendices to the government. The advice indicated that the Stage 4 assessment report would be finalised and all appendices attached once all outstanding issues were resolved. We have not seen evidence that this occurred.

In particular, the business case referred to was an incomplete draft. Victoria Police had not approved it and we saw no evidence that DTF reviewed it.

DTF advises that references to the business case were removed from the final Stage 4 assessment report and it was not relied on in advice to the Treasurer to approve the lease. However, the business case was cited as part of the evidence to support DTF's assertion that there had been a comprehensive assessment of the proposal.

The business case was flawed because:

- the executive summary incorrectly stated that the VPC proposal was the only option to have a lower NPV compared to the base case. Two of the other three options also had lower costs than the base case.

- Victoria Police incorrectly calculated the scores for the financial analysis of two of the four options. While these errors did not result in an incorrect ranking of the options assessed, they increased the margin by which the VPC proposal option outscored the others. This resulted in the VPC being shown as the only option with a positive unweighted score and the only option with a weighted score above 1.0.

Valuer-General opinion on VFM

The Valuer-General provided valuation advice on the proposed VPC lease terms in October 2016. A contracted valuer performed the valuation in response to instructions issued by the SSP in August 2016.

The valuation advice issued by the Valuer-General had important caveats, including that:

- there was no market evidence available for 30-year lease terms, with market evidence showing the majority of lease terms were 10 to 12 years with a maximum lease term of 15 years
- the site location was not seen as attractive in the market for commercial office development and had an estimated site value of $64.2 million
- the market evidence relied on to establish a benchmark rental related to properties that were all considered to be in significantly superior locations to 311 Spencer Street
- the valuation of market rental rates did not account for the potential opportunity for the proponents to gain significant added value by creating a de facto government-backed indexed security while retaining ownership of the underlying real estate.

The Valuer-General advised that the commencing annual rental cost was acceptable in VFM terms but that:

- the annual rental increase of 3.75 per cent should be renegotiated 'to assist with maintaining the integrity of the office rental market', suggesting that the escalation rate was significantly out of step with the market
- further advice was needed on the potential for the proponents to securitise and market the long-term rental income stream associated with the 30-year lease.

In their detailed advice to the government on the Stage 4 VFM assessment, DTF and Victoria Police accurately reflected the issues raised by the Valuer-General and made a commitment that they would be resolved before a contract was signed with the proponents.

<table>
<tr><th>Issue Valuer-General raised</th><th>Valuer-General advice</th><th>Resolution/recommendation</th></tr>
<tr><td>Annual rental escalation rate of 3.75 per cent out of step with the market</td><td>Seek renegotiation of annual rental escalation rate</td><td>Victoria Police negotiated a revised escalation rate down to 3.65 per cent.</td></tr>
<tr><td>Additional benefits to proponents from 30-year lease:
lowered risk profile of the development for the proponents</td><td>Direct benefits from the long-term lease term could be given an estimated value and the rental negotiated with the proponents provided the state with a reasonable share of these benefits</td><td>No further action required.</td></tr>
<tr><td>Additional benefits to proponents from 30-year lease:
the long lease length may enable securitisation of the lease, impacting on the state's VFM</td><td>Obtain commercial advice on the viability of the proponents securitising and putting to the market what was effectively a government-guaranteed income stream for the lease term

Note: The valuer indicated that this would be attractive to risk-averse investors as the state's lease commitment removed a significant amount of risk normally associated with major office accommodation property developments, such as risks around vacant tenancies and re-leasing expenses removed</td><td>Victoria Police obtained commercial advice in November 2016 indicating it was highly unlikely that the proponents could secure additional value by securitising the lease. This was because the underlying investment was still commercial real estate and subject to the risks and uncertainties of that asset class. It was not an institution such as government under a long-term bond.</td></tr>
</table>

Source: VAGO from information provided by DTF and Victoria Police.

Property yield represents the annual return on the investment in the property typically calculated by expressing annual rental income as a percentage of the property value.

The valuer calculated a property yield on the VPC development of 4.65 per cent. This was seen as reasonable because the 30-year lease term significantly lowered the risks for the developers. The market evidence suggested a benchmark yield of 5.5 per cent for similar grade commercial property developments without the benefit of 30-year leases.

Stage 5 and resolution of outstanding VFM issues

The government agreed to authorise the Treasurer and Minister for Police to approve the VPC proposal to move to Stage 5, in which the contract is awarded, subject to the resolution of all outstanding issues to DTF's satisfaction.

In late December 2016, DTF provided the Treasurer with comprehensive advice that the outstanding issues were resolved and recommended that the VPC proposal progress to Stage 5 with signing of the lease.

Figure 4G shows DTF's advice to the Treasurer on the resolution of the outstanding issues.

Figure 4G
DTF advice to Treasurer on resolution of VFM issues

Outstanding issue to resolve	Summary of DTF advice on resolution
Victoria Police to obtain commercial advice addressing the following issues raised by the Valuer-General: • Can the proponents gain significant additional value from the offer by creating and marketing a de facto government-backed indexed security while retaining long-term ownership of the VPC? • Does Victoria Police have the ability to use the additional value to leverage current negotiations with the proponents regarding the proposed lease escalation rate or other lease terms?	Victoria Police's commercial adviser advised that there was no additional value available through a de facto government bond. The Valuer-General was provided with this advice but offered no further comment or instructions on the issue.
Victoria Police to negotiate a memorandum of understanding with the AFP that provides a non-binding commitment to co-locate at the VPC.	Victoria Police signed a memorandum of understanding with the AFP including a non-binding commitment to co-locate at the VPC. Victoria Police expected the AFP to sign the sublease documents in mid to late 2017.
Reduce the rental escalation rate, while maintaining the current overall commencing net face rental rate and incentive amount.	Rental escalation rate reduced from 3.75 per cent to 3.65 per cent, while maintaining a commencing rental of $\$445/m^2$. The Valuer-General assessed the revised terms and indicated they provided the state with improved VFM.
Negotiate an option to reduce the floor space of the building to meet AFP requirements at a cost acceptable to the AFP.	AFP reduced its space requirement by one floor as part of negotiating the memorandum of understanding. Victoria Police to take over this space given funding for additional resources, meaning the VPC would stay at 39 floors.
Negotiate ability to reduce subtenancy fit-outs under a revised agreement for lease regime, either to be recognised in the rent or, in the case of the AFP fit-out, compensated by a further cash incentive payment by the proponent.	Contractual documents amended to allow a 'negative variation process'. This allows the state to reduce the standard of fit-out in subtenancy areas, particularly the AFP space, with a higher standard fit-out for Victoria Police or other state government tenants. The SSP reviewed and accepted this change and the related financial compensation for the state. The arrangements involved the rent remaining at the higher rate applicable to the AFP space with the new tenant reimbursed with a rent-free period or a cash payment. The SSP noted it would be problematic to attract state government tenants for the space allocated to the AFP if it did not commit to a sublease as, even with compensation, rent for this space would be higher than market rent.
Victoria Police obtaining confirmation from its commercial adviser on the appropriateness of the proposed sublease rentals for the proposed subtenants.	The commercial adviser provided written advice confirming that the sublease rentals were appropriate.

Source: VAGO, based on information from DTF.

On 21 December 2016, the Treasurer accepted the advice and recommendation from DTF and wrote to the Minister for Police seeking agreement to progress the VPC proposal to Stage 5. The Treasurer requested that the Minister confirm that there was negligible risk that the AFP would not commit, given the critical impact of this subtenancy on the VPC proposal.

On 23 December 2016, the Minister advised the Treasurer that there remained a risk that the AFP would not formally commit to the subtenancy arrangements, but that Victoria Police advised the risk was very low and had mitigation strategies should it eventuate. These strategies involved reducing the standard of fit-out for the AFP-allocated areas and seeking alternative state government tenants.

On 7 January 2017, the state signed an agreement to lease the VPC with Cbus/Australia Post without binding agreements in place with the expected subtenants. The final building design and fit-out agreed on reflected the needs of these subtenants. The total annual lease costs including estimated outgoing and cleaning costs is $44.6 million.

On 11 January 2017, the Minister of Finance wrote to the Minister of Police seeking confirmation that in the event the AFP or another proposed law enforcement agency did not sign subleases that Victoria Police would cover the shortfall in rent costs until a replacement tenant(s) is secured.

Subsequent subtenancy issues

In December 2016, DTF's advice to the Treasurer and the agreement for lease indicated that the size of the VPC building would be unchanged at 39 floors. The SSP advised Victoria Police in December 2016 that the deadline for decisions to reduce the fit-out scope—a key mitigation strategy if Victoria Police did not secure tenants—was 1 December 2017.

The IDC monitored ongoing delays in securing binding agreements with the subtenants throughout 2017 and 2018.

In October 2017, Victoria Police received advice that ESTA would not relocate to the VPC. ESTA had been allocated one floor comprising about 3 per cent of the VPC at an annual cost of $1.1 million. To address this, Victoria Police intends to relocate an operational group from the City West Police Complex to take this floor in the VPC.

In early June 2018, six months after the deadline for the state to reduce the VPC fit-out scope, the AFP advised that it would not move to the VPC.

At the end of June 2018, Victoria Police advised its Chief Commissioner that:

- the AFP had been allocated six floors and car parking at an estimated all-inclusive annual cost of about $12 million
- the state is obliged to cover the costs of this space at a rate of $555 per square metre, which is higher than the Victoria Police rate of $418 per square metre
- Victoria Police had contacted Cbus/Australia Post about the potential to reduce scope of the AFP fit-out to reduce costs
- Victoria Police would work with DTF to identify alternate tenants and reduce the cost exposure to the state.

In August 2018, DTF advised the IDC of the AFP withdrawal from the VPC and that Victoria Police was working with the SSP to identify other government tenants. DTF indicated that Victoria Police could lease up to a maximum of two floors of additional space in the VPC.

The IDC raised questions on whether subleasing space in the VPC to non-Victoria Police tenants would impact on the secure nature of the facility and therefore the primary reason for assessing the VPC proposal as unique under the MLP guideline.

While we understand that the other law enforcement agency subtenant is committed to taking up its tenancy, the loss of two of the three subtenants means the state is exposed to additional costs under the lease signed with the VPC proponents and that the VFM proposition put to the government by Victoria Police and DTF has been compromised.

The extent to which the government's VFM benchmarks will be breached depends on whether Victoria Police can secure replacement tenants at rentals and lease terms equivalent to those assumed when signing the lease.

In June 2019, Victoria Police advised us that it was progressing negotiations with several organisations that had expressed interest in tenanting the vacant floors and that it expected to finalise terms once concept designs had been developed. At the time of this report, none have been confirmed.

5

Alternative proposals for a new police headquarters

Since the MLP interim guideline was issued in early 2015, it has included the government objective of ensuring a transparent and fair process, with the highest level of probity and public accountability maintained throughout.

While the state was considering the VPC proposal from Cbus/Australia Post, it received two alternative MLPs for a Victoria Police headquarters, one of which was from the owners of the WTC, which currently houses the Victoria Police headquarters.

Figure 5A
Two alternate MLPs

Alternative MLP proponent	Proposed Site	Submitted	Assessment outcome
WTC owners	WTC*	February 2016	Rejected at Stage 1 in November 2016
MAB Corporation	NewQuay	December 2016	Rejected at Stage 1 in January 2017

Note: *Existing Victoria Police headquarters location.
Source: VAGO.

This Part examines the assessment process and outcomes for these alternative proposals.

5.1 Conclusion

The WTC proposal was rejected largely because DTF and Victoria Police assessed it as incapable of meeting Victoria Police security requirements. However, despite an extended Stage 1 assessment, DTF and Victoria Police did not give the WTC proponents the same opportunity to address these security requirements as the VPC proponents. There was no clear reason why the requirements could not have been shared with the WTC proponents.

The MLP guidelines do not provide specific guidance on ensuring equity and procedural fairness when assessing ‘competing’ MLPs for the same project.

5.2 The WTC proposal

The MLP from the WTC owners was based on providing ongoing accommodation for Victoria Police at their current location. Figure 5B shows key events in relation to the WTC proposal.

Figure 5B
WTC proposal: Key events

Date		Key event
2015		Victoria Police discussed end-of-lease options for the WTC with its owners
2015	March	Victoria Police commissioned a report on security weaknesses at the WTC site
	November	The government publicly announced that the Cbus/Australia Post VPC MLP has been approved to proceed to Stage 3
2016	February	WTC owners submitted an MLP to provide ongoing accommodation for Victoria Police at the WTC. This was assessed against Stage 1 MLP guideline requirements.
	March	WTC owners expressed concerns to the Minister for Finance saying they understood that Victoria Police was considering an expression of interest process for its future and that they would have an opportunity to participate in that process.
	November	The government accepted DTF's recommendation that the WTC proposal not progress to Stage 2.

Source: VAGO, based on information from DTF and Victoria Police.

Lease terms, features and benefits

The WTC proposal included commitments to:

- upgrade and refurbish the existing WTC complex including enhancing security
- enter into a new lease commencing 1 January 2018.

Figure 5C outlines the key features and benefits claimed in the WTC proposal.

Figure 5C
WTC proposal claims

Features	Claimed benefits
A-grade office campus between 40 000 and 50 000 square metres 600 car parks Location Accelerated time frame for project delivery 15-year term Commencing rent of \$360 to \$385/m^2 Annual rental reviews of 3.75 to 4 per cent Rental abatement or fit-out incentive of 20 to 25 per cent Some fit-out and relocation costs to be paid by the state	Enhanced security Direct access to arterial roads and the Yarra River Close proximity to the CBD, including the City West Police Complex at 313 Spencer Street Mitigation against relocation risks such as timing, movement of critical infrastructure and operational continuity A \$153 million saving to the state over the term of the lease

Source: VAGO, based on information from DTF.

Victoria Police's commercial adviser estimated the annual rental costs under the WTC proposal at about \$19.25 million based on a rental rate of \$385 per square metre over 50 000 square metres.

DTF and Victoria Police did not know whether the WTC proposal included the costs for car parking and other outgoings in this rental cost and did not resolve this uncertainty despite an extended Stage 1 assessment period.

Assessment of WTC proposal and IDC oversight

The MLP guideline describes the Stage 1 assessment as a 'preliminary filtering process' that DTF should complete within 30 days. The guideline specifies assessment criteria that primarily relate to:

- sufficiency of information provided
- potential to meet or demonstrate ability against service need, VFM, benefits, deliverability and uniqueness criteria.

DTF completed the Stage 1 assessment of the WTC proposal with significant input from Victoria Police and oversight from the IDC. This process took approximately eight months.

The key reason for the delay was lack of consensus between DTF, Victoria Police and the IDC on whether the proposal should progress to Stage 2.

The government rejected the WTC proposal at the end of November 2016, nine months after DTF received it. This decision was based on DTF's Stage 1 assessment and advice that the proposal could not meet Victoria Police's critical security requirements and was unlikely to offer VFM for the state.

Figure 5D summarises key issues and events as DTF and Victoria Police assessed the WTC proposal during 2016.

The IDC clearly identified the need for all MLP submissions to receive procedural equity and be considered on their merits, and that the WTC and VPC proposals be assessed against the same requirements.

However, Victoria Police did not provide the WTC proponents with the same information provided to the VPC proponents on its security specification requirements.

Figure 5D
WTC proposal assessment: key issues and events

2016	Key issues and events
April	The IDC: • received a presentation from the WTC proposal proponents • noted an extended time frame for the Stage 1 assessment to allow the proponents to provide additional information • discussed the approach to assessing two alternative proposals for the Victoria Police headquarters given the VPC proposal was in the public domain and the WTC proposal was confidential • agreed that the WTC and VPC MLPs had to be assessed using the same process and against the same outcome requirements, including for security, determined by Victoria Police to ensure consistency in the evaluation.
May	The IDC discussed the need for Victoria Police to provide a security benchmark to enable consistent evaluation of the VPC and WTC proposals. Victoria Police advised the IDC that: • its security requirements were principle-based and it was completing a security specification document for its CBD buildings that could be used for benchmark purposes • the sensitivity of this document prevented its circulation to the IDC. The IDC agreed that a DTF officer with appropriate security clearance would review the report on the IDC's behalf.
June	The IDC: • received a summary physical security specification report from Victoria Police and advice that a DTF officer had reviewed the full document and was satisfied that Victoria Police had applied a robust methodology • agreed that the security specification requirements should be communicated to Cbus/Australia Post so they could address the requirements in a revised VPC offer • noted that the Stage 1 WTC proposal also needed to be assessed against the same security specifications. Victoria Police advised the IDC that it did not consider that the WTC site met the security requirements.

Figure 5D
WTC proposal assessment: key issues and events—*continued*

2016	Key issues and events

July	The IDC discussed a draft Stage 1 assessment report on the WTC proposal. This draft report did not include any recommendations and DTF and Victoria Police had divergent views in some areas. The IDC:
	• noted that the WTC proposal generally met the MLP guideline requirements for Stage 1
	• noted concerns about whether the WTC facility and site location met Victoria Police security requirements
	• agreed that further information was needed to assess the proposed security enhancements at WTC
	• noted that the Cbus/Australia Post proposal was at Stage 4 of the MLP process and agreed that all MLP submissions should receive procedural equity and be considered on their merits
	• noted the Victoria Police view that the WTC proposal could not meet its security requirements and recommendation that the WTC proposal not progress Stage 2
	• considered various options to progress the WTC proposal including:
	    • not progressing the proposal to Stage 2
	    • undertaking an extended Stage 1 assessment focused on security
	    • progressing the proposal to Stage 2 and seeking further information from the proponents on how proposed security enhancements would meet Victoria Police's security requirements.
	The IDC agreed:
	• to recommend that the WTC proposal progress to Stage 2 of the MLP process as the proposal met the MLP guideline requirements for Stage 1 regarding sufficiency of information, scope and potential to meet the assessment criteria
	• that the WTC proponent be requested to provide additional information on the proposed security enhancements and the commercial lease offering
	• that the state formally advise the VPC proponents that it had received another MLP regarding end-of-lease options for the Victoria Police headquarters.
	The Chief Commissioner of Victoria Police requested a meeting with the DTF Secretary to discuss the IDC recommendation that the WTC proposal progress to Stage 2.

August	The Chief Commissioner of Police and DTF Secretary agreed that: • the WTC proposal should not progress to Stage 2 • further information would be sought from the proponent regarding the proposed security enhancements at the WTC. DTF asked the WTC proponents to respond to questions prepared by Victoria Police on proposed security enhancements to the WTC facility. The WTC proponents raised concerns with DTF about the fairness of the MLP assessment process, advising: • that they were alarmed by the absence of a specification document outlining Victoria Police's future requirements to enable the state to assess the WTC and Cbus/Australia Post proposals fairly • that they wanted a copy of any such specification to enable them to formally respond. DTF advised the proponents that the MLP guideline allows only limited interaction with proponents in Stage 1 and that the Victoria Police requirements would be disclosed if their proposal progressed to Stage 2.
September	The WTC proponents: • met with DTF and Victoria Police on the request for additional security information • provided a draft and then final response to the additional security information request. Victoria Police advised DTF that the proponent's responses to the security questions were inadequate.

Figure 5D
WTC proposal assessment: key issues and events—*continued*

2016	Key issues and events
October	Victoria Police approved a detailed security specification for the new police headquarters. DTF: • updated the Stage 1 assessment report on the WTC proposal and recommended that it not proceed to Stage 2 • provided IDC members with the updated assessment report.
November	DTF provided the final Stage 1 assessment report on the WTC proposal to the government. The government agreed with DTF's recommendation that the proposal not move to Stage 2. DTF advised the WTC proponents of the outcome.

Source: VAGO, based on information from DTF and Victoria Police.

WTC Proposal and Victoria Police security requirements

During the assessment process, DTF asked the WTC proponents to respond to a set of questions prepared by Victoria Police on how they would address Victoria Police security requirements. The WTC proponent's responses sought to address these questions, but included requests for additional information to enable a more comprehensive response on some matters.

The WTC proponents raised concerns about this lack of information. It was not unreasonable for the WTC proponents to expect the same opportunity as the VPC proponents to understand, respond to and address the Victoria Police minimum security requirements.

DTF explained to us that Victoria Police did not provide the WTC proponents with the same set of security specifications provided to the VPC proponents due to:

- security considerations
- the government not generally sharing information with proponents in Stage 1 given the preliminary nature of the assessment.

DTF's extension of the time frame for the Stage 1 assessment meant it had advanced beyond a preliminary assessment. Given the WTC proponents were the landlord for Victoria Police's existing headquarters, we expect they would be trusted to access this information.

Victoria Police security specification

Following receipt of the WTC proposal in February 2016, the IDC repeatedly stressed the need for Victoria Police to document a security requirements specification. It desired this to enable a fair and consistent assessment of the two MLPs. Victoria Police did not approve a detailed security specification for the new police headquarters until October 2016.

Victoria Police completed the draft Victorian Police Physical Security Specifications (VPPSS) in June 2016. This draft document:

- was designed for 'major police facilities', not specifically for the new police headquarters
- was high-level and based on broad references to security framework guidance for Victoria Police and government buildings.

The VPPSS document we examined is broad and summary in nature and lacks specific technical design information. The draft specification could be largely reconstructed using information, policies and security framework guidance in the public domain and was not highly sensitive. There was no clear reason why Victoria Police and DTF could not have shared the VPPSS with the WTC proponents.

Victoria Police drafted a more detailed security requirements specification document for the new police headquarters during August 2016 and engaged security consultants to assist in preparing this document. Victoria Police finalised and approved this document, the 'Victoria Police Precinct Security Strategy', in October 2016.

Advice to the government on the Stage 1 assessment of the WTC proposal

DTF's advice to the government, in late November 2016, on the Stage 1 assessment outcome for the WTC proposal indicated that the proposal did not meet the criteria required by the MLP guideline as:

- it did not satisfy the critical security requirements of the VPPSS, therefore did not meet a service need of Victoria Police
- once fully costed, the project would be unlikely to be affordable within existing budgets and would not offer VFM
- it did not fully demonstrate the proposed upgrade and refurbishment works had potential to be unique, and the time frame for completion appeared unfeasible
- commercial and financial advisers engaged to provide additional independent analysis concluded that the savings claimed by the proponent were excessive and unlikely to materialise.

We examine the basis for key aspects of this advice.

Advice on security

DTF's advice to the government described the process by which:

- it extended the Stage 1 assessment process
- Victoria Police developed detailed security questions for the WTC proponents.

However, DTF's advice did not inform the government that the WTC proponents had qualified their response to the security questions. The WTC owners had raised several areas where they requested further information and consultation with Victoria Police to better understand and respond to the questions raised.

DTF's advice to the government claimed that expert security consultants had reviewed security at the current WTC complex against the specifications in the VPPSS and concluded that:

- the WTC complex posed a significant security risk that was not acceptable given the current and emerging threat environment
- the WTC site had security risks that could not be rectified due to geographical constraints as it is surrounded by a range of commercial, residential and public land uses as well as major roads and the Yarra River
- the WTC site had numerous approaches for attack such as air, water, roads and multiple pedestrian points, all of which were difficult to secure
- planned further development in the surrounding areas increased the vulnerability for the WTC complex and the risk to the general public in its vicinity.

DTF did not have a copy of the security consultant's report because Victoria Police would not release it on security grounds. DTF provided its advice to the government based on:

- written advice it received from Victoria Police, in May and July 2016, that referred to and included quotes from the security consultant's report
- advice from a DTF officer with an appropriate security clearance who sighted Victoria Police security-in-confidence information on the security risk and threat profile of the WTC.

However, DTF's advice to the government on this report was not comprehensive because:

- the security consultant review and report were completed in April 2016, two months before the VPPSS was drafted, which means that the report could not have reviewed the WTC facility against the VPPSS specifications
- there is no evidence that either DTF or Victoria Police specifically documented an assessment of the proposed WTC security features against the specific requirements in the VPPSS
- Victoria Police's advice to DTF on the scope and content of the security consultant report did not include any reference to, or claim that, the review specifically assessed the WTC against the VPPSS
- DTF's summary of the conclusions from the review reflects the advice from Victoria Police, but the quotes from the security consultant's report included in Victoria Police's advice to DTF do not include the specific conclusions attributed by DTF to the review.

We have reviewed the report from the security consultant and confirm that the report did not include a conclusion that 'the WTC complex poses a significant security risk that is not acceptable given the current and emerging threat environment'.

The security consultant clearly found significant inherent security risks in relation to the location and configuration of the WTC facility. However, the consultant focused on identifying key risks, possible treatments and residual risk levels. Of the seven key risks identified, five were rated as very high prior to treatment, but none were rated as very high if the identified treatments were implemented and only one was rated as high after treatment.

This indicates that the security consultant considered that all risks except one could be mitigated to a medium level. This may not have been acceptable to Victoria Police, but that is not what the consultant concluded. Victoria Police advised us that many of the mitigations recommended by the consultant included the need for further comprehensive risk and threat assessments and process-based controls that are considered less effective than physical security controls.

In addition, the security consultant review cited by DTF and Victoria Police was of the WTC as at April 2016, not the refurbished facility proposed by the WTC owners. The review was undertaken before the WTC proponents had provided additional information in response to Victoria Police questions on specific security issues. Given this, DTF's advice to the government on the outcome of the review did not provide a comprehensive assessment of the extent to which the WTC proposal could meet Victoria Police security requirements.

DTF's advice to the government included further statements indicating that:

- DTF had assessed the proposal taking into account the identified security risks at the current complex and concluded that while the proposal may potentially address aspects of the security requirements in relation to the WTC building, the proposal could not address the site-specific requirements
- given that the WTC proponents needed to address both the site and building-related requirements, DTF considered that the proposal did not satisfy the critical security requirements in the VPPSS and therefore, this proposal could not meet a service need of Victoria Police
- Victoria Police had also assessed the proposal and advised that they did not consider the proposed security enhancements satisfied the requirements of the VPPSS in relation to both the WTC building and site.

We have seen evidence supporting the basis for the claim about Victoria Police views on the security suitability of the WTC site. However, the basis for DTF's conclusions is unclear given that we saw no evidence that it documented an assessment of the proposed WTC security features against specific requirements in the VPPSS.

The security risks associated with the WTC site were clearly significant. However, a subsequent report from the same security consultant in August 2016 highlighted that the co-location of the VPC with the City West Police Complex and the proposed subtenancies involving the AFP and another law enforcement agency significantly increased the potential for that site to be a target for known threat actors, noting that the risks could be mitigated.

Advice to the government on costs and VFM

DTF's summary advice to the government stated that:

- once fully costed, the WTC proposal would be unlikely to be affordable within existing budgets
- the WTC proposal would be unlikely to offer VFM
- commercial and financial advisers engaged to provide additional independent analysis concluded that the savings claimed by the proponent were excessive and unlikely to materialise.

This advice was broadly consistent with the advice from Victoria Police's commercial adviser. However, DTF's summary advice to the government did not highlight that the WTC proposal did not require any increase to comparable recurrent leasing costs for Victoria Police or an up-front capital contribution from the state.

In addition, DTF's advice did not compare, or reconcile the differences, between the rental costs to Victoria Police under the WTC proposal with the advice to the government on the estimated rental costs at the WTC as part of the VFM benchmark for the VPC proposal. The upper bound of the rental charge sought by the WTC proponents was $385 per square metre, while the Victoria Police estimate of this cost in its VFM benchmark advice on the VPC proposal was $408 per square metre, about 6 per cent higher.

DTF's advice to the government stated that financial analysis by Victoria Police's commercial adviser indicated at Stage 4 that the VPC proposal was lower in cost than what would be expected from the WTC proposal and referenced an attachment that supposedly evidenced this claim. We could not locate this advice in the submission and attachments provided to the government and the basis for this comparison is unclear. The lease transaction entered into by the state for the VPC proposal involves significant whole-of-life costs as discussed in Part 4.

5.3 NewQuay proposal

The MAB Corporation submitted an MLP to DTF on 12 December 2016 to develop a new VPC at 396 Docklands Drive, NewQuay, Docklands, and lease the facility to the state for 15 years.

The proposal indicated that the upgraded facility would deliver an 'A-grade' office complex of between 50 000 and 66 000 square metres. The proponents considered that the facility would meet the security requirements of Victoria Police and highlighted the risk-mitigation benefits associated with accepting their proposal because this would deliver a police headquarters in a different location to the relatively new City West Police Complex at 313 Spencer Street.

DTF documented its Stage 1 assessment of this proposal in January 2017 and recommended that the proposal not progress to a Stage 2 assessment.

DTF stated in its assessment report that given the government was due to execute contracts for the VPC by the end of January 2017, there was no service need for a new Victoria Police headquarters. DTF also assessed the proposal as not sufficiently unique, and therefore not meeting the MLP guideline.

Appendix A
Submissions and comments

We have consulted with DPC, DTF, DoT, Victoria Police and DJPR, and we considered their views when reaching our audit conclusions. As required by the *Audit Act 1994*, we gave a draft copy of this report, or relevant extracts, to those agencies and asked for their submissions and comments.

Responsibility for the accuracy, fairness and balance of those comments rests solely with the agency head.

Responses were received as follows:

RESPONSE provided by the Secretary, DPC

Department of
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Melbourne, Victoria 3002 Australia
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D19/306359

Mr Andrew Greaves
Auditor-General
Victorian Auditor-General's Office
Level 31, 35 Collins Street
MELBOURNE VIC 3000

Dear Auditor-General

Thank you for your letter of 31 October 2019 providing me with a copy of the Proposed Performance Audit Report - *Market-led Proposals.*

I note the report and that the Secretary of the Department of Treasury and Finance will provide a response to its recommendations.

Yours sincerely

Chris Eccles AO
Secretary

RESPONSE provided by the Secretary, DTF

Department of Treasury and Finance

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Mr Andrew Greaves
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Dear Mr Greaves

MARKET-LED PROPOSALS PERFORMANCE AUDIT

Thank you for the opportunity to comment on the proposed Market-led Proposals (MLP) Performance Audit Report (Report) provided to the Department of Treasury and Finance (Department) on 31 October 2019.

The Department considers the Report does not provide a reasonable basis to support any of the audit's recommendations.

As you are aware, the Department has consistently raised concerns about successive drafts of the Report and the lack of substantiation of its key findings. A number of the findings are based on analysis undertaken by external consultants employed by the Victorian Auditor-General's Office (VAGO) that misunderstand and misrepresent key elements of the assessments for the West Gate Tunnel (WGT) and Victoria Police Centre (VPC) proposals.

The Department was fully transparent in its advice to the Government on the MLP assessment process and outcomes, and strongly refutes the assertion that the Government was not fully informed in its decision-making processes. In most instances, VAGO proposes alternative approaches and interpretations that are not supported by accepted commercial practice and relevant government guidelines.

The MLP assessments undertaken were supported by experienced and credentialled technical, commercial and financial advisers with extensive transport and finance expertise which was industry leading.

The Department remains disappointed in the process adopted by VAGO and its external consultants to undertake the audit and formulate the Report. The Department sought to engage with VAGO and its external consultants from the outset to fully explain key elements of the MLPs to assist in their understanding on how to interpret reviewed material to better inform the Report's findings. It is therefore regrettable that VAGO and its external consultants did not substantively engage with the Department during the nine months taken to prepare the first draft report of the audit's findings.

VICTORIA State Government

I address each of VAGO's key findings for WGT, VPC and the overall MLP Guideline process requirements below.

WEST GATE TUNNEL

Value for Money

The Report fails to adequately highlight the thorough and comprehensive value for money assessment undertaken for the WGT.

More than 93 per cent of the design and construction (D&C) costs were competitively tendered, which by VAGO's own admission, resulted in a "low risk" that value for money would not be achieved in respect of these costs. Any costs not competitively tendered were benchmarked against costs derived by leading specialist advisors with strong reputations and track records in the market.

The value of the State's contribution to the construction costs of the WGT, in this case $1.389 billion, was therefore determined as the residual between the costs outlined above and the net revenue streams proposed and financed by Transurban.

To assist the assessment of value for money, the Department engaged a leading global investment bank experienced in the toll road sector to provide independent advice on how other bidders would value these revenue streams, if the State had sought multiple bids through a competitive process. Not surprisingly, they provided a range of discount rates reflecting the perspective that bidders would have different approaches to valuing their risk and return requirements. For VAGO and its external consultants to suggest that all private sector bidders would price risk the same (by using a single point estimate for the discount rate) is inconsistent with market practice. Transurban's ability to offer a lower return or take more risk on traffic forecasts than a third party is a legitimate component of why Transurban was able to offer value to the State and ultimately a fundamental reason as to why MLPs exist.

The Department's assessment complied with all relevant government guidelines including the MLP Guideline and National PPP Guidelines and the final value for money report clearly and transparently tested value for money in aggregate and for each individual component of Transurban's proposal, with the results presented in advice to Government.

VAGO suggests that a large component of the value for money benefit was driven by differences in the State's and Transurban's valuations of tolling revenues, specifically for CityLink toll escalation, and the Department should have been "sceptical if its own toll revenue estimates were less than Transurban's". This directly contradicts VAGO's own acknowledgement of the "balancing act" created by competing incentives on Transurban not to understate or overstate its revenue forecasts. VAGO highlights that Transurban had a commercial incentive to undervalue its tolling estimates to strengthen the argument to escalate and extend the CityLink concession. Conversely, VAGO also acknowledges that if Transurban's tolling estimates were higher than the State's, then this would reduce the State's contribution to the project, making the proposal attractive to the State. Transurban also faced a real risk that the State would not proceed with the proposal if the State assessed Transurban's forecast tolling revenues as unrealistic and not providing value for money against State benchmarks. To support our analysis, the Department sought independent traffic forecasts from a leading forecaster with a proven track record in the toll road sector, with more than 20 years experience forecasting tolled traffic on the Melbourne network.

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VAGO suggests that the State contribution made towards the D&C costs should have been treated as risk free and therefore, this contribution should be discounted at a risk free rate. This is not correct as the State contribution was directly and inextricably linked to the successful completion of high risk D&C works as certified by an independent expert. The concept of the discount rate taking into account the risks inherent in the cashflows to be discounted is clearly accepted by VAGO as evidenced elsewhere in the Report.

VAGO suggests that the discount rate range applied in the assessment was insufficiently challenged and that the Department did not sufficiently consider risks involved. However, the State used a discount rate range consisting of an upper and lower benchmark precisely to address the uncertainty and risk associated with estimating required rates of return for a project of this nature. The Department has provided evidence to VAGO of the ongoing interaction on the discount rate methodologies including various meetings where the Department scrutinised, challenged and sought to validate all inputs into the discount rate analysis. I reiterate that the discount rates were independently assessed and determined by a leading global investment bank experienced in the toll road sector.

Uniqueness

VAGO supports the Department's conclusion that the CityLink toll escalation revenue, a key funding source for the project, was unique. However, VAGO suggests the assessment did not transparently assess the uniqueness of the CityLink concession extension compared to the next best alternative such as a competitive process with additional government guarantees. As we have pointed out to VAGO on several occasions, the Department did consider whether an alternative operator could access the CityLink extension funding source on a value for money basis as part of its MLP assessment. The Department ultimately concluded, in compliance with the MLP Guideline, that this was unlikely. The Department provided evidence to VAGO that it engaged key market participants to gain objective confirmation of market appetite, willingness and ability to price the CityLink funding sources.

Service needs and benefits

VAGO's suggestion that the business case lacked justification for including the Monash Freeway Upgrade works in the WGT project scope is not supported. The business case was compliant with relevant guidelines. In addition, it provided a strong rationale for investment along the M1 corridor, including connectivity of the west to the south-east economic clusters and key strategic transport assets, supporting development of a single business case for the Monash Freeway and WGT works.

VAGO also suggests that the business case did not have a sufficiently transparent cost benefit analysis, with potential double counting or overstating of benefits. However, this assessment shows a lack of understanding of the approach used to estimate benefits for a project of this nature and of relevant economic appraisal guidelines.

The documentation provided to VAGO sets out how each benefit stream was calculated, and it demonstrates there is no double counting. Each of the benefits identified by VAGO as 'non-standard' were specifically developed in line with Victorian/Australian Transport Council economic appraisal guidance as at 2015 and are regularly used in other projects.

The Economic Evaluation for Business Cases Technical Guidelines clearly state that "a cost-benefit analysis requires that all relevant costs and benefits are identified, whether they

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are readily identifiable or not", demonstrating that economic appraisal guidelines are not prescriptive on benefits and instead provide a framework for practitioners to apply as appropriate. As improved data is available in the transport sector and research and methodologies develop, the methodologies, parameters, and benefits captured will also change and progress over time.

VAGO suggests that the business case did not justify the use of blended fixed and variable matrices in assessing the benefits of the project. However, this approach was adopted to address previous VAGO recommendations in relation to other projects. If VAGO is now recommending a new approach, this should have been acknowledged in the report.

For the reasons detailed above, the Department does not accept that advice to Government lacked transparency regarding the sensitivity of the WGT scope. In fact, the business case provided to Government included separate economic results in relation to WGT and the Monash Freeway Upgrade scope elements, together with a range of other scenarios considered useful for decision making.

I reiterate that VAGO would have benefited from consultation on the economic modelling with the Department of Transport (owner of the business case) and this Department, particularly given the strength of the Report's findings and the departments' knowledge of the models and inputs used. Both departments were not provided this opportunity.

VICTORIA POLICE CENTRE

Uniqueness

VAGO's conclusion that the VPC proposal is not unique is based on a simplistic interpretation of uniqueness that does not accurately reflect the complex nature of the MLP framework. The VPC assessment met the requirements of the MLP Guideline and demonstrated that the proposal was unique. There is no other site which could have provided the combined security and co-location benefits of the 311 Spencer Street site.

The 311 Spencer Street site provides significant security benefits including extensive surveillance capabilities and limited oversight by surrounding buildings. The State is the ultimate controlling party of the adjoining railway land, Southern Cross Station tenancy, Spencer Street and nearby Melbourne Assessment Prison. As such, the State has an enduring interest and level of control over the VPC and adjacent City West Police Centre. Victoria Police considered the 311 Spencer Street site to be considerably superior regarding security and the Department rightly relied on Victoria Police's expert advice regarding its security risk and requirements. This was an important consideration in the assessment of uniqueness and it is unclear on what basis VAGO disputes the security needs identified by Victoria Police.

VAGO has concluded that there was ample time for a competitive process and therefore the VPC proposal should not have progressed as an MLP. However, the Department did not claim at any stage of the assessment process that there was a time pressure that called for exclusive negotiations. Rather, the timeframe of proposal delivery was acceptable because it aligned with the need for a new police headquarters facility in 2020. The fact that 311 Spencer Street was the only site that could provide the combined security and co-location benefits means that the MLP process was an appropriate way to progress with the procurement of this important piece of infrastructure.

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RESPONSE provided by the Secretary, DTF—continued

In addition, VAGO wrongly concludes that the submission of alternative proposals for a police headquarters demonstrates that the VPC proposal was not unique. This finding reflects a misunderstanding of the MLP framework which, by its very nature, is initiated by the private sector and not the Government. The submission of an alternative proposal gives no indication that it could meet Victoria Police's needs or could have been feasibly delivered. The World Trade Centre (WTC) proposal was thoroughly assessed by the Department and Victoria Police and it was concluded that it did not meet the requirements of Government and therefore was not a viable alternative.

Value for money

VAGO acknowledges that the Department provided accurate advice to Government on the stage four assessment of value for money but infers that the lease term and size of the building were increased so that necessary benchmarks were met. This inference is misleading and incorrect. The 30-year lease term was sought by Victoria Police as its headquarters will remain in the VPC for the long term given the facility is being purpose-built to meet the complex and specific needs of the State's premier law enforcement agency. VAGO infers that because the lease term is longer than normal government accommodation tenancies, it is somehow inappropriate or not justified. However, this fails to acknowledge that the Victoria Police's needs differ significantly from normal office accommodation, where there is more flexibility in design and location. This is common practice for the management of property portfolios in both the public and private sectors.

VAGO's conclusion that the value for money benchmarks should have been based on whole of life costs shows no consideration for the treatment of government leases at the time of the MLP assessment. Whilst the Report concludes that the per square metre rental rate was not appropriate, it still uses these per square metre figures to make comparisons with the rental rate at the City West Police Station. VAGO fails to acknowledge that the rental rate at the VPC is significantly lower than that of the neighbouring City West Police Centre, which further confirms the assessment outcome that the VPC does represent value for money.

Most importantly, VAGO fails to adequately reflect that a key aspect of the value for money assessment was an independent assessment undertaken by the Valuer-General of Victoria. The Valuer-General provided advice that the VPC provided a value for money outcome for the State, subject to the resolution of two issues (which were both resolved).

Alternative proposals

VAGO concludes that it was not unreasonable for the WTC proponent to expect the same opportunity as the VPC proponent to understand, respond to and address Victoria Police security requirements and that classified information should have been provided to the proponent to assist in the development of their proposal.

However, I reiterate my earlier point that MLPs are initiated by the private sector and proponents should not rely on confidential government information to make a compelling case for a proposal to progress from the preliminary stages of the MLP assessment process. The successful VPC proponent was not provided with information relating to Victoria Police's security information in the early stages of its assessment and in fact both proposals were assessed in an equitable and transparent manner.

I note that if security information was provided to the WTC proponent in stage one, this would have resulted in an inconsistent application of the MLP assessment framework. This is a contradictory finding in the Report given a key focus of the audit was to determine that the assessment process was applied consistently to all proposals. Accordingly, the

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Department rejects this recommendation and will continue to apply the MLP Guidelines in a consistent and equitable manner.

MLP PROCESS REQUIREMENTS

A key objective of the MLP framework is to ensure that a fair and transparent process is undertaken with the highest level of probity. This aspect of the assessment process is taken seriously by the Department and both the WGT and VPC assessments were undertaken in accordance with specific probity and process deeds and probity plans.

VAGO has inferred in its Report that the Department did not adhere to the probity requirements of the MLP assessment process, particularly relating to the declaration of conflicts of interest. As previously advised, the WGT and VPC assessments were undertaken in accordance with the Government's and Department's conflict of interest guidelines.

The WGT and VPC assessments were also supported by highly respected probity advisers who advised and signed off on compliance with key probity requirements at each stage of the assessment process.

Yours sincerely

David Martine
Secretary
15 / 11 / 2019

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RESPONSE provided by the Secretary, DoT

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Ref: BSEC-1-19-828

Mr Andrew Greaves
Auditor-General
Victorian Auditor-General's Office
Level 31/35 Collins Street
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Dear Mr Greaves

PROPOSED PERFORMANCE AUDIT REPORT – MARKET LED PROPOSALS

I refer to the Proposed Performance Audit Report – Market-led Proposals (the Report) provided on 1 November 2019 to the Department of Transport (the Department) which details your final conclusions in relation to the West Gate Tunnel Project (the Project) market-led proposal process, value for money assessment and the advice subsequently provided to Government in relation to the Project.

I thank you for the opportunity to comment on the Report.

The Department and I strongly support the response to the Report provided by the Secretary of the Department of Treasury and Finance.

Yours sincerely

Paul Younis
Secretary

Date: 15 / 11 / 19

VICTORIA State Government

RESPONSE provided by the Chief Commissioner, Victoria Police

VICTORIA POLICE

Graham Ashton AM
Chief Commissioner of Police

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Mr Andrew Greaves
Auditor-General
Victoria Auditor-General's Office
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Melbourne VIC 3000

Andrew
Dear ~~Mr Greaves~~

Provisional Draft Report *Victoria Police Centre Market-Led Proposals*

Thank you for the opportunity to respond to the proposed Market-led Proposals (MLP) Performance Audit Report (Report).

We note this Audit encompassed a 'whole of government' approach, analysing two market-led proposals. Whilst Victoria Police was not a stakeholder in the West Gate Tunnel project, we are the beneficiaries of the new Police Complex which is almost complete at 311 Spencer Street, Melbourne.

In 2020, Victoria Police will move into a secure and purpose-built facility, and for the first time since the bombing of the Russell Street Police Headquarters in 1986, our Senior command leadership and capability will be co-located.

This co-location ensures time efficiencies in management, improved capability and response, and supports leadership to deliver an improved policing service. The benefits of locating our senior decision-makers with our specialist commands improves timeliness of communication enhancing community safety outcomes.

The location of the building provides a secure footprint for our police service with vital security features. Our building must support a safe work environment and ensure we are protected from potential targets which harm, and ultimately could deplete our capability to respond.

While we acknowledge the efforts of your office to consult with Victoria Police on the content of the Report, we continue to disagree with the substantive conclusions that have been drawn. In particular:

- The Report concludes that the Australia Post/Cbus proposal (Proposal) was not sufficiently unique to satisfy the MLP guideline. We believe the uniqueness of the Proposal is clear when its substantial security attributes are combined with the significant benefits of co-location of the approximately 3600 Victoria Police staff expected in the 311 Spencer Street building with the 1500 staff in the City West Police Centre (CWPC) at 313 Spencer Street. The opportunity to link the two buildings into a single police precinct with the combined location's inherent security benefits simply could not be achieved with any other site. The Proposal was therefore correctly assessed as unique.

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RESPONSE provided by the Chief Commissioner, Victoria Police—continued

- The Report states that the value for money provisions of the MLP guideline were demonstrated but infers that the length of the term of the lease and the size of lettable area were increased so the necessary benchmarks could be reached. This is incorrect as these increases were made for important operational and policy reasons. A new police headquarters with expanded lettable area provides a 'once in a generation' opportunity to co-locate with other law enforcement related agencies with the inherent benefits that come with proximity. Similarly, the length of lease reflects the expected duration of Victoria Police's occupancy of such a dedicated, purpose-built facility, especially one with the unique characteristics previously described. The Valuer-General of Victoria supported the conclusion that the Proposal provided a value for money outcome for the State.

- The Report concludes that classified security information should have been made available to the alternate World Trade Centre MLP proponents during Stage 1 of the assessment process. This is contrary to the MLP guidelines and, if followed, would have resulted in an inconsistent application of the guidelines between the competing MLPs.

Victoria Police are also concerned by references to 'superficial' assessments and a perceived 'lack of transparency' from Victoria Police at critical points of the MLP decision making process. We strongly disagree with these conclusions. We have reflected on the way in which our organisation participated in the Market-led process and are satisfied that our actions were appropriate and considered.

We have also had the opportunity to consult with the Department of Treasury and Finance regarding their intended response to the assessment of the Victoria Police Centre MLP in the Report and support the content of their correspondence to you.

We note that there are no recommendations for Victoria Police in the Report and again thank-you for the opportunity to respond to the findings of this Audit.

Yours sincerely

Graham Ashton AM
Chief Commissioner

18/11/19

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RESPONSE provided by the Secretary, DJPR

Department of Jobs, Precincts and Regions

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Ref: BSEC-2-19-1392

Mr Andrew Greaves
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Victorian Auditor-General's Office
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Dear Auditor-General

VAGO PERFORMANCE AUDIT REPORT - MARKET-LED PROPOSALS

Thank you for your letter of 31 October 2019 providing the Department of Jobs, Precincts and Regions (DJPR) with a copy of the proposed Performance Audit Report - Market-led Proposals.

The department appreciates the invitation to respond to the proposed report. The department has reviewed the report and, in this instance, has no submissions or comments for inclusion in the report.

If you require any further information please contact Ms Sarah-Jane McCormack, Executive Director Agriculture Policy, DJPR, on telephone (03) 8392 7184.

Yours sincerely

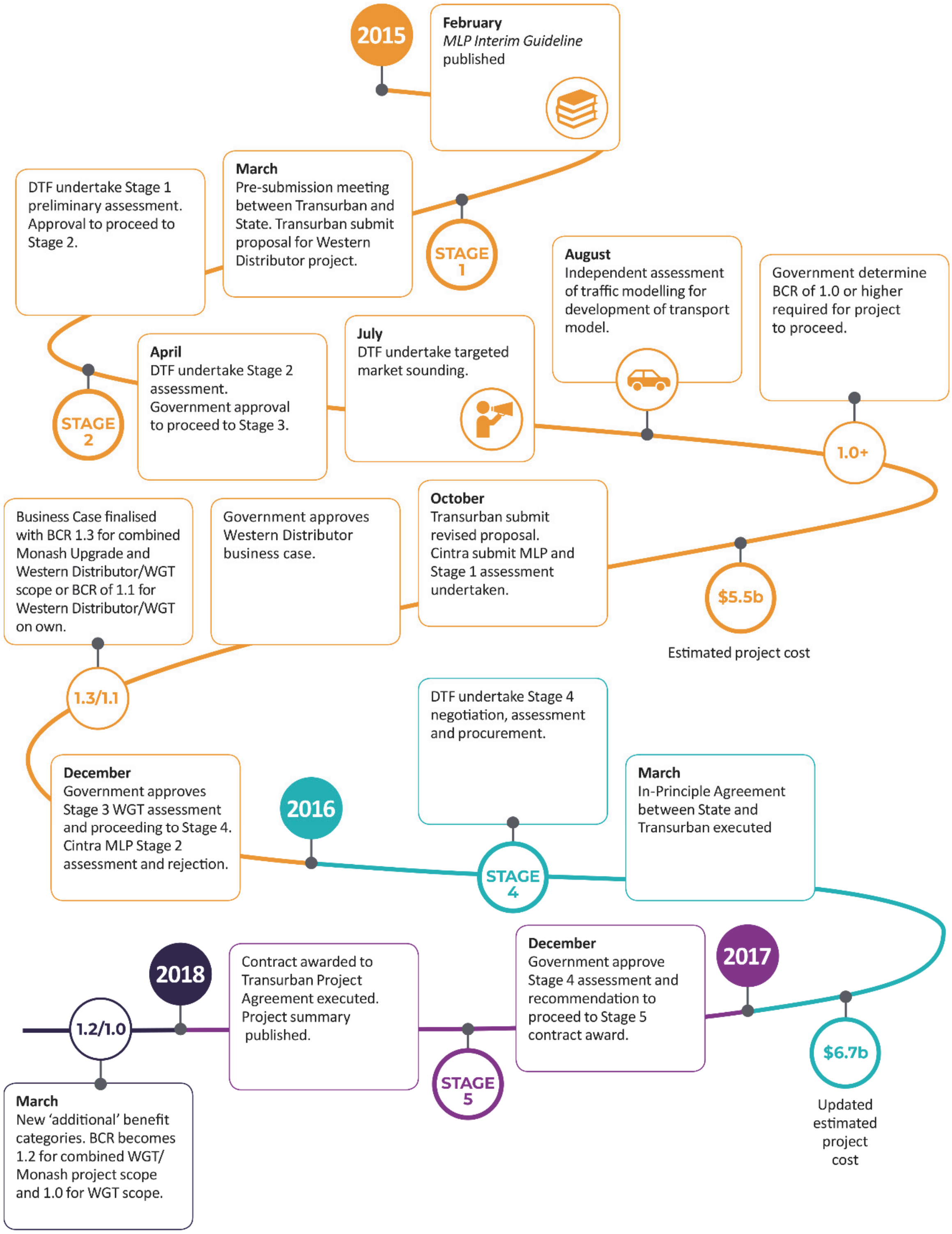
Simon Phemister
Secretary
Department of Jobs, Precincts and Regions

Date: 12 / 11 /2019

Appendix B
West Gate Tunnel chronology

Figure B1 on the following page provides a chronology for the assessment of the WGT MLP.

Figure B1
Chronological outline of WGT MLP process



Appendix C
Victoria Police Centre context and chronology

DTF and Victoria Police assessed the Cbus/Australia Post VPC proposal through the five stages of the MLP process between May 2015 and December 2016 with input from the SSP, the Valuer-General and external commercial and legal advisers. The:

- Stage 1 and Stage 2 assessments applied the February 2015 *Market-led proposals Interim Guideline* and were led by DTF with significant input from Victoria Police and its advisers
- Stage 3, Stage 4 and Stage 5 assessments applied the November 2015 MLP guideline with Victoria Police leading negotiations with Cbus/Australia Post in Stages 3 and 4 and leading the Stage 3 and Stage 4 assessments in consultation with DTF.

The IDC oversaw the assessment by:

- monitoring DTF and Victoria Police progress in assessing the VPC proposal
- monitoring the progress of Victoria Police's negotiations with the VPC proponents
- reviewing the draft Stage 2, Stage 3 and Stage 4 assessment reports and the draft advice to government on the results and recommendations arising from these assessments
- endorsing the assessment reports.

Figure C1 provides a timeline for the assessment of the three MLPs received for a new secure headquarters and information on how the key features of the VPC proposal moved over time.

Figure C1
Timeline for assessment of MLPs for a new police headquarters

Date		Events and assessments	Decisions and Approvals	VPC size and lease term	VPC Rental costs: per sqm and Annual
2015	Mar	Lease for City West Police Complex at 313 Spencer Street commences. Victoria Police commission security report on security weaknesses at WTC site.			
	May	Cbus Property and Australia Post submit MLP to develop 311 Spencer Street and lease it to the state for a new VPC (the VPC proposal). DTF undertakes Stage 1 assessment on VPC proposal	DTF approves Stage 1 assessment: VPC to progress to Stage 2.	41 392 sqm office space 20 years	Net rent $455 per sqm $27.4 million (total including outgoings & cleaning)
	Sept to Oct	DTF undertakes Stage 2 assessment of VPC proposal in consultation with Victoria Police and SSP and recommends proposal move to Stage 3.	Government approves Stage 2 assessment and VPC proposal progressing to Stage 3 in October.	41 392 sqm office space 20 years	Net rent $455 per sqm $27.4 million (total including outgoings & cleaning)
2016	Feb	Victoria Police finalises Stage 3 assessment of VPC proposal in consultation with DTF and recommends proceeding to Stage 4 WTC owners submit MLP to keep the police headquarters at the WTC (WTC proposal)	Government approves Stage 3 assessment to progress to Stage 4	41 392 sqm office space 30 years	Net rent $424 per sqm $26.9 million (total including outgoings & cleaning)
	Jul	DTF drafts Stage 1 assessment of WTC proposal	IDC recommends WTC proposal progress to Stage 2		
	Aug	Chief Commissioner of Police and DTF Secretary meet and agree that WTC proposal will have an extended Stage 1 assessment rather than progress to Stage 2			

Figure C1
Timeline for assessment of MLPs for new police headquarters—*continued*

Date		Events and assessments	Decisions and Approvals	VPC size and lease term	VPC Rental costs: per sqm and Annual
	Nov	Victoria Police finalises Stage 4 assessment of VPC proposal in consultation with DTF DTF finalises Stage 1 assessment of WTC proposal and recommends it not progress to Stage 2.	Government approves Stage 4 assessment of VPC proposal and authorises Treasurer and Minister for Police to approve agreement for lease subject to resolution of outstanding VFM issues. Government approves WTC proposal not progressing to Stage 2.	Victoria Police: 41 423 sqm office space 30 years Total VPC including proposed subtenants: 60 784 sqm	Victoria Police: Net rent $418 per sqm $29.0 million (total including outgoings & cleaning) Total VPC including proposed subtenants: Net rent $445 per sqm $44.6 million (total including outgoings & cleaning)
	Dec	DTF briefs Treasurer on satisfactory resolution of outstanding VFM issues on VPC proposal Property developer submits MLP for a police headquarters at NewQuay site (NewQuay proposal).	Treasurer approves VPC proposal moving to Stage 5 and Minister for Police agrees		
2017	Jan	Victoria Police undertakes Stage 5 contract award DTF complete Stage 1 assessment of NewQuay proposal against 1 MLP guideline requirements. This MLP did not progress to Stage 2.	State signs agreement for lease for VPC proposal DTF approves NewQuay proposal not proceeding to Stage 2.		
	Apr	DTF releases Project Summary for VPC proposal.			
2018	June	AFP withdraws commitment to take up space in the VPC			
2019	Dec	Expected construction completion for VPC			

Source: VAGO based in information from DTF and Victoria Police.

Auditor-General's reports tabled during 2019–20

Report title	Date tabled
Managing Registered Sex Offenders (2019–20:1)	August 2019
Enrolment Processes at Technical and Further Education Institutes (2019–20:2)	September 2019
Cenitex: Meeting Customer Needs for ICT Shared Services (2019–20:3)	October 2019
Auditor-General's Report on the Annual Financial Report of the State of Victoria: 2018–19 (2019–20:4)	November 2019
Council Libraries (2019–20:5)	November 2019
Market-led Proposals (2019–20:6)	November 2019
Results of 2018–19 Audits: Local Government (2019–20:7)	November 2019

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