Tackling Housing Needs in Australia – Social and Affordable

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I. Introduction

A fundamental human right is to have a roof over one's head. Housing provides a stable base for establishing a platform for family, health and education. The location and proximity of housing to employment and social infrastructure has a significant impact on productivity in the economy. It is a key driver in a number of policies from health and education to economic and infrastructure development.[1] Housing is also central to the social welfare system in Australia.

Against the backdrop of widespread and worsening housing affordability crises across Australia's major cities, it is unsurprising that we are seeing an increasing strain on social housing infrastructure.[2] With high occupancy rates and long waiting lists, governments in Australia have been under growing pressure to reformulate social and community housing models in order to increase availability and efficiency of social and community housing.

In Australia, governments have a set policy and, where they can, partnered with community housing providers and the private sector to deliver projects aimed at relieving the strain placed on the availability of housing. [3] This paper provides an overview of how the NSW government is tackling what has become an increasingly prominent social issue. However, political will and policy are not on their own sufficient – social and community projects require long term financial investment whether that finance is sourced from the government, not-for-profit or the private sector. Faced with the challenges of obtaining finance, rising house prices and project delivery risks, Australian governments have had to procure projects using a number of different structures. This paper looks at some recent structures adopted by the New South Wales (NSW) government including the legal framework within which these project structures must operate. As many projects have only recently been procured, it remains to be seen how they fare in the future and whether they will be sufficiently robust to withstand the inherent uncertainty in the housing market and in government itself.

Whilst housing may be a fundamental right, ensuring equitable access to housing is not straight forward. It requires continued effort and an open mind as to which policy and project delivery approaches work best for each community so as not to marginalise further those who struggle to afford housing.

II. The Role of Government

1. The Commonwealth Approach

The Commonwealth and various state governments have adopted a multi-pronged approach to alleviating the strain placed on Australian housing. The Commonwealth government delivers policy aimed at controlling demand in the social and affordable housing sector whilst State and local government sets policy targeting housing supply.

The Commonwealth government also directly intervenes by providing assistance such as Commonwealth Rent Assistance[4], and programs such as the National Disability Insurance Scheme.

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1 CECODHAS Housing Europe, 'Financing Social Housing after the Economic Crisis' (2009).

2 Australian Institute of Health and Welfare, 'Housing Assistance in Australia 2017' (2016) <https://www.aihw.gov.au/reports/housing-assistance/housing-assistance-in-australia-2017/contents/housing-assistance-why-do-we-need-it-and-what-supports-exist> accessed 1 December 2017.

3 NSW Government, 'Social Housing in NSW: A discussion paper for input and comment' (November 2014) <http://www.facs.nsw.gov.au/__data/assets/file/0009/303030/Social-Housing-in-NSW_Discussion-Paper.pdf> accessed 1 December 2017.

4 Commonwealth Rent Assistance is a non-taxable income supplement payable to eligible people who rent in the private or community housing rental markets. Pensioners, allowees and those receiving more than the base rate of Family Tax Benefit Part A may be eligible for Rent Assistance.

2. The State Approach

The NSW Government has developed a raft of policies with a particular emphasis on Sydney. In early 2016, the NSW Government announced its 'Future Directions for Social Housing in NSW' (Future Directions) policy.[5] Future Directions is a ten year plan with three main aims:

- increase the supply of social housing;
- incentivise tenants to transition out of social housing;
- improve the social housing experience.[6]

As part of Future Directions, the NSW Government has outlined several key strategies through which it plans to increase the supply of social housing in NSW. These include redevelopment projects in collaboration with private sector and/or community housing providers (CHPs), housing management transfer programs, and innovative financing mechanisms. Described by one commentator as a 'big ticket item',[7] the NSW Government's building program seeks to expand supply by 'fast-tracking redevelopment of its social housing portfolio'.[8] As part of the amelioration of the social housing experience, larger redevelopment projects will be integrated with private housing, unlike the more traditional model whereby social housing is contained in a concentrated estate.[9]

Another policy is the 'Pathways Program' delivered by Housing NSW (an agency of the NSW Department of Family and Community Services (FACS)). This program assists with public housing, community housing, housing for Aboriginal and Indigenous Australians, private rental assistance and provides assistance to those looking to transition out of social housing.[10]

These policies have been implemented through projects such as the SAHF Program, the Communities Plus Program and Youth Foyer Project. Each of those projects will be examined further below.

The Victorian government has also established a $1 billion fund to meet service payment costs for 2,200 social housing dwellings that will be owned and operated by CHPs. This draws upon the NSW government's SAHF Program.

III. Role of Community Housing Providers

CHPs play a pivotal role in delivering housing. They are required to undertake strategic planning to ensure that the social housing assets that they own or manage are used efficiently and effectively in delivering social housing outcomes. In Australia, CHPs are broadly categories into three tiers. Each tier reflects their performance and regulatory engagement with tier one CHPs operating at higher levels of risk. CHPs are regulated by a National Regulatory Code delivered through the National Regulation System for Community Housing (NRSCH). [11]

1. Increasing the Prominence of CHPs Through Management and Services Transfers

An example of government partnership with CHPs was the NSW Government's announcement of the transfer of ownership of social housing properties to not-for-profit CHPs to provide them with an asset base with which to secure private sector loans to finance new development.[12] The plan is for those CHPs to be able to deliver more housing than government could through its own investment.

The NSW Government has also recently implemented its Social Housing Management Transfer Program (SHMTP) as part of its Future Directions policy. That program transfers responsibility for management services of those transferred homes

5 NSW Government, 'Future Directions' (2016) <http://www.socialhousing.nsw.gov.au/?a=348442> accessed 1 December 2017.

6 ibid, 5-7.

7 Steven Rowley, 'Focus needs to be on helping tenants leave social housing: academic' *Domain* (New South Wales, 25 January 2016).

8 (n 5) 9.

9 ibid.

10 NSW Government, 'Housing Pathways' <http://www.housingpathways.nsw.gov.au/> accessed 1 December 2017.

11 The NRSCH was established in 2011 through a joint initiative of the States, Territories and Commonwealth in 2011 (Charter published by the National Regulatory System for Community Housing Directorate, Document ID 001-04-13/NRSD <http://www.nrsch.gov.au/__data/assets/file/0011/288218/D_Charter.pdf> accessed 1 December 2017. By comparison, in the UK, social housing is provided by registered social landlords (generally called RSLs or housing associations) which are governed by the Homes and Communities Agency (HCA) Rules.

12 NSW Government, 'Community Housing Asset Ownership' <http://www.housing.nsw.gov.au/community-housing/community-housing-providers/community-housing-asset-ownership> accessed 1 December.

from government to CHPs.[13]

These transfers enable CHPs to:

- access additional revenue from rental income (including the Commonwealth Rent Assistance);
- access new streams of Commonwealth funding for affordable housing supply such as the National Rental Affordability Scheme (NRAS);
- minimise transaction costs such as the goods and services tax, which may be incurred during the acquisition and management of new housing, through their status as a charitable and / or public benevolent institution (PBI); and
- minimise other costs that would otherwise be incurred by a standard developer.[14]

2. Challenges with Transfers

Despite the apparent advantages of these transfers, they are complex and give rise to a number of risk considerations for the CHPs to manage. Firstly, CHPs need to ensure they have the capacity to take on the sudden influx of properties. CHPs need also to have a sufficient risk appetite and the experience to engage successfully with private sector financiers to secure finance for new housing. Transfers – whether they be of assets or services – are a technically demanding exercise which require considerable investment during the procurement stage.

Furthermore, there may be concerns in instances where there is staged transfer of existing service contracts, particularly around how incumbent service providers' work health and safety systems are to integrate with the CHP's system. In Australia, breach of work health and safety laws can result in criminal sanctions against the directors of an organisation. As such, concerns in this regard are at the forefront of issues considered by CHPs when partaking in such transfers.

Finally, it is not uncommon, as part of an asset transfer, for government to transfer employees to CHPs which adds an additional layer of complexity. CHPs will need to consider whether there are government enterprise agreements which have been incorporated into employment contracts, whether there are employment guarantee periods required as part of the transfer, and how accrued long service leave and annual are dealt with.

IV. Role of Finance

1. Challenges to Obtaining Finance

A persistent difficulty for the social and affordable housing sector is obtaining finance. This difficulty becomes particularly prominent when contrasting the internal rate of return of the social housing sector (1% - 2%) against that of property developers (20% - 25%) or institutional investors (7% - 9%).[15] Whilst the Commonwealth government provides Commonwealth Rent Assistance to tenants and there are other forms of indirect subsidies through Commonwealth and State grants, financiers and property developers generally treat those subsidies as being somewhat uncertain in the context of budget cuts, conservative fiscal policy and inconsistent public policy.[16]

Another challenge arises out of the segmentation of the social housing sector. Tier one CHPs typically manage or own around 2,000 to 3,000 properties which do not generate returns on a scale that financiers or institutional investors prefer (generally transactions greater than $100 million).[17]

2. Financing Social Housing

As with typical project financing structures, project financiers considering social and community housing projects generally focus on delivery risks and rev-

13 ARTD Consultants, Social Housing Management Transfer Program: Industry Sounding Paper 2 (2016) <https://www.facs.nsw.gov.au/__data/assets/file/0003/387507/IndustrySoundingPaper2.pdf> accessed 1 December 2017.

14 See also, H Pawson, V Milligan, I Wiesel and K Hulse. 'Public housing transfers: past, present and prospective' (2016) AHURI Final Report No 215. Australian Housing and Urban Research Institute.

15 A Sheko, Martel A Spencer, 'Leveraging Investment for Affordable Housing: A, Policy, Planning and Financing Options for Affordable Housing in Melbourne, Melbourne School of Design' (2015); A Conteh, B Liu, E Roca, 'Yes, Social Housing in Australia desperately needs Financial Institution' (2016), Discussion Paper, Griffith Business School; Infrastructure Partnerships Australia, 'From housing assets, to housing people: Fixing Australia's Social Housing System' (2016).

16 The Commonwealth, States and Territories provide approximately $10 billion per annum in housing assistance. The Commonwealth accounts for around 60 per cent of this assistance.

17 Mark Peacock, 'New model for financing affordable housing' (28 April 2016) <http://www.socialventures.com.au/sva-quarterly/new-model-financing-affordable-housing/> accessed 1 December 2017.

enue risks to ensure that the cash flows of the project are able to service repayment obligations.

In a more traditional project financing structure, financiers tend to require that risk be contained in a closed circuit to minimise any risk gaps. However, in the social infrastructure and social services projects discussed in this paper, project companies tend to retain more flexibility and risk having regard to the nature and size of each of those projects.

The sources of financing may include senior debt, mezzanine debt and/or subordinated debt including, or in addition to, debt provided by project sponsors, as project vehicles are frequently companies limited by guarantee and not-for-profit equity investments are often not feasible.

For some CHPs such as St George Community Housing, they have procured favourable loan terms by entering into financing arrangements with the Clean Energy Finance Corporation (CEFC).[18] This financial institution is a government created organisation that operates under the *Clean Energy Finance Corporation Act 2012* to support investment in the clean energy sector. For the CEFC financed projects, the projects are required to incorporate energy saving appliances and systems.

A key consideration for any investors and financiers (whether banks or other participants) in any project financing transaction is to ensure that the revenue streams are sufficient to cover the debt service payments, and provide an adequate rate of return on the investment.

For the social and affordable housing sectors, and the disability housing sector or youth foyers, the key revenue streams include:

- Commonwealth Rent Assistance and Continuity of Support Payment[19]
- Special Disability Accommodation payments[20] and Disability Support Pension[21]
- Independent Living Allowance for youths[22]
- NSW rental support[23]

Generally, financiers would require these payments to be directed by the tenants to bank accounts controlled by the financiers to service the debt payments in the first instance.

Another key consideration is the rate of return on the investments. In Australia, the sector is trying to get more investments from superannuation funds and other equity funds. One of the challenges is to get a sufficient rate of return for these investors. The ROR for social housing projects tend to fall in a range between 8-12%. Most funds will only invest with returns above 10%.

In the UK, there is limited but increasing real estate investment trusts (REITs) being established to focus on social housing with yields of 5-8%.[24] The additions to the increased opportunities for social impact investments to generate not only financial returns but also social returns.[25] There is renewed interest from individuals and institutions who wants to make a positive impact to help with society's disadvantaged citizens.

3. Social Benefit Bonds

Part of the innovation in the design and delivery of social housing projects has been the increase in the availability of novel financing options as part of social impact investments. One such example is the use of social benefit bonds or social impact bonds (commonly known as SIBs), which seek to ease the

18 CEFC, 'New Finance Gives NSW Community Housing a Clean Energy Boost' (September 2015) <https://www.cefc.com.au/media/107497/cefc-factsheet_sgcommunityhousing_lr.pdf> accessed 1 December 2017.

19 Australian Government, 'Commonwealth Rent Assistance' (September 2017) <https://www.dss.gov.au/housing-support/programmes-services/commonwealth-rent-assistance> accessed 1 December 2017.

20 NDIS, 'SDA Pricing and Payments' (July 2017) <https://www.ndis.gov.au/SDA-pricing-payments.html> accessed 1 December.

21 Australian Government, Department of Human Services, 'Disability Support Pension' (December 2017) <https://www.humanservices.gov.au/customer/services/centrelink/disability-support-pension> accessed 11 December 2017.

22 Australian Government, Department of Social Services, 'Families and Children' (2015) <https://www.dss.gov.au/our-responsibilities/families-and-children/benefits-payments/transition-to-independent-living-allowance-tila/eligibility> accessed 1 December 2017.

23 NSW Government, 'Community Housing Rent Policy' (February 2012) <http://www.communityhousing.org.au/Gold/story_content/external_files/CommunityHousingRentPolicy.pdf> accessed 1 December 2017.

24 Ashley Armstrong, 'Social housing trust targets £300m listing' *The Telegraph* (London,11 June 2017); Danielle Levy, 'New social housing Reit targets 5% yield' *Investment Trust Insider* (London, 27 April 2017); Rachel Fixsen, 'Social Housing: Homing in on cash flows' IPE Real Assets Magazine (London, May/June 2015)

25 K Muir, et al, AHURI, 'The opportunities, risks and possibilities of social impact investment for housing and homelessness' (August 2017) <https://www.ahuri.edu.au/__data/assets/pdf_file/0021/15339/The-opportunity-risks-and-possibilities-of-social-impact-investment-for-housing-and-homelessness-Executive-Summary.pdf> accessed 1 September 2017.

fiscal burden on government that comes with funding such programs, through the raising of private capital. Under these bonds, private investors provide an upfront capital injection to fund the development or expansion of social projects. Governments are then able to estimate the anticipated savings that they will derive from the successful long-term delivery of these social programs. The additional funds are then shared between government, the organisation delivering the service, and the private sector investors.

One of the defining features of social benefit bonds is that the return to investors – both periodic interest payments and repayment of principal at the end of the term – is pinned to certain performance indicators, which are aligned with the overarching objectives of the social program. Both the government's remuneration of the social organisation and the return-on-investment for bondholders are adjusted based on the program's performance against key outcome-oriented metrics. This performance-based payment structure incentivises the delivery of superior quality services, and the emphasis on 'outcomes rather than outputs' affords social organisations greater flexibility to explore innovative delivery models.[26] In this way, it is evident that social benefit bonds provide an effective solution for the financing of social programs, while also presenting a sound investment opportunity for private sector players. A recent example is the Newpin Social Benefit Bond (geared towards restoring families) which has raised $7 million and is expected to enable the NSW government to save approximately $95 million over the long term.[27]

4. A Way Forward

Governments, financiers and venture funds have at different times proposed various financing options including establishing the Australian Housing Finance Aggregator (AHFA).[28] Its role would be to aggregate the need for finance from multiple CHPs and obtain finance from the private sector for that aggregate amount. The proposed AHFA is expected to operate in a manner similar to the Housing Finance Corporation in the United Kingdom.

V. Case Studies in New South Wales

1. Communities Plus Program[29]

A recent example of the NSW Government's partnership with a private developer is the planned development of the Ivanhoe Estate at Macquarie Park, NSW as part of the broader Communities Plus program.[30] The estate will be developed into 3000 units which will include at least 950 social housing units and 128 affordable rental units.[31] This mix of social and private housing is part of the NSW Government's drive to ameliorate the social housing experience and encourages the transition out of social housing. The private housing aspect enhances the project's viability which has attracted the attention of some of Australia's largest developers.

A key risk that governments need to consider is movement in the housing market. Although developers may partner with governments to deliver social housing or mixed use developments, their focus will generally be on the sale of the private housing component of the project.

a. Project Delivery Structure

An example of this type of delivery structure is for the developer to undertake the financing and delivery of the dwellings through a project delivery deed.

26 Social Ventures Australia, 'Information Memorandum Newpin Social Benefit Bond April 2013' (April 2013) 13 <http://www.osii.nsw.gov.au/assets/office-of-social-impact-investment/files/Newpin-Information-Memorandum.pdf> accessed 1 December 2017.

27 Around 50% of those savings will be retained by government with the remainder to be distributed to UnitingCare and investors. More information available at <http://www.socialventures.com.au/work/newpin-social-benefit-bond/> See also, (n 27).

28 Mark Peacock, 'New Model for Financing Affordable Housing' (28 April 2016) SVA Quarterly.

29 NSW Government, 'Communities Plus' <https://www.facs.nsw.gov.au/reforms/social-housing/communities-plus> accessed 1 December 2017.

30 Where developers and CHPs have been invited to redevelop a number of sites. The major sites in NSW include the Ivanhoe Estate (8 hectares), Waterloo (18 hectares), Riverwood (30 hectares), Arncliffe (1.33 hectares). See further detail at <http://www.communitiesplus.com.au/major-sites/ivanhoe-1> accessed 1 December 2017.

31 NSW Government, 'Media Release: Ivanhoe Estate: Australia's Biggest Social and Affordable Housing Development' (14 August 2017) <https://static1.squarespace.com/static/5625d102e4b0040b09643cc5/t/5990f65ae58c6284b2a7760a/1502672478421/NSW+Government+Media+Release+-+Ivanhoe+Redevelopment+-+14+Aug+2017.pdf> accessed 1 December.

A CHP – in this case, Mission Housing Australia – provides support services such as education, training, employment programs and other tenancy management services. The provisions of these services is typically governed by the terms of a lease (or an agreement for lease). The CHP may also enter into an implementation agreement with the developer to govern the CHP's involvement in the project during the deliver phase. The implementation agreement typically obliges the CHP to assist the developer with obtaining approvals, reviewing design and variation to design, and other assistance that can be supplied using the CHP's internal resources. The implementation agreement is the mechanism through which the private housing and social housing aspects of a project are coordinated and integrated smoothly.

As with projects that receive project finance, side deeds are required which primarily govern the financier's step-in and cure rights. Figure 1 above sets out the framework of such a structure.

b. Project Delivery Risk

The Ivanhoe Estate project has been structured such that the dwellings are to be delivered in a number of stages over the course of 10 to 12 years. The developer is responsible for delivery risk and management of different builders for various project stages.

c. Revenue Risk

The revenue which will be received by the developer will be based on the sale of the private housing dwellings. The appropriate yield that the developer will receive as part of the overall commercial deal has been pre-agreed with FACS, and is intended to allow the developer to deliver the project with an acceptable rate of return.

2. Social and Affordable Housing Fund

Another example of the NSW government's push to deliver social housing is creation of, and $1.1 billion contribution to, the Social and Affordable Housing Fund (SAHF). Contracts have been awarded to five parties[32] who will deliver and then manage 2,200 additional social and affordable homes cumulatively.

The NSW government has previously adopted the public private partnership (PPP) model to deliver social housing projects. Whilst there have been some difficulties in the past, particularly during the onset of the global financial crisis[33], a variant of this model is used for the SAHF program. In a PPP styled structure, a special purpose vehicle is established as the project company which is key contracting party that enters into the project or delivery agreement with the government. There are a number of risks percolating throughout the structure which need to be considered in a social housing context.

Financiers will need to consider the feasibility of social housing projects having regard to the project delivery and revenue risks. In most cases, the project risks associated with social housing projects are less risky than major infrastructure projects or private housing development projects. However, the consequences of a default on a social housing project is likely to trigger a social and political reaction greater than that which would be expected on a traditional infrastructure or development projects. Furthermore, the project companies contracting for social housing projects are usually not-for-profit CHPs or companies limited by guarantee with a charitable status.

In June 2017, the NSW government announced the market sounding exercise of phase 2 of the SAHF program to commence in 2017/2018 financial year.[34]

a. Project Delivery Structure

The first phase of the SAHF program is based on a public private partnership type structure where a project company enters into an agreement (the Services Agreement) with the Department of Family and Community Services (FACS). The services will be delivered in two stages.

The first stage is a design and construction phase where the project company will deliver dwellings over a number of building sites at different stages of the planning approval process. The project company

32 They are BaptistCare NSW & ACT, Compass Housing Services Co Ltd, St George Sustainability Limited, St Vincent de Paul Housing and Uniting. See further details at <https://www.facs.nsw.gov.au/reforms/social-housing/SAHF>

33 On the Bonnyrigg project, a $733 million redevelopment of a government-owned estate, the developer struggled to refinance the project during the global financial crisis. Accordingly, the project was terminated.

34 ANZIP, 'Social and Affordable Housing Fund' (2016) <http://infrastructurepipeline.org/project/social-and-affordable-housing-fund/> accessed 1 December 2017.

will then engage a number of builders who will execute separate design and construct contracts to carry out certain packages of work.

The second stage is a services stage where the project company provides tenancy and asset management services, coordinates access to support services, and performance and data reporting for a 25 year period. In the case of St George Community Housing, it will be providing these services through a services subcontract.

b. Project Delivery Risk

As this project was based on a public private partnership type structure, financiers expected the project company to retain as little risk as possible and for risk to be contained in a closed system. The risk exposure of the project company is mitigated by crafting downstream agreements to mirror upstream agreements on a back to back basis. Figure 2 (below) sets out the general structure.

c. Revenue Risk

Revenue will be based on service payments to be received from FACS. To the extent there is poor performance, those service payments will be abated. Performance is measured against specific key performance indicators (KPIs) which are set out for each type of service – for example, tenant satisfaction, dwelling condition, and timely completion of reports. Against each KPI, performance incidents –such as negative tenant feedback and failing to report when required – are described. If performance incidents occur, service payments are abated according to preset formulae. See, Figure 2.

3. Youth Foyer Program[s]

In a recent Youth Foyer project, the Foyer 51, the proponent, Uniting Care [35] has undertaken the delivery of a youth foyer project financed with a social benefit bond, which will operate similarly to the Newpin social benefit bond model.[36]

a. Project Delivery Structure

Under this structure, Uniting will enter into an implementation agreement with the NSW government to deliver services and receive payment for those services. The revenue that Uniting will receive from the government is based on the outcomes it delivers as part of the services. The funds from the social benefit bond will be used to repay a loan from the social benefit bond provider with security granted over the implementation agreement.

Under a separate services agreement, St George Community Housing, a CHP will finance and develop the building that Uniting is required to make available the accommodation as part of the services under the implementation agreement.

b. Project Delivery Risk

Uniting Care retains primary responsibility for delivering a performance based outcome. The housing obligations are transferred to the CHP. Figure 3 (above) sets out a typical structure involving social benefit bonds.

c. Revenue Risk

Payments will be reduced if the requisite outcomes are not met which will impact on Uniting's ability to meet its debt service obligations.

VI. Legal Issues to Consider

The social housing projects outlined above are quite complex when considering the structure and commercial risk characteristic of projects of a similar scale and nature. Overlaying this is the legal and regulatory framework within which these projects must operate.

1. Performance-Based Contracting

Whilst the delivery structure of social housing projects may vary, they share a common feature in that they are performance-based contracts (PBCs) (in

35 Uniting Care is the services and advocacy arm of the Uniting Church NSW and ACT.

36 NSW Government, 'Social impact investment to increase opportunities for young people at risk' (12 September 2017) <https://www.facs.nsw.gov.au/about_us/media_releases/social-impact-investment-to-increase-opportunities-for-young-people-at-risk> accessed 1 December 2017.

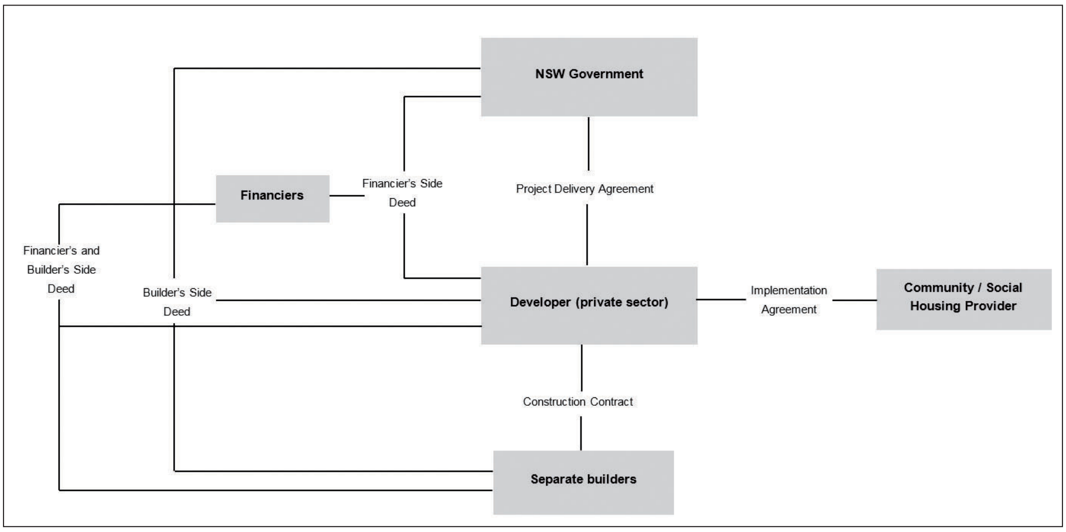

Figure 1: Financiers.

general, measured in outputs or outcomes). PBCs include three key features:

- clear definition of objectives and indicators by which contractor performance can be measured;
- collection of data on the performance objectives and indicators to assess the extent to which the contractors are successfully (or unsuccessfully) implementing the scope of services; and
- performance leading to consequences for the contractor, such as the use of a monetary pain share – gain share schemes, and other rewards or the imposition of sanctions. These can include further extension of the contract terms based on outstanding performance, provision of performance bonuses, or public recognition. Sanctions can include termination of the contract, financial penalties, public criticism, and debarment from receiving future contracts.

Results-oriented statements of work with clear objective performance standards and measurement tools and incentives encourage superior performance. The payment mechanism can be based on a fixed fee or costs plus structure with an incentive or abatement regime (or both).

2. Payment

In the project agreements for PPP projects and service delivery projects in Australia, a typical payment mechanism for a social infrastructure project (such as a hospital, school, or prison) is monthly service payments based on a formula which allows for abatement of the service fee for failures to achieve performance standards and certain volume and energy adjustments. The service payments are subject to meeting KPIs, which are typically set out in service specifications.

For social housing projects, services typically required from a contractor include asset management, tenancy management, cyclical and life-cycle maintenance, property management and delivery of a broader housing program. The contractor may be paid by service payments from the government or rent collection (including government rent assistance where available), or a combination of both. These payments may include indexed and non-indexed components and are adjusted to reflect the quantum and quality of the services provided by the service provider.

Whilst the mere transfer of services to the private or social housing sectors may appear to be a simple method of leveraging industry-specific expertise, as outlined above, these transfers are usually complex. For example, where there is more than one party delivering different services, and where governments require those parties to coordinate their activities amongst themselves, each party needs to consider how this coordination can impact on their performance (and thus their payment) and their ability to claim for loss or damage.

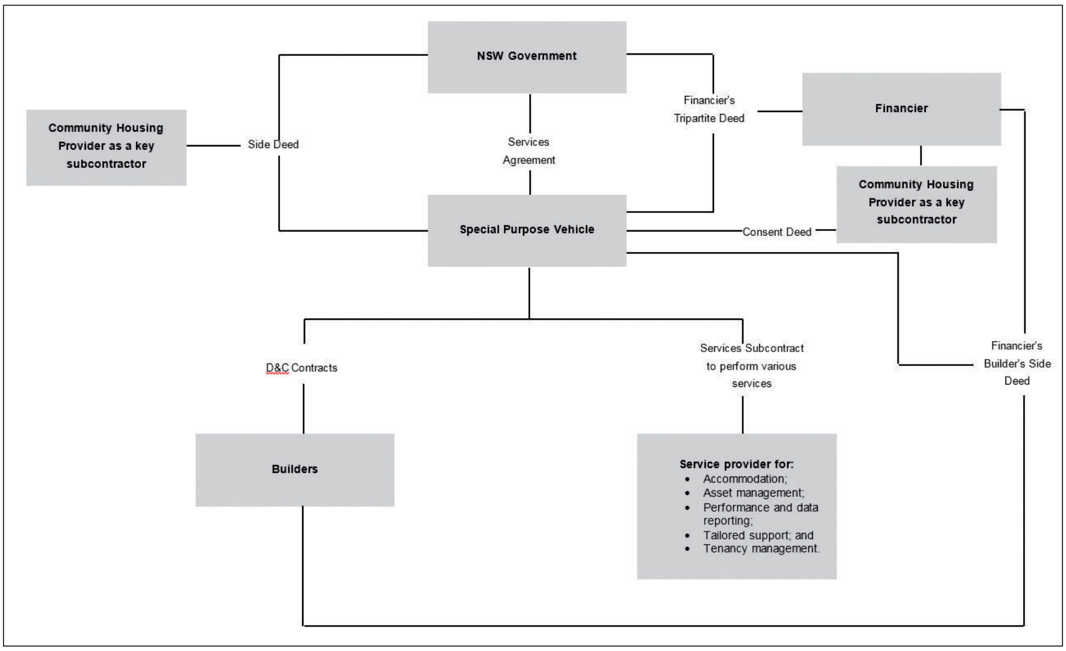

Figure 2: Community Housing Provider

3. Performance Measurement

In PBCs, a failure to provide services in accordance with KPIs typically constitutes a 'service failure' (or other similar term), including area failures (where the failure affects one or more particular area) and quality failures (failures that are not specifically linked to areas – for example, security and reporting).

There are number of ways in which the project company's performance can be measured. For example, the project company may be required to provide performance and data reports as part of the package of services delivered. The performance frameworks may set outcomes such as program specific KPIs against which the project company's performance is measured.

For social housing projects, the project company is also typically required to meet certain outcomes or targets which reflect broader policy objectives, such as:

– successfully transitioning tenants from social and affordable housing to private housing;
– supporting economic independence;
– promoting personal wellbeing;
– facilitating access to learning and education;
– providing support services to promote stability and physical wellbeing; and
– providing a permanent house for the duration of the tenant's needs.

These outcomes may be measured through means such as tenant surveys, tenant complaints and appeals, the number of positive exits from social housing, and use of support services. However, changes to policy (and thus to the outcomes measured) over the term of the project can be problematic if those changes impact on performance. It can also be difficulty to elicit tenant responses so as to consistently and objectively measure performance.

Performance may also be measured through information sharing arrangements between government agencies and the project company. Reports of those outcomes are typically required to be provided on a periodic basis (quarterly, biannually, annually or otherwise) and may include information such as the standard of assets, medium to long term asset plans and the like.

4. Abatements

There are often detailed formulae set out in the contract relating failures to abatement or deduction. A recent example of such an arrangement that was litigated is *Compass Group UK and Ireland Ltd v Mid Essex Hospital Services NHS Trust*.[37]

In Australia, because of the fundamentality of breach, before *Andrews v Australia and New Zealand Banking Group Ltd*,[38] such abatements or deductions were not considered penalties. They were contractually agreed formulae based on non-achievement of pre-agreed targets in KPIs. Any deduction or payment was not dependent on breach of contractual terms.

Following *Andrews,* the inquiry has changed. The question is no longer whether there has there been a breach (ie the first prerequisite to the penalty doctrine pre-Andrews). Rather, the question is now simply whether these abatements are unconscionable (or perhaps 'unconscientious')[39] and are, in substance, an extravagant attempt to secure a level of service in line with the service specifications. If so, the abatement (or the portion of it that is extravagant) may be a penalty. Alternatively, a court may find that the abatement is a genuine pre-estimate of the loss suffered by the government (or facility owner) for suboptimal performance.[40]

Due to the potential unenforceability of contractually agreed abatements, parties will need to be careful in how they structure the incentive and abatement regimes commonly used in PBCs. Fundamental to PBCs is the ability to create incentives for good performance by punishing a contractor for poor performance. Despite the many recognised efficiencies arising from PBCs,[41] the mechanism by which these efficiencies are achieved may (at least to some extent) be unenforceable. This creates difficulties both at the pre-contractual negotiation stage and at the performance stage.

At the pre-contract stage, parties are forced to effectively guess how tolerant a court will be in balancing their right to contractual freedom with legal and equitable principles. Owners and contractors must attempt balance two competing forces, the first being a desire to set an abatement that is large enough to secure performance and the second being to ensure that the abatement is not so large that it is unenforceable. Whilst this uncertain balancing exercise is not desirable, the recent social housing projects continue to be performance-based particularly during the longer services component of the contract term.

There are also significant issues which arise during the performance stage. For example, where an abatement may be set aside and the only recourse is to provable loss, contractors may find it more profitable to fail to perform an obligation to the agreed level. This effectively creates incentives to underperform in contracts as the onus of proving loss falls on the project company. This issue is magnified in PBCs as the contract price for PBCs tends to be higher than that for traditional contract. This is because the owner (in this case, the government) expects to receive optimal performance and has the comfort that where such performance is not achieved, the price will be discounted through abatements. Where an abatement is set aside in social housing projects, the government will be paying higher than normal prices for contracts and only receiving the benefit of minor

37 [2012] EWHC 781 (QB) at [12]–[18], [36]–[46]. How it was applied in practice (and, in the result, in breach of contract) is set out at [47]–[78]. The decision illustrates that, penalty doctrine aside, there are already a number of complex legal issues that arise in the context of PBCs. *Compass* was a dispute between Medirest, a catering company, and the NHS Trust, a hospital administrator. The parties entered into a long-term facilities contract for the provision of catering services. The contract included a mechanism that enabled deductions to be made by the NHS Trust in the event of performance failures by Medirest. Following unrelenting deductions by the Trust for apparently minor service failures, including the storing of out-of-date ketchup, both sides claimed the other had repudiated the contract. The High Court found that the Trust abused the abatement regime in order to reduce its service payments. The Court held that this breached the Trust's explicit obligation of good faith in the contract and that this amounted to a repudiation by the Trust. *Compass* illustrates that even where an abatement is not unconscionable in magnitude, such that it may be considered penal, where an otherwise enforceable regime is applied unconscionably, such conduct may constitute a breach of contract. See also *Portsmouth City Council v Ensign Highways Ltd* [2015] EWHC 1969 (TCC).

38 (2012) 247 CLR 205. Andrew's case was followed by: Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28, and a later case Australia Capital Financial Management Pty Ltd V Linfield Developments Pty Ltd (2017) NSWCA99 which at para [374] stated "If compensation can be made ... for the prejudice suffered by the failure of the primary stipulation, the collateral stipulation and the penalty are enforced only the extent of that compensation. The first party is relieved to that degree from liability to satisfy the collateral stipulation." (Andrews v ANZ Banking).

39 See *Australian Broadcasting Corporation v Lenah Game Meats Pty Ltd* (2001) 208 CLR 199 at 244–245 [98] per Gummow and Hayne JJ; [2001] HCA 63, citing *Commonwealth v Verwayen* (1990) 170 CLR 394 at 444, 446 per Deane J.

40 This, presumably, will be tested—at least for the moment – according to the principles set out by the High Court in *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656 where the High Court expressly left open a reconsideration of the relevant principles at 663 [12].

41 There are numerous studies that consider the merits of PBCs. While the net benefit of PBCs is still being heavily debated, most academics agree there are efficiency gains from PBCs. For a recent study, see J Guajardo, M Cohen, and S Kim, 'Impact of Performance Based Contracting on. Product Reliability: An Empirical Analysis', (2012) 58(5) Management Science 961.

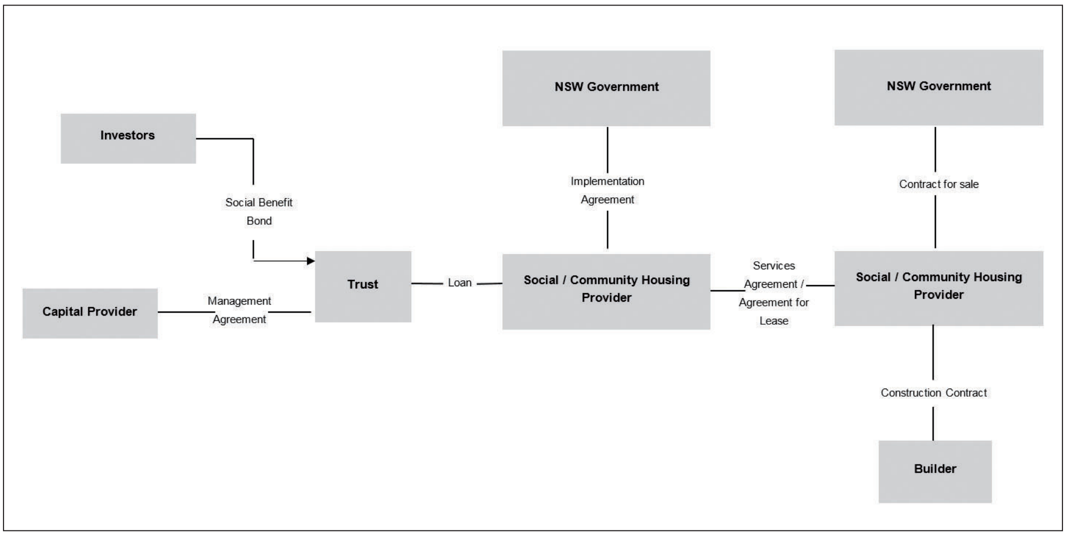

Figure 3: Capital Providers / Investors

deductions for suboptimal performance which defeats the intent of the contract and undermines the financing innovations developed at the pre-contract stage.

5. The Obligation to Act in Good Faith in Australia

The contracts for tenancy and lifecycle management contracts are often long term contracts with the duration of the contracts matching the concession periods under the project delivery agreements or implementation agreement with the government. Such contracts will often contain an express obligation that the parties are to act in good faith, imposing a standard of behaviour on the parties when performing their obligations. As a general proposition, an agreement to negotiate 'reasonably' and 'in good faith' is sufficiently certain to be enforceable.[42] However, in Australia there exists no clear judicial statement on the definition of good faith, therefore debate continues as to its scope and application, and what is considered good faith will inevitably turn on the facts of each case.[43]

This was confirmed in *Strzelecki Holdings Pty Ltd v Cable Sands Pty Ltd*,[44] where Pullin J considered that good faith is determined by the objective meanings of the words which a reasonable person would have understood them to mean rather than the parties' subjective understanding.[45] The contract must be considered as a whole and the construction and interpretation of the contract is determined by taking into account the objective background of the transaction or factual matrix of the contract.[46]

In *Macquarie International Health Clinic Pty Ltd v Sydney South West Area Health Service*,[47] Also Pullin described the 'usual content' of the obligation of good faith, as incorporating obligations:

- to act honestly and with a fidelity to the bargain;
- not to act dishonestly and not to undermine the bargain; and / or
- to act reasonably and with fair dealing having regard to the interests of the parties (which will invariably conflict) and to the provision, aims and purposes of the contract, objectively ascertained.[48]

42 See United Group Rail Services Ltd v Rail Corporation of New South Wales (2009) 74 NSWLR 618.

43 See Jobern Pty Ltd v Breakfree Resorts(Victoria) Pty Ltd & Ors [2007] FCA 1066, [138].

44 [2010] WASCA 222.

45 ibid 46; see also *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd* (2004) 219 CLR 165.

46 ibid 47; see also Australian Broadcasting Commission v Australasian Performing Right Assn Ltd (19730 129 CLR 99 at 109 and *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd* at [40]-[41].

47 [2010] NSWCA 268.

48 ibid, citing Renard Constructions (ME) Pty Ltd v Minister for Public Works (1992) 26 NSWLR 234; Hughes Bros Pty Ltd v Trustees of the Roman Catholic Church for the Archdiocese of Sydney (1993) 31 NSWLR 91; Burger King Corporation v Hungry Jack's Pty Ltd (2001) 69 NSWLR 558, Alcatel Australia Ltd v Carcella (1998) 44 NSWLR 349 and United Group Rail Services v Corporation New South Wales (2009) 74 NSWLR 618.

In *North East Solutions Pty Ltd v Masters Home Improvement Australia Pty Ltd*,[49] the Supreme Court of Victoria recognised that an express obligation to act reasonably and in good faith to attempt to resolve differences in regards to the valuation of construction works was enforceable. Croft J found that the parties committed to act reasonably and in good faith having regard to the express terms of the arrangement and the circumstances of the case. In this case, the commercial relationship between the parties played a role in the court's decision.

Whilst the duty of good faith is well established in the United States of America[50] and a number of European civil law jurisdictions[51], the High Court in Australia is yet to make a final determination. What is clear is that where there is an express obligation under a contract to act reasonably and in good faith, all parties to that contract must adhere to the principles outlined above. Parties to a contract should continue to be mindful of the possible implications when agreeing to take on an obligation to act in good faith.

VII. Regulatory Framework in Australia

There is an extensive regulatory framework within which social housing projects must be delivered. In developing integrated housing developments, there are various planning, property and construction laws which the parties must navigate. There are also important titling considerations in respect of shared rights of access, use of common facilities, use of shared services, rules governing the interface between owners of different parts of a building (including airspace division) and the potential for future development. A number of documents may be required to deal with these issues such as survey plans, building management statements,[52] community management statements (for strata schemes), leases, licences, easements, and side agreements. For larger projects, these documents are generally based on airspace subdivisions whereas smaller projects will be based on land or strata subdivisions.

There may also be a need for voluntary planning agreements which are a mechanism through which authorities and developers cooperate to develop and deliver infrastructure outcomes.[53] Typically, developers are required to contribute a monetary amount, dedicate land free of cost or provide other material benefit for a public purpose (including, for example, public amenities, public services, affordable housing, transport, etc).

VIII. Conclusion

It seems that a genuine effort is being made by Australian governments to tackle the limited supply of affordable housing for those most in need – particularly in NSW and Victoria. This effort is evident in the push to deliver social housing projects and the innovative financing structures used for these projects. This readiness, coupled with increasing involvement of the private and not-for-profit sectors, suggests that the outlook for those most marginalised by unaffordable housing may improve in the not too distance future. As many of these projects are still in their early stages, it remains to be seen which structure ends up being the preferred approach for social housing projects.

49 [2016] VSC 1.

50 See UCC § 1-201 which defines 'good faith' as 'honesty in the conduct or transaction concerned'.

51 Art 1134, s 3 French Civil Code; § 242 German Civil Code; art 2 Swiss Civil Code; Art 1175 and 1375 Italian Civil Code; Art 288 Greek Civil Code; Art 762, s 2, Portuguese Civil Code, Arts 6:2 and 6:248 Dutch Civil Code. Art 7 Spanish Civil Code.

52 These generally provide for the establishment of the building management committee, insurance, rights and obligations on the use of shared facilities, services, architectural codes, maintenance standards, cost-sharing agreements, arrangements for future development. See, for example, the approved form as required by section 196E of the *Conveyancing Act 1919* (NSW).

53 In NSW, these are formalised under section 93F of the *Environmental Planning and Assessment Act 1979* (NSW).