OBSERVATION
TD Economics

March 20, 2017

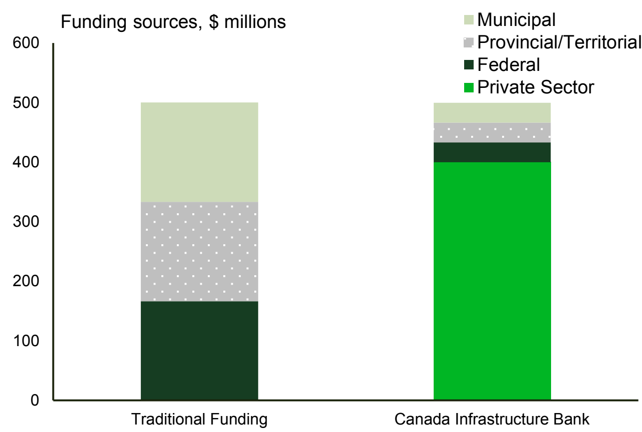
BANKING ON A NEW INFRASTRUCTURE BANK: SOME CONSIDERATIONS

Highlights

- The federal government is in the process of creating a Canadian Infrastructure Bank (CIB), an arm's length investment vehicle intended to leverage an initial $35 billion in public funds to attract about $140 billion in private capital. Further details regarding the agency are expected to be revealed in the 2017 budget, but on its face, this would deliver a much-needed boost to Canada's aging system of infrastructure.
- The Canadian Infrastructure Bank adds to the existing funding landscape, which includes provincial agencies focused on bringing infrastructure projects to market and advising on funding structure. As such, it will be crucial for the CIB to fill a need that exists rather than cover the same turf - ensuring its operational independence will help achieve this goal.
- To help ensure that it will be an additive force for infrastructure, the CIB is set to focus on a sub-set of 'economic infrastructure' projects with revenue-raising potential, such as roads, rail, and other transportation projects. Other potential areas include broadband, water systems, and power generation. The use of a revenue model could open the door to increased risk transfer to the private sector.
- In order to attract private investment, the Bank plans to apply an innovative and broad range of financing tools, including loans, equity and debt guarantees. Most importantly, in a break from past models, the CIB intends to use the potential for private ownership of assets to attract and lever a broader universe of financial partners - a common model in other jurisdictions.
- Placing the Infrastructure Bank in the current context, and drawing on international examples, guiding principles can be established. It is recommended that a focus be placed on large scale, net-new projects that fit with clearly defined priorities, while developing a center of expertise. At the same time, a commitment to transparency and critical evaluation, including at the project level, will help ensure the long term success of the agency and its projects.

In the Fall 2016 Economic Update, the federal government announced that it will create a "Canadian Infrastructure Bank", with the goal of leveraging public funds to attract private investment in infrastructure. Canada faces sizeable needs for infrastructure investment to support future growth and there are hopes that such an approach could reduce the fiscal impact by as much as a factor of four (Chart 1). It is still early days however, and details are scarce. Given that the Bank is still in its design phase, this report takes a high level view of the current state of play, as well as what guidelines should be considered in designing the organization. We draw on international experience to provide some guidance on the best way to structure an infrastructure bank, taking stated goals and the Canadian context into account.

CHART 1. INFRASTRUCTURE BANK AIMS TO LEVERAGE PRIVATE SECTOR FUNDS



Source: Government of Canada; Example based on a $500mm project with 4:1 leverage.

Brian DePratto, Senior Economist, 416-944-5069
Dina Ignjatovic, Economist, 416-982-2555
Guillaume Couture, Research Analyst, 416-982-6855

@TD_Economics

Setting the stage: context and progress to date

The federal government has been forging ahead with its newly-created Canadian Infrastructure Bank (CIB). A transition office is now open, with Jim Leech (an experienced pension plan executive) in place as special advisor, with some limited hiring already taking place.

Specific goals of the CIB have not been formalized, but a November statement from Finance Minister Morneau's economic advisory council provides some guidance, suggesting a focus on "… projects such as toll highways and bridges, high-speed rail, port and airport expansions, smart city infrastructure, national broadband infrastructure, power transmission and natural resource infrastructure".

Beyond these broad guidelines, little is yet known about the specific functioning of the Bank. At the moment, it appears that all possibilities are on the table in terms of financing arrangements, with direct loans, loan guarantees, equity stakes, or hybrid approaches all under consideration. The innovation of the CIB, as it stands, is not necessarily in the financing arrangements, but rather in terms of ultimate ownership: private ownership of infrastructure assets is seen as a key incentive to attract private capital, leveraging government funds to generate additional investment and helping develop projects that would otherwise not be feasible under current structures.

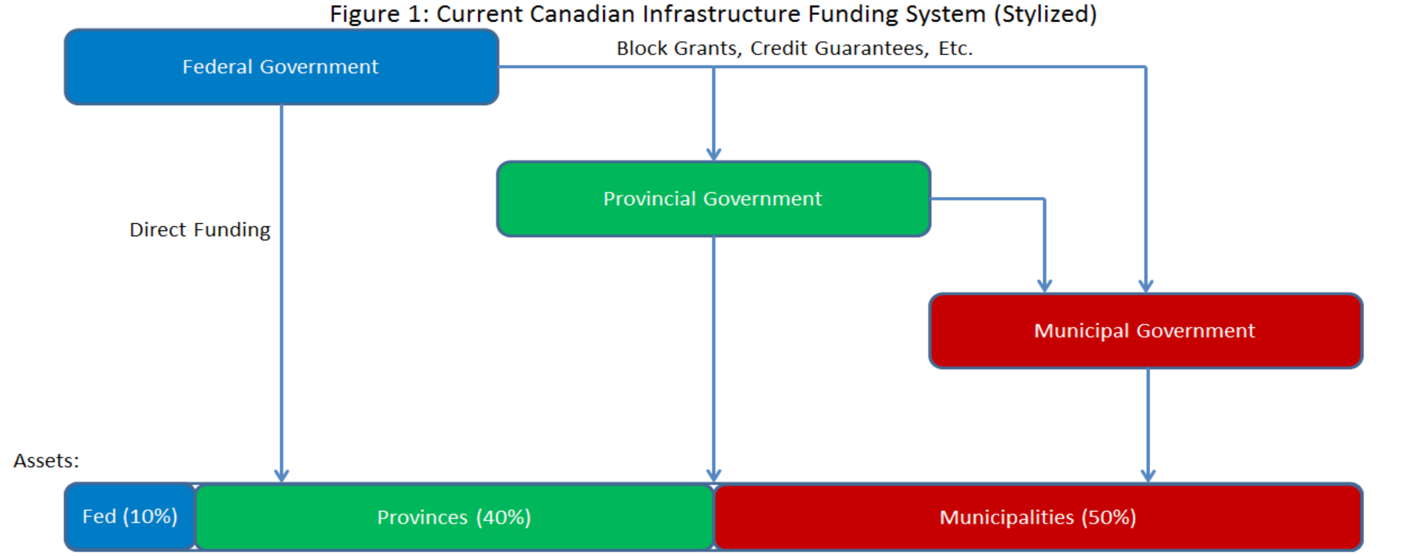
In the Fall Update, the government committed to investing $35 billion (on a cash basis) to seed the CIB. The exact structure of the initial capitalization is unclear, with the government expecting an impact on the fiscal framework (i.e. in net debt terms) of approximately $15 billion (or about 10% of total planned infrastructure planning over the next 10 years), amortized over time. The remaining $20 billion is not expected to have an impact on the government's fiscal framework as assets funded with this tranche are to match liabilities (presumably the government/CIB would record the assets as financial assets given the associated revenue streams).

CIB expands the Canadian funding ecosystem

The public infrastructure funding ecosystem in Canada is perhaps best described as a tier of waterfalls: funds from the federal government either pour over into sub-national government tiers, or flow directly to infrastructure projects. In turn, provinces may fund assets directly, often with federal government funds included, or provide funds and/or other assistance (such as credit enhancement) to municipalities. Municipalities sit at the bottom of these falls, developing infrastructure with a mix of their own funds, as well as potential funds from the other two tiers of government. The bulk of Canadian infrastructure is held at the municipal level, with significant assets at the provincial level as well. In contrast, the federal government directly controls only a small fraction of infrastructure assets (Figure 1).

Within this framework are a multitude of funding agencies with differing goals and strategies. Several federal agencies exist, while many larger provinces have one or more funding agencies. Some, such as Infrastructure Canada, are focused on direct financing of projects, while others, such as Partnerships B.C. and the Ontario Financing Authority are

Figure 1: Current Canadian Infrastructure Funding System (Stylized)



Source: TD Economics. Asset ownership figures are approximate.

focused on driving projects forward, often through promotion of a public-private partnership (PPP or P3) model. Some agencies, notably the P3 Canada Fund, focus on delivery, rather than identification or development of projects: the P3 Canada Fund provides a financial incentive (federal funding for 25% of the total project cost) for municipalities to deliver assets using the P3 approach. In many cases, agencies also offer their expertise to municipalities in areas such as contract design and procurement. Nearly all agencies function as an arm of their respective governments.

With the rich and varied Canadian infrastructure procurement and delivery landscape has arisen a body of expertise, particularly around the delivery of projects using the P3 model. To date however, with limited exceptions, the focus among these agencies has been on traditionally non-revenue generating projects in areas such as health care, as well as transportation projects (also, to date, generally without revenue generating components). Thus, the CIB's stated emphasis on revenue-generating projects and the prospect of innovation around asset ownership structures should serve to clearly differentiate it. Moreover, independence in how the CIB achieves its goals will both further distinguish the agency from its existing counterparts, and attract private capital. These characteristics should ensure that the CIB is truly additive to the Canadian infrastructure ecosystem.

Looking beyond delivery

It is the focus on leveraging public funds to attract private investment that should separate the CIB from existing agencies. What this will specifically mean in practice is yet to be seen, but the focus on revenue-generating projects suggests that the bulk of assets will eventually not just be private sector operated, but also privately owned. Currently, there are three broad delivery systems for infrastructure:

1. Traditional public: Public sector funds, delivers, maintains, and owns the asset;

2. Public-private partnerships: Private sector involved in funding, delivery, and potentially maintenance of the asset, with the public sector retaining ultimate control/ownership;

3. Traditional private: Private sector funds, develops, maintains, and owns the asset without direct public sector involvement.

The approach being discussed for the CIB would appear to place it somewhere between numbers 2 and 3. Infrastructure projects with clear and defined future revenue streams which make them well suited for private sector and institutional investors. The challenge is that these projects also come with significant risks (i.e., long-term horizons, large capital costs and revenue unpredictability) that can be major impediments to private investment, or may have social benefits that are difficult to capture/price (positive externalities). The role of the CIB would likely be to structure deals in a way that ensures project viability while still transferring an appropriate amount of risk to the private project owner.

While the CIB initiative represents a shift in the status-quo, it is important to stress that both models 1 and 2 will remain the dominant delivery structures. At the federal level, investments through the CIB are incremental to the $105 billion in funding that the government has set aside over the next 12 years under its existing funding programs (as it represents $15 billion of the $81 billion in additional spending pledged in the 2016 Fall Economic Statement, or less than 10% of the total spending plan). Nor is federal participation in private infrastructure projects unprecedented. One example is the development of the Confederation Bridge in the 1990s, while more recent (and still ongoing) projects include the Champlain Bridge in Montreal and the Gordie Howe International Bridge between Windsor and Detroit. Still, the list of projects is very small. The establishment of the CIB represents a major step to more formally adopting this approach to address Canada's large infrastructure needs.

'Infrastructure gap' of the future, not the past

Much has been made of the need to address Canada's 'infrastructure gap'. No single definition exists, but a common measure, produced by the Canadian Construction Association, Public Works Association, Society for Civil Engineering, and the Federation of Canadian Municipalities suggested an infrastructure gap of $388 billion (or roughly 20% of GDP) in 2016. This figure is calculated by, effectively, looking at the state of municipal infrastructure, and determining the cost to replace assets that are in disrepair, or close to it – a 'state of good repair' calculation.

It is unlikely that the CIB will do much to address this backward-looking gap. To begin with, much of the infrastructure types captured by the measures do not match up with the guidance provided by Minister Morneau, although commonalities likely exist in terms of 'smart city infrastructure', as well as roads and bridges. Moreover, the existing funding ecosystem is well placed to address this gap, as it funded this infrastructure to begin with, and the CIB is to a large extent 'new money' – that is to say that funds will still exist for maintenance and repair of assets in the existing system. Finally, there is the issue of size: the majority of Canadian infrastructure assets are small in size, and thus, absent bundling of projects, unlikely to be of much interest to potential private sector partners.

While it is possible that the CIB may work to address these deficiencies, it would seem that a better use of resources would be for the CIB to focus on a more forward-looking infrastructure gap – addressing the potential needs of tomorrow, rather than maintaining yesterday's assets. This does not rule out a role in the replacement of existing infrastructure, but rather that in such cases a need for more than repair/replace should be identified, alongside a potential revenue structure.

Existing organizations offer guidance

While the notion of an "infrastructure bank" may be new in Canada, there are many models being adopted abroad that can provide some guidance. Among the major international organizations, goals and characteristics tend to vary: for instance, the European Investment Bank has a very wide remit and a multitude of tools/approaches at its disposal. In contrast, the UK Green Investment bank takes an asset ownership approach that appears to parallel the approach the CIB is likely to take, but as its name implies, it has a fairly narrow focus. Some organizations, notably Infrastructure Australia, do not get directly involved in funding, but instead focus on providing expertise and advice to government. Government goals cannot be ignored in these agencies' operating contexts – for instance, the Australian government has introduced incentives to encourage asset recycling (selling existing assets to fund new ones), kicking in an additional 15% of the sale price to the disposing government – an approach unlikely to be prioritized in Canada.[1]

The heterogeneity of international organizations makes cross-organization comparisons challenging, and both defining and measuring success is an ongoing issue. That said, there are some features that tend to be common across organizations, and represent 'best practice', broadly defined. First, there tends to be a **focus on large scale projects** (although definitions of 'large scale' vary), intended to both attract private-sector partners, and justify the overhead costs of the agencies themselves. Many of the international bodies also aim to **serve as a centre of expertise**, sharing their body of institutional knowledge with other smaller or subnational agencies. It is very common for international agencies to **leverage government credit ratings**, helping to reduce project funding costs, thereby broadening the universe of economically feasible projects. Finally, and most importantly, **providing transparency and accountability**. Nearly all organizations have some form of audit/value for money analysis, but best practices suggest raising the bar to include publicly available, project-level analysis and 'after battle' reports, placed in terms of the organizations' goals and long-term economic contexts.

Bringing it together

When we consider the domestic context that the CIB is entering, the experience and lessons of similar agencies domestically and internationally, and Minister Morneau's publicly stated goals, a number of key recommendations for the CIB emerge.

First, **focus on larger projects, but maintain line-of-sight for infrastructure projects more broadly**. The focus on larger projects will emphasize the types of infrastructure that Minister Morneau has suggested as a focus, while at the same time serving to attract private capital (the CIB's reason for existing). Moreover, by maintaining line-of-sight into the broader universe of Canadian infrastructure development, the CIB will be able to seize opportunities to potentially 'scale up' other projects, such as those focused on the 'state of good repair'-type infrastructure gap. For instance, this could occur by aggregating or 'bundling' a number of similar, smaller projects to reach the scale needed to attract private capital.

Second, and somewhat related: **serve as a centre of expertise**. This should extend naturally from the ongoing operations of the CIB, and the necessity of staffing the agency with experts in project design and delivery. The appointment of Mr. Leech creates a promising precedent in this regard given his extensive experience. Capturing the best talent may require more flexibility in areas such as remuneration than typically associated with government agencies. The CPPIB provides a good prototype in this regard. As expertise is brought into or developed within the CIB, its capacity to advise other agencies should expand accordingly.

It appears almost certain that given the body of expertise that already exists in Canada, in the initial phase the CIB will need to rely on existing agencies to kickstart its expertise via knowledge-sharing arrangements. Both during this process and as it becomes a centre of expertise, the CIB should **work with existing agencies** to enhance project delivery. This can be both in a passive manner (waiting for proposals, with an incentive system for those who deliver innovative proposals) and an active manner (a high-level view of the pool of infrastructure projects creates opportunity for the CIB to propose project enhancements, and/or new ways of structuring project delivery). The active approach has the further benefit of creating a pipeline of potential projects, attractive to private sector partners.

Third, **focus on net-new projects**. As noted above, focusing on expansion of Canada's infrastructure stock appears consistent with Minister Morneau's goals. Moreover, it will help ensure an additional role for the CIB, rather than duplicating existing agencies, which, as previously discussed, are already well placed to address the maintenance of existing infrastructure. As such, the CIB should focus on the 'infrastructure gap' as it relates to future needs, rather than the much discussed gap related to current infrastructure (although opportunities are likely to arise for the CIB to help transform a current infrastructure project into a forward-looking one).

Fourth, **set priorities, and establish a clear framework for achieving them, but allow autonomy in implementation and operation**. The government undoubtedly has goals in mind for the CIB to achieve, such as enhancing longer-term Canadian productivity. These priorities should be clearly laid out, and a framework should be established to create discipline around project selection, ensuring that only those projects meeting these goals move forward.

A broad measure of success that can serve as a starting point for setting priorities is that the agency 'crowd in' private capital, although measuring this will prove challenging. In keeping with a net-new project focus, success may also be measured by bringing projects to market that would not otherwise exist were it not for the CIB.

The priorities and the ultimate remit of the CIB will and should ultimately sit with elected officials, including sign-off authority on the terms of specific (large) deals. That said, autonomy in implementation and operation will be important. An arms-length approach to the daily operations of the agency would help attract private capital, which may be reticent to invest if the agency is seen as a tool of the government of the day.

Achieving autonomy in operation while still providing access to the government balance sheet suggests that the CIB be structured as a crown corporation. The CPPIB may again be a useful prototype in this regard.

Finally, **ensure accountability and transparency, both vis-à-vis parliament and Canadians more broadly**. This means going beyond accountability via the auditor general and standard value for money analyses, to provide proactive accountability and transparency. A good starting point would be to provide post-completion evaluation on a by-project basis, measuring project outcomes against the goals of the CIB, and drawing 'lessons learned'. In turn, these lessons will feed into its body of knowledge, further enhancing the CIB's role as a centre of expertise. An additional advantage of enhanced transparency will be achieving and maintaining the 'buy-in' of the public at large, who will be able to see that the organization is (hopefully) striking a good balance between incentivizing private sector capital and delivering returns (broadly defined) on public funds.

Bottom Line

How successful the CIB will be in leveraging private sector funds to expand Canadian infrastructure has yet to be seen. However, international experience suggests that this new approach to infrastructure development has the potential to deliver big results, provided that the agency is structured appropriately. To this end, as details of the agency are fleshed out in the 2017 federal budget, and the budget implementation bill, an increased focus will likely be placed on the 'nuts and bolts' of the organization. Although getting these details right will be crucial, focusing on the five key principles presented here early in the design phase will help the government ensure that the end product is a successful organization that truly adds value to the Canadian infrastructure development ecosystem.

ENDNOTES

1 The Australian approach stemmed, in part, from government balance sheet pressures/fiscal constraints which do not exist at present at the federal level in Canada.