CREATING THE WINNING CONDITIONS FOR PUBLIC-PRIVATE PARTNERSHIPS (P3s) IN CANADA

TD Economics

Special Report

June 22, 2006

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Executive Summary

Canadian governments are increasingly joining a number of countries around the world exploring newer ways of financing and managing public capital assets such as roads, hospitals and schools. At the top of this list is the public-private-partnership (P3) or, as it is sometimes referred to, alternative financing and procurement (AFP). Unlike the traditional form of delivering and managing infrastructure, whereby the government takes on the bulk of activities, P3s involve the sharing of responsibilities, rewards and risks across the public and private sectors.

In stepping outside the conventional box, governments have been recognizing that the status-quo is simply not doing the job. Most importantly, the dramatic turnaround in budget positions from the massive deficit era of the mid-1990s has not proved to be the panacea that many had hoped for. In fact, growth in public capital spending has lagged behind growth in the economy over the past three years. This result can be attributed to the fact that as quickly as governments see their fiscal fortunes improve demands to reinvest in the operations of virtually every area of public service rise in lockstep.

In May 2004, TD Economics joined the infrastructure debate by releasing a special report, entitled *Mind the Gap – Finding the Money to Upgrade Canada's Aging Public Infrastructure.* In that report, we argued that closing this gap would require a shift in government strategy towards smarter, more efficient ways of doing business. *One of the key ingredients was the notion of throwing down the gauntlet for increased private-sector participation in infrastructure delivery would be an essential ingredient to closing the gap.*

P3s involve governments, privatization doesn't

When referring to a P3, we are not talking about government selling its inventory of assets, although in some instances "privatizing" may be the optimal route to take. Rather, we are alluding to the notion of transferring the components of capital asset procurement and management – including designing, building, financing and operating (DBFO) – to the private sector. In this regard, the government's role in a P3 changes from directing and managing assets to overseeing and ensuring that a pre-determined level of service quality is performed. Core program delivery, particularly in health care, is maintained by the government in a P3. Even in the case when the private sector agrees to take on the full range of DBFO activities, the public sector maintains an ongoing business relationship with the private partner and control and ownership of the asset. This distinguishes P3s from full privatization, as the latter involves minimal government involvement except to the extent that regulation is deemed to be necessary. Lastly, the asset is also handed back to government in prescribed good conditon at the end of the contract term.

Potential benefits of P3s

One benefit of P3s is the added flexibility they provide to public planners. Indeed, just as a homebuyer makes purchasing and financing decisions that best fit his or her circumstances, governments can look across a wider array of public and private options to tailor-make a procurement choice to the project. But, increased flexibility is only one of a handful of potential benefits of P3s.

- *Frees up governments to focus on what they does best* – The number one role of governments is to serve the public interest by implementing effective policy. This goal is easier to achieve when the private sector takes on responsibility for non-core functions.
- *Improved care of public assets* – Planning cycles in traditional procurement have often been based on a short horizon, resulting in sub-optimal maintenance and rehabilitation being carried out. In contrast, P3s encour-

age a "life cycle" approach to planning and budgeting through the use of a long-term contract, the inclusion of maintenance costs and the requirement that the asset remains in a good state of repair.

- *Maintain service quality through innovation* – Not only can service quality be maintained in a P3 through the contract output specifications and payment schedule, but competitive tendering can lead to creative private-sector solutions to infrastructure delivery, design, construction and facility management.
- *Shifting risk from taxpayers to private sector* – A golden rule of project management is that a risk should be transferred to the party best equipped to deal with it. Rather than taxpayers bearing all the risk of a project, P3s allow risks such as those of cost over-runs, time schedule delays and service demand to fall on the private sector.
- *Synergies from combining components of a capital project* – There may be economies created by "bundling" the various components and transferring them to a single contracting party.

What's more, the benefits of P3s would not only accrue to taxpayers. Under a flourishing P3 market, the private sector would have access to secure, long-term investment opportunities under the relative security of a government contract. Moreover, the country's large pension plans, which are armed with a whopping $800 billion in invested assets, are increasingly looking to P3 investments as a way of diversifying their holdings. Indeed, infrastructure assets are well-suited to pension plans, since real asset returns provide an excellent match to pension benefits, which are indexed to inflation.

P3s a tough sell in Canada

Around the world, the use of P3s as a procurement model for infrastructure delivery has been expanding rapidly, with some 60 countries taking practical steps toward the development of their own programs. But, while Canada has started down the same path – with the development of some high profile projects like P.E.I.'s Confederation Bridge and the Fredericton-Moncton Highway – P3s have continued to face an overall bumpy ride in this country. For example, the fewer than 20 DBFO deals that have reached financial close over the past few years pales in comparison to the some 340 P3 projects that the U.K.– the global leader in P3 development – has completed over the past five years alone.

In Canada, P3s have been trapped to some extent in a classic Catch-22 situation. To start with, there exists in this country both a lack of understanding of the P3 concept and a general wariness about private-sector involvement in public-service delivery. Faced with this public skepticism, governments have either tended to shy away from using P3s or pulled back on certain projects at the first signs of controversy, often spearheaded by union opposition. As a result, there has been little opportunity to showcase the benefits of P3s, while the negative publicity attributed to aborted projects has further hindered their acceptance.

Answering public concerns about P3s

The successful communications strategy of opponents to P3s has been built on a number of oft-repeated assertions that have influenced the public's perception. According to these critics, P3s are more costly, lead to weaker transparency and accountability, lower public employment, and a reduced quality of service compared to the traditional model. These arguments – which are overly simplistic in our view – have prevented a fulsome debate on the issue. We take aim at each of them in the report on pages 13-17.

For example, the concern that P3s can cost more is true at face value, since governments can borrow at a lower rate and don't require a rate of return. However, borrowing is only one component of project cost. But, even more importantly, comparing the absolute price tags of private versus public delivery is like comparing apples and oranges, since no effort is taken to factor in which party bears the risk of unanticipated cost over-runs and missed time schedules. In a well-structured P3, the private sector takes on the risks for an appropriate reward, similar to an extended warranty on a car. In traditional procurement, these same total risk and costs are no less; they are merely borne by taxpayers, and effectively concealed under a government guarantee.

For this reason, it is not the cost but the *net benefit*, which is the most relevant benchmark when considering the best road to travel between traditional and P3 procurement. In a well-executed P3, the higher borrowing cost will be more than offset by the accompanying benefits. And, although Canadian experience with P3s has been too

limited to get an accurate reading of value for money, a study commissioned by the UK Treasury showed that the P3 model has delivered an average saving of 17 per cent compared with conventionally publicly-procured schemes.

Risks of P3s can't be pushed under the carpet

That said, we must be careful not to present them as a miracle solution to a daunting challenge. Not only is the private sector not always more efficient than the government, but it is clear from international experience that P3s can actually leave taxpayers worse off. Among the several risks that we identify on pages 17-18, one of the most significant involves the government's ability to accurately measure and transfer risks to the private sector. To the extent that these risks are underweighted or improperly evaluated, the result can be excessive returns at the expense of the taxpayer.

Needed: a robust P3 model

The success of P3s in overcoming these inherent risks ultimately boils down to the strength of the public procurement model that has been adopted. Indeed, a major reason why the U.K. has achieved success on the P3 front is the moves by the central government to develop a standardized procurement model under the Private Finance Initiative (PFI) Legislation. In contrast, Canada's approach to P3s thus far can only be described as piece-meal, with little federal involvement and provincial practices that differ widely across jurisdictions. This has been a major stumbling block in P3 development from coast to coast.

At the same time, however, the model that has been emerging in British Columbia is one that holds considerable promise within Canada's borders and has been gaining international recognition. In B.C., the provincial government has taken steps to lay the key building blocks for a successful P3 program. These include:

- *Developing P3 expertise* – Partnerships BC was formed as an arm's length organization with a mandate to provide expertise to public-sector clients on matters related to P3s and other non-conventional approaches to delivering capital assets.
- *Developing a standardized capital asset management and evaluation model* – the government adopted the Capital Asset Management Framework (CAMF) to assist public-sector employees in assessing and comparing P3 options with traditional public procurement. The CAMF is not a perfect tool by any means. Still, it is a necessary step that imposes rigorous financial and costing discipline on the public sector, requires a full life-cycle approach and ensures consideration and management of risks.
- *Focusing on transparency and accountability* – through strides taken in providing P3 documentation in a timely manner on the website, the B.C. government appears to have struck a good balance between satisfying the public's desire to know with the company's desire to protect intellectual property and commercial confidentiality.
- *Demonstrating commitment* – the B.C. government has backed up these earlier steps with sound commitment to P3 development. It is expected that 10-20 per cent of the capital projects will be procured as P3s.

With B.C.'s model in its early stages, the jury remains out on how much bang for the taxpayer buck the P3 projects approved to date will ultimately deliver. However, there is a growing consensus in Canada and abroad that the program is on the right track. A number of awards have been handed out to P3 projects in the province, including the Abbotsford Regional Hospital and Cancer Health Centre and Sea-to-Sky Highway Improvement Project. And, there are indications that investors, too, are warming up to the province's P3 market, as further signaled recently by moves by two P3 players – ABN AMRO and Macquarie Banks – to set up regional offices in Vancouver among other firms in areas such as advisory legal and accounting.

Other provinces – such as Ontario, Quebec and Alberta – have begun to move forward with models of their own not unlike that of B.C. In particular, Ontario has established a Framework Strategy for Alternative Financing and Procurement (AFP), underpinned by some of the same principles as those followed by British Columbia. Further, the Ontario government has set up Infrastructure Ontario, which will have the same function as Partnerships BC. At present, the Ontario government has designated over 40 projects to be delivered under the AFP model, of which most are earmarked for the health sector.

P3s a work in progress

While governments have continued to make strides, there is no disguising the fact that the Canadian P3 market remains in the early stages of development. As such, the next few years will be under a microscope. Even in the case of B.C., which is the furthest along the learning curve, ongoing refinements to the process will no doubt be required to ensure that the P3 program continues to gain widespread public acceptance. Reporting on P3s in a timely manner and raising awareness in terms of benefits and risks of these arrangements are areas where further progress is required.

Still, for the P3 model to continue to flourish it will not just be about laying down the key building blocks of a standardized assessment and selection process, a high level of expertise, an open, transparent and accountable environment and a strong commitment from political leaders. P3s are highly complex processes. Hence, a flexible approach, driven by a willingness for governments to make changes in the mechanism as required, is critical. Above all, to the extent that provinces move to align their approaches and regulations and the federal government steps up to take on a leadership role, the winning conditions for P3s in Canada would be further cemented. And, on this front, Canada can learn from developments in Australia, where the federal and state governments are currently working towards a more consistent, pan-national model.

At the same time, the private sector will need to show increased participation to make the system function well. Private-sector involvement both in project management and financing has been largely dominated by European and international players with a few exceptions, highlighting the lack of depth of Canadian capital markets. On the plus side, Canadian banks have quietly been moving into secondary roles in the P3 market, including buying bank debt from existing P3 projects and selling it to institutional buyers.

Finally, there needs to be an increasing recognition in Canada that not all P3 projects are created equally. Certainly, for a P3 to work – regardless of the area of public service – there must be opportunities for competitive bidding, private-sector innovation, clearly definable and measurable output specifications, and some risk that can be transferred. Still, research has shown that those projects that are large in scale, capital intensive, require technical capabilities that exceed that inside of government and have an indentifiable revenue stream are most amenable to P3s. Although not alone, transportation is one particular area that fits the bill. Given the lack of depth of most Canadian P3 markets and the discomfort that many Canadians about less-conventional approaches, governments would be wise to first try their hand in areas that meet the criteria and are less vulnerable to public sensitivity.

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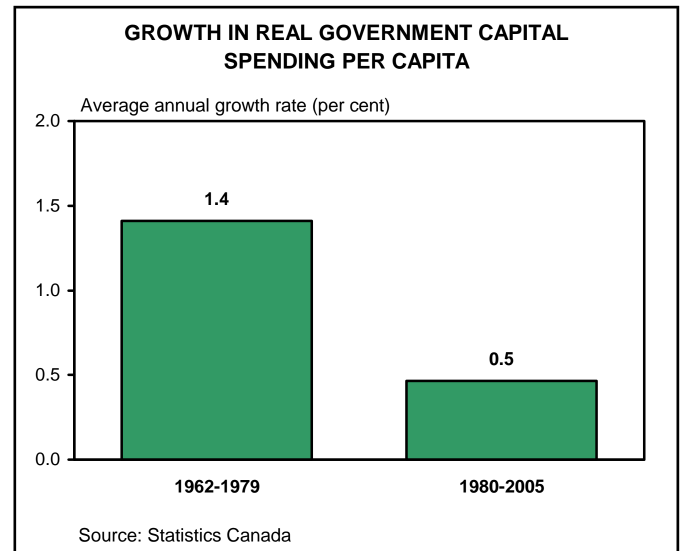
Canadian governments have been joining a number of countries around the world exploring newer ways of financing and managing public capital assets such as roads, hospitals and schools. At the top of this list of approaches is the public-private-partnership (P3), which is also referred to under a number of monikers including alternative financing and procurement (AFP) and Private Finance Initiative (PFI). Unlike the traditional form of delivering infrastructure – whereby the government takes on the bulk of the activities related to financing, designing, building, operating, maintaining and repairing public capital assets – P3s involve the sharing of these responsibilities and risks across both the public and private sectors. And, if properly executed, these arrangements have the potential to deliver public infrastructure more cost efficiently at equal, or even enhanced, levels of service.

In spite of their potential rewards, P3s have had difficulty gaining traction in Canada, as they have been trapped in a classic Catch-22 situation. To start with, there exists in this country both a lack of understanding of how the P3 model works and a general wariness about private-sector involvement in the realm of public-service delivery. Faced with this public skepticism, governments have either tended to shy away from using them altogether or, in some cases, have pulled back at the first signs of controversy. As such, there has been little opportunity to showcase the benefits of P3s, while the negative publicity attributed to aborted projects and altered ground rules has further hindered their acceptance. This vicious circle is not unique to Canada – indeed, other nations that have trotted down the same path have encountered similar headwinds. However, international experience has also shown that these headwinds tend to dissipate as successful projects are completed, private- and public-sector expertise is built up, and the risks and costs of carrying them out decline.

In Canada, it is heightened concerns about the state of public infrastructure that is causing governments to increasingly look outside their comfort zones in consider-



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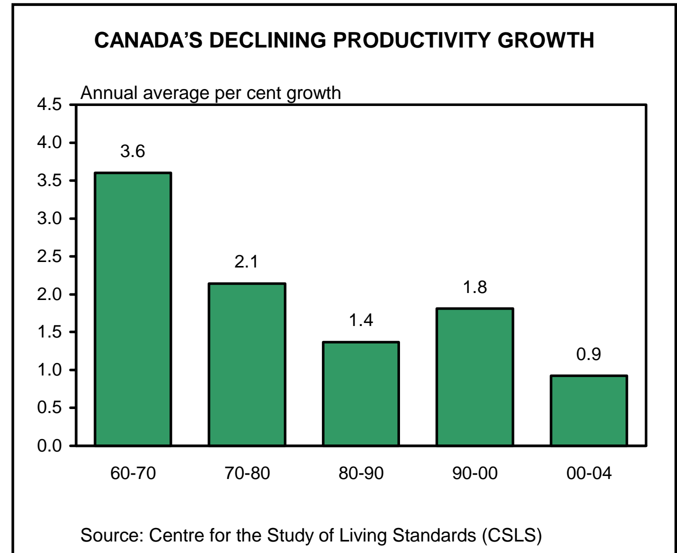
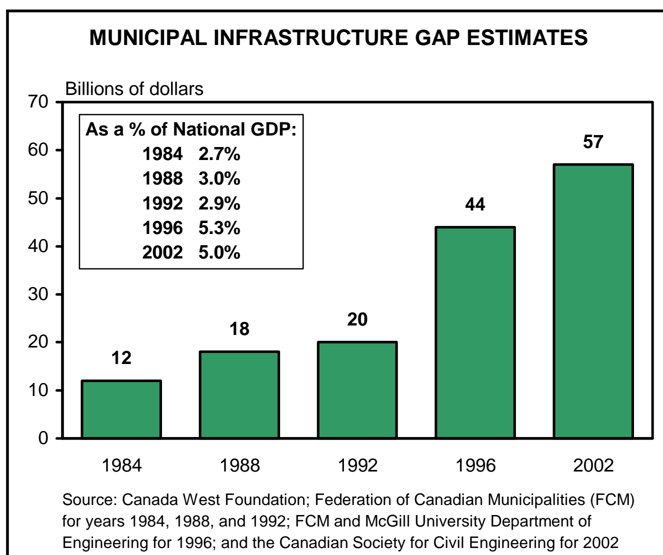
ing newer arrangements such as P3s. Improvements in budget positions have been providing support to governments' efforts to rebuild aging roads and sewers. Yet, overall increases in public capital spending have continued to lag behind growth in the economy over the past three years, as infrastructure funds compete with pressures to re-invest in virtually all areas of government. Put simply, there is a growing consensus that the *choice* in renewing, building and managing infrastructure is not between the traditional approach and P3s, but between using a P3-style model and deferring urgently needed projects indefinitely.

The primary aim of this report is to close some of the knowledge deficit with respect to P3s. Up until now, the debate has been largely drawn across ideological lines, with staunch critics – led by organized union opposition – labeling P3s a "lose-lose" proposition for the taxpayers, regardless of the circumstances. On the flip side, many P3 advocates believe that bringing the private sector and its innovate capacity on board is *always* the best route to go. As usual, international experience suggests that the reality falls somewhere in the middle: P3s can make an important contribution to addressing the infrastructure challenge, but only if their inherent risks are managed effectively.

Finally, Canadian governments are in a fortunate position in that they can build their P3 models based on the experiences of countries that have been applying them extensively in recent years. Moreover, research carried out both at home and abroad into the necessary "winning conditions" for P3s can be leveraged. But, while jurisdictions such as the United Kingdom and Australia are often regarded as best practices on this front, less commonly known is the fact that some promising models are currently being developed right on on Canadian soil. One notable strategy is that of British Columbia, which we take a closer look at on pages 18-21. To the extent that provinces work to build their approaches on consistent guidelines and processes, and to the degree that the federal government steps up as a champion in this area, the winning conditions for P3s in Canada would be further cemented.





Infrastructure gap threatens living standards

In May 2004, TD Economics released a special report on how to address the country's infrastructure challenge, entitled *Mind the Gap – Finding the Money to Upgrade Canada's Aging Infrastructure.* In that report, we provided a survey of estimates of the so-called "infrastructure gap", which ran in the hefty $50-$125 billion range or 6-10 times annual public investment flows. Worse, the funding deficiency was found to have grown steadily over time, was widespread across types of public services and poised to grow further under the status quo.

We acknowledged in the study that gauging the size of the gap is a bit of mug's game, which explains the large range of estimates. Nonetheless, there is a concurrence that the negative impact of a weakening state of public infrastructure has become increasingly visible to Canadians on a day-to-day basis, as they confront growing potholes, large swaths of brownfield sites close to city centres and worsening pollution and congestion. In fact, as we discuss in the text box on page 3, economists and public policy experts have been increasingly tying the infra-

Closing Infrastructure Gap Essential to Boosting Productivity in Canada

In recent months, the spotlight has been turned up on Canada's weak labour productivity record (defined as output per worker per hour). Since the start of the decade, productivity in Canada has barely grown. What makes this trend worrisome is that productivity gains are critical to supporting growth in incomes and Canada's overall standard of living over the longer haul. And, without rising incomes, it will become increasingly difficult to protect the social programs that Canadians currently benefit from. This challenge will be made worse by the onslaught of baby boomers moving into retirement in the next decade.

Canada's high tax burden has been viewed a chief culprit of the nation's productivity woes for many years. More recently, however, there is growing agreement within both government and business circles that a weakening state of public infrastructure has been a contributing factor. Some statistics illustrate how the infrastructure gap is dragging down productivity and economic growth. The Ontario Chamber of Commerce estimates the annual loss from backlogs at Canada-U.S. border crossings at about $8.3 billion per year. The cost of delays in shipping goods in the GTA has been found at $2 billion. Business also recognizes that public infrastructure cuts their costs. Indeed, Statistics Canada found that a one-dollar increase in the net public capital stock generates approximately 17 cents in average private-sector cost savings.

As we argue in a TD Economics October 2005 Special Report, *Canada's Productivity Challenge*, reversing the infrastructure trend will need to play an important role in turning around the flagging productivity performance. We also spelled out a number of other items on the "to do" list, including cutting the overall tax burden, shifting the mix of taxation from investment and savings to that of consumption, reducing regulation hindering competition in domestic markets, and investments in education. Still, we acknowledge that not all of this responsibility is on the doorstep of governments. Indeed, business can do more in the areas of capital investment, research and development, identifying economies of scale, implementing new technologies and innovative approaches, as well as maximizing the efficiency of an increasingly diverse workforce.

Recently, there have been some mixed developments on the productivity file. A number of business leaders – including the CEO of TD Bank Financial Group – have continued to champion the importance of raising economy-wide efficiency. In November 2005, the Governor of the Bank of Canada built on a number of earlier speeches on the importance of raising productivity in an address to the Canadian Council of Public-Private-Partnerships (CCPPP). In those remarks, he focused on the need to improve the infrastructure investment climate and the crucial role the private sector can play in supporting government efforts. Meanwhile, at the political level, there has been a lack of urgency in addressing this problem in recent budgets, with most governments offering little in the way of tax relief in areas that is most beneficial to raising productivity growth (i.e., capital and income taxes) and largely spreading available funding across a host of areas on an ad-hoc basis. The federal government has offered a glimmer of hope that it will soon tackle the issue. Notably, in its May 2006 budget, it commits "to pursue a broad approach in the coming year ... to develop a strong results-oriented agenda to promote a more competitive, productive Canada for the benefit of all Canadians."

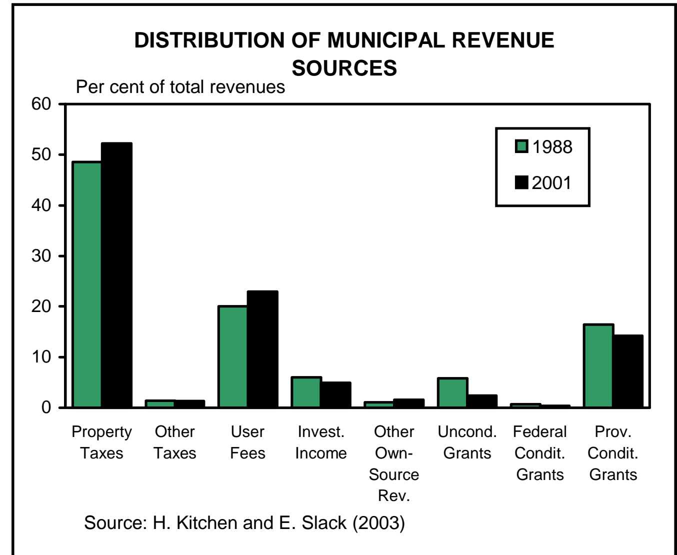
structure problem with Canada's weak productivity record. This marks a significant shift from the past, when the pro-business perspective boiled down to a simple assertion that tax cuts and lower government debt burdens were unique to driving productivity. That has since been replaced with concurrence that investments in areas such as education and infrastructure are key ingredients to a successful economy.

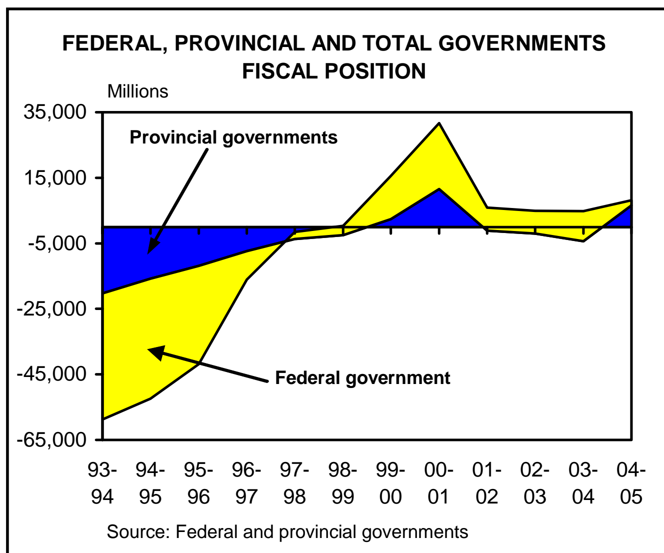
Private involvement needed to close the gap

After putting the infrastructure problem in context, the May 2004 TD report concluded with a multi-part strategy aimed at closing the gap. Undeniably, some of the traditional managing and accounting practices related to infrastructure require a major overhaul. For example, the useful life of infrastructure assets has been cut short in many cases by provincial and local governments failing to carry out proper maintenance and rehabilitation on schedule, while provincial and municipal land planning and tax policies have raised the cost of infrastructure by encouraging sprawl. Still, adding new funding to the system and fixing the existing leaky holes in the procurement process would,

in our view, not be enough to put the ship back on a sustainable course. Given the lack of resources and the multitude of priorities facing governments, we argued that it would also be necessary to look outside the conventional box in order to achieve greater efficiency in infrastructure delivery, while at the same time, creating a vision that is deeply rooted in the all-important principles of accountability, transparency and equity. We highlighted the following four guiding principles of how governments can find the money to upgrade the country's aging public infrastructure:

- *A greater tilt towards the user-pay model* – often in Canada, there has been little effort put to aligning the price of services with the full marginal cost of delivery (including capital replacement and environmental impacts). This has fuelled waste and inefficiency. While user fees are regressive, we see significant potential to increase their usage in areas where there are no overriding equity issues, including roads, bridges, water, sewers, electricity, and garbage collection.
- *Giving cities the right tools for the job* – partly reflecting downloading of responsibilities over the past decade, municipalities are now the number-one direct providers of infrastructure among the levels of government. Yet, while many cities have been guilty of not applying their property tax systems effectively, the number of financing tools available to municipalities – and their administrative flexibility – remains limited. We argued that cities need more control over their own destiny. One possibility we supported was the idea of the federal and provincial governments cutting their gasoline excise taxes and allowing cities to pick up the vacated room by levying a tax of their own. Such a move would provide cities with a revenue source that grows reliably over time and would enhance accountability to taxpayers, as the government spending the money would be responsible for raising it.



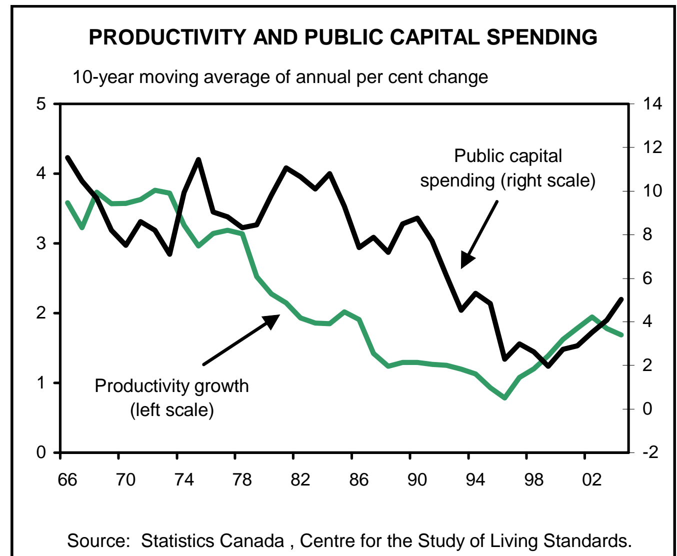


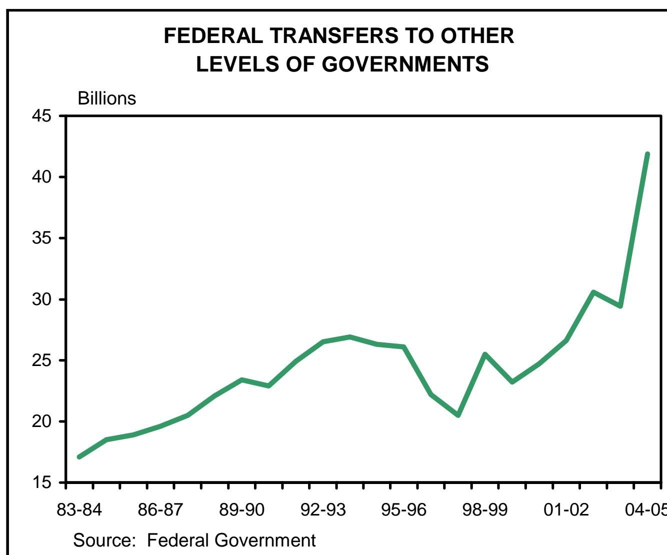
- *A bigger role for the federal government* – during the late 1990s and early 2000s, the federal government established a number of infrastructure funds, of which a large share was earmarked to municipal needs. As noted, transferring tax room to cities would probably achieve the greatest longer-term results since local governments could best address local priorities. Still, if the federal government opted to continue along the path of providing contributions toward municipal projects, we identified ways to improve the design of existing infrastructure programs. These included establishing an independent advisory board to ensure federal monies are spent effectively, making education projects eligible for funding and avoiding substituting taxpayer funds in cases where user pay works.
- *More fully engage the private sector* – the private sector is already a major investor in many areas of Canada's infrastructure system, including telecommunications, power and pipelines. Still, there are enormous opportunities to better leverage the pools of money and talent of the private sector in the procurement and management of public capital assets.

This four-part strategy would require some boldness on the part of governments in the short term, but would reap benefits for Canadians in the longer haul. A focus on more efficient ways of delivering infrastructure would be the best chance at addressing the gap between public capital investment and needs. Furthermore, this plan would be consistent with the goal of turning around Canada's anemic productivity performance, and by definition, the longer-term outlook for household income growth.

Some good news since TD's May 2004 report

In the two years that have passed since the TD study was released, there have been some encouraging signs that Canadian governments have begun to stand up to the infrastructure challenge. For one, armed with much-improved fiscal positions compared with the early-to-mid 1990s, provincial jurisdictions have allocated additional public funds to rehabilitating and building new public capital. This reinvestment has been supported by a shift in capital accounting practices from a "cash" basis (i.e., booking the full cost of the asset when cash leaves the door) to an "accrual" basis (i.e., gradually over the asset's useful life), which has lessened the budget hit up front. Furthermore, the federal government has anteed up additional big-ticket measures. In particular, the 2005 federal budget allocated $5 billion in gasoline tax revenues over five years to help fund environmentally-sustainable municipal infrastructure, which built on the federal Liberals' earlier promise to fully-exempt cities from paying GST on purchases. The newly-elected Conservative government plans to keep the momentum going by committing to renew infrastructure programs introduced by former governing Liberals, and to build on those investments with the establishment of a $2 billion Highway and Border Infrastructure Fund. Some provinces have also provided help to cities through increased grants. For example, in Ontario, the provincial government followed suit by earmarking 2 cents of its gasoline tax to its municipalities.





Traditional culture largely remains entrenched

Although these positive steps have set the stage for a turnaround in the level of public capital spending since the late 1990s, Canadian governments continue to cling to the status-quo by and large rather than step down some bolder new paths. For example, there remains reticence to move down the road of full-cost pricing. Meanwhile, expectations that a return to budget surpluses in Canada would be the panacea for ailing public infrastructure appear to be dwindling. Despite an all-government budget surplus of roughly $16 billion in fiscal 2005-06, capital spending by governments managed to rise by only 2 per cent in nominal terms. And, over the past three years, the average annual gain in public capital spending (4.5 per cent) actually fell short of growth in the overall economy (6.0 per cent). At the same time, the average age of public infrastructure has only managed to stabilize in recent years, and remains over half of the estimated useful life. At this rate, governments are unlikely to put a large dent in the infrastructure gap.

This outcome can be attributed to the fact that just as quickly as governments see their fiscal fortunes improve demands to reinvest in the operations of virtually every

Infrastructure implications of dealing with the fiscal imbalance

The concept of "fiscal imbalance", in its popular form, is taken to mean that the federal government has "excess" revenues to meet is responsibilities, while provinces have too little to meet theirs. In some respects, the notion of a federal-provincial fiscal imbalance does not hold water. The provinces have unfettered access to the same major sources of revenue as the federal government with the sole exception of customs import duties. However, where the notion of fiscal imbalance has merit is to the extent that the federal government has kept taxes higher than needed to finance spending in its areas of jurisdiction, hasn't used the excess to aggressively pay down debt and sought to spend the excess in areas of provincial and municipal jurisdictions. There can be no denying that this has been taking place in recent years.

Provincial governments had been encouraged by the new Conservative government's campaign promise to address the issue of fiscal imbalance. However, the release of the May 2006 federal budget has since dampened hopes. For one, based on the budget projections, there is little room left over after taking into budget measures and the remaining GST cut. Hence, any transfer of tax room would need to be accompanied by a drop in federal spending. But, as cuts to federal spending might shift responsibilities onto provincial-territorial-municipal shoulders, such a move would not necessarily be the financial windfall those governments were looking for.

The 2006 federal budget paper, "Restoring Fiscal Balance in Canada", goes some way in clarifying the issues at hand. Interestingly, the term "fiscal imbalance" was morphed into "restoring fiscal balance." And, the federal government is seemingly more concerned about dealing with "blurred accountability due to reduced clarity in roles and responsibilities" and those "over predictable, long-term funding for fiscal arrangements." than merely turning cash over to the provinces. The budget documents also suggest the government plans to look at the issue from the other end, namely first defining respective federal, provincial, territorial and municipal responsibilities. And, as noted, the revenue side would only likely come into play if the federal government vacates provincial-territorial-municipal areas sufficiently to pay for the transfer, thus potentially offloading some of the pressures to those orders of government.

area of government rise in lockstep. These pressures have not been limited to health care and education. Indeed, after a 5-year hiatus, support for cutting taxes is now back on the radar screen. But, while a recent C.D. Howe study showed that Canada's marginal effective income tax rate on capital is second highest among the developed and developing countries studied, there is increasing recognition that high personal marginal income tax rates faced by low-income Canadians is an even bigger problem. Addressing this issue will come at a high price tag.

In its December 2005 election platform, the Harper government promised to address the so-called "fiscal imbalance". Conceptually, such a move to reallocate fiscal room from the federal government to provincial (and perhaps municipal) governments should provide a boost to public capital investment, since it would shift taxpayer resources to those levels of government that are more direct responsibility for delivering infrastructure. However, the recent May 2006 federal budget has poured some cold water on hopes that provincial-territorial governments are poised to enjoy a revenue windfall. Based on information contained in budget documents, the federal government appears to be willing to transfer revenues only if it can sufficiently create the offsetting fiscal room by exiting from provincial-territorial-municipal areas. Hence, the provinces, territories and municipalities might have to spend more in those areas that the federal government vacates. In any event, merely transferring tax room is unlikely to be the whole answer to slaying the infrastructure dragon. *In our view, a a shift away from the traditional model of fully funding public capital projects through taxpayers' resources is required to put infrastructure in Canada on a sustainable course.*

Engaging the private sector rounds out the list

That brings us to fourth and final piece of the TD Economics solution to closing the infrastructure gap and the focus of this report – the need for increased private-sector involvement. When referring to private involvement in infrastructure, we are not talking about government selling its inventory of assets, although in some instances privatizing may be the optimal route to take. We are referring instead to partnering with the private sector in the operation and provision of public infrastructure, and in doing so, sharing the risks, costs and rewards of developing large projects. There is no doubt that public-private-partnerships (P3s) – or alternative financing and procure-

ment (AFP) as they are sometimes referred to as – are complex arrangements that require careful planning and execution. But, while they have been used only sparingly in Canada, other countries around the globe have demonstrated that if P3s are pulled off right, they can be a valuable part of the overall solution to addressing the infrastructure challenge.

It is here, too, that some encouraging signs have been witnessed of late. Over the past few provincial government budget rounds, the notion of bringing the private sector on board to assist in acheiving infrastructure objectives gathered increased attention – undeniably the most to date. This rapidly-growing interest was further evidenced at last year's annual meeting of the Canadian Council of Public Private Partnerships (CCPPP) that drew a record attendance by both Canada's public and private sectors along with international players. As noted in the box on page 3, Bank of Canada Governor Dodge kicked off the conference with a keynote address that linked P3s with both raising economy-wide productivity and closing the country's infrastructure gap.

P3s are different than other methods of procurement

The main characteristics of P3s set this model apart from other approaches of capital asset procurement. A few hallmarks of P3 projects are the following:

- The roles, responsibilities and general ground rules for both the governmental agency or authority and the private-sector partner are clearly laid out in a contract;
- Projects vary widely in terms of duration and nature depending on the type of services being provided, but those arrangements which involve a "concession agreement" (i.e., an arrangement whereby a public-sector asset will be operated under a license or lease for a specific period) can be an ongoing business relationship that lasts up to 35 years or longer;
- The risks and rewards of a project are properly allocated and shared between the public and private partners.
- Both the public and private partners contribute resources based on their relative strengths. Joint investment also ensures commitment by partners.

By agreeing to transfer a number of components of a capital project to the private sector, the government's role in a P3 changes from directing and managing assets to

A simple illustration of some P3 options

A municipality plans to develop a sports centre. It has the option of using its staff to carry out all of the components of the project, including the funding of the project through tax revenues or debt. Alternatively, it can develop a Request for Proposals (RFP) to partner with the private sector.

Design/Build – this approach has been used extensively by governments in the past. Bids for tender would be asked to present innovative options. For example, one proposal might include the design of a playhouse and entertainment complex on the top floor of the sports centre. The public sector will chose the preferred option and manage the operations and finance the project. The private sector will receive payment based on whether performance requirements are met.

Design/Build/Operate (DBO) – The design build is taken a step further, with the private firm also in charge of operating the arena. A long-term "concession" agreement would be developed, usually encompassing 25-35 years or longer. Revenues could consist of pre-set annual payments by the government, user fee receipts or a combination of both. At the same time, the government's ability to monitor progress and quality and renegotiate the agreement is included in the contract. This approach will often increase the life span of the private business involvement and provide a stronger incentive for the private sector to invest more effort in the initial project and develop a higher quality product requiring fewer repairs.

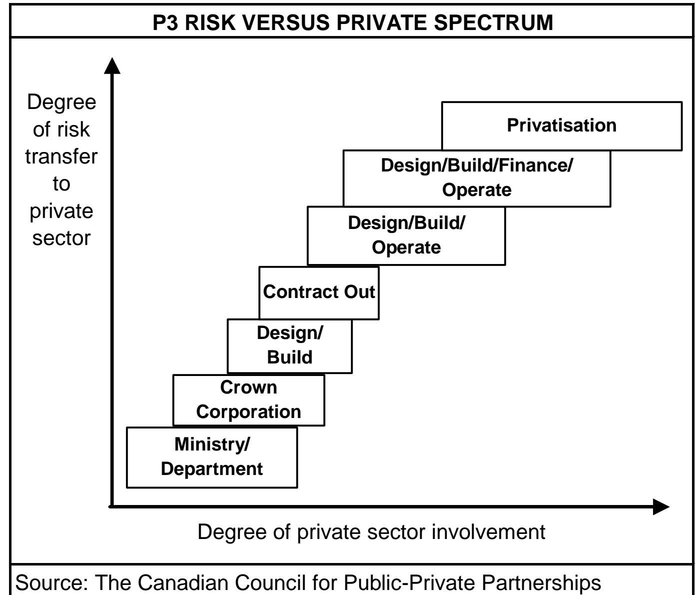
Design/Build/Finance/Operate (DBFO) – in addition to constructing and operating the project, the private sector can fund the project through an equity stake and debt financing. On the debt side, three options are generating capital through bank lending, private placement (i.e., pension funds) or tapping financial markets through an initial public offering (IPO). Cash or "in kind" contributions to the project by the government would lower the required private funding needs. In this approach, the private sector operates the sports complex for a certain period of time, after which the asset is usually transferred to the public sector.

overseeing and ensuring that a pre-determined level of service quality is performed. But, even more importantly, it is the fundamental requirement of an *ongoing business relationship* between the public and private sectors that distinguishes a P3 approach from that of full privatization. In the case of privatization, a public asset or service is sold outright to the private sector, and there is minimal government involvement except to the extent that regulation is considered to be necessary. In contrast, in a well-functioning P3, the government retains control and ownership over the asset. As we discuss later, this confusion between public-private-partnerships and full privatization has been commonplace in Canada, and has acted to hold back public acceptance of the P3 approach.

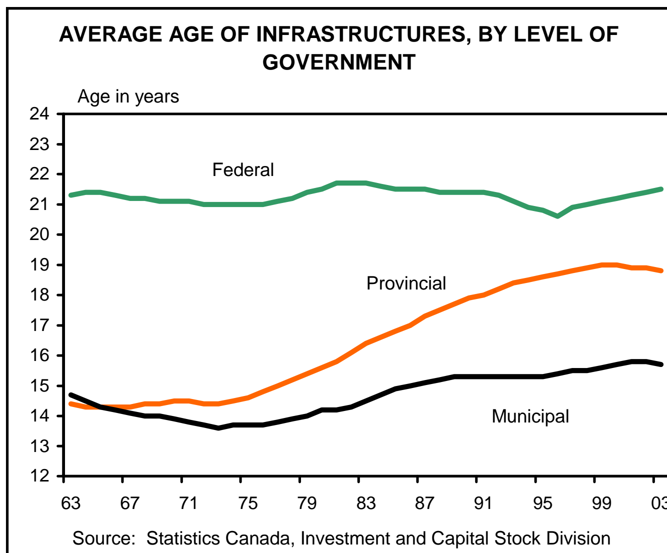
Still, it is important to distinguish between different types of P3s. The "contracting out" of various services, such as garbage collection, laboratory services and the designing and building activities of an infrastructure project, would usually meet the broad definition of a P3. Indeed, these types of arrangements have been used by Canadian governments for many years. However, it is the more sophisticated partnerships involving private-sector provision and management of a larger range of activities – i.e., designing, building, operating and even *financing* (DBFO) – where Canadian governments have barely scratched the surface. And, it is in these arrangements that we see the greatest opportunities on the infrastructure front.

Deciding among options not unlike that of a household

The range of capital asset procurement options is shown in the accompanying chart. The left hand side of the continuum consists of the more traditional approaches while privatization occupies the extreme right. Keep in mind that this is not an exhaustive list. Notably, global innovation in response to changing circumstances has led to the emergence of a number of sophisticated alternatives to DBFOs, including build, own, operate and transfer (BOOT) and lease, develop and operate (LDO).



Source: The Canadian Council for Public-Private Partnerships



Source: Statistics Canada, Investment and Capital Stock Division

The addition of various types of P3s to the warchest of capital asset procurement approaches has made governments' infrastructure planning process increasingly complicated. In addition, many governments are now mulling over a number of other infrastructure financing instruments, such as tax increment (TIFs) and enterprise zones. At the same time, however, governments have never had more flexibility in applying the optimal strategy depending on the circumstances.

In actuality, the decisions before public-sector planners are not unlike those faced by households when contemplating the purchase of a house. The homebuyer must determine his priorities (i.e., size, distance to work and school, etc.), place a value on those priorities and determine whether a specific home satisfies those requirements. There are a multitude of choices. For example, handy individuals might have a comparative advantage in performing maintenance, which might affect his list of demands and the ultimate cost of the project. Above all, consideration will be needed to determine the best financing alternative across a number of options (i.e., own-source, loan through a bank loan, or lease to own arrangement.).

How an individual determines the plan of attack will depend on which arrangement best fits his or her circumstances.

POTENTIAL BENEFITS OF P3s

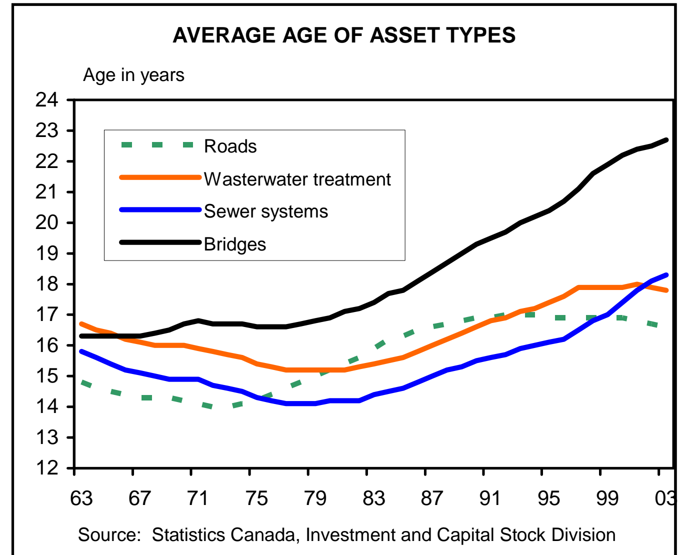
Having an improved ability to tailor-make a procurement type to a project is one benefit of adding P3s to the arsenal of infrastructure procurement options. However, as we discuss below, there are other potential rewards that are often put forward by advocates of P3s. Many of these benefits flow from the private sector's comparative strength in innovation, competition and in overall efficiency.

Frees up government to focus on what it does best

The number-one role for governments – which is to serve the public interest by implementing effective policy – is more easily accomplished when the private sector takes on responsibility for non-core functions. Case in point is in the health care sector, where public resources are particularly stretched at the moment. The private sector could be asked to take responsibility for the "bricks and mortar" and a number of non-clinical services such as maintenance, food and janitorial service. All clinical services could continue to be delivered by the public sector hospital corporations directly with funding from the respective provincial ministries. This arrangement would essentially free up the resources of public officials to focus on what matters – achieving improved health outcomes – while at the same time preserve Canada's single-payer model.

Improved care of public assets

One major pitfall of the traditional model of capital asset procurement is that governments have failed to take a long-term view of infrastructure management. Planning cycles have often been based on a 2-3 year horizon, which is only a fraction of the 30-50 year usual life of a capital asset. As a result, maintenance and rehabilitation schedules have been sub-optimal, shortening the life of an asset and contributing to problems of deferred maintenance and backlogs. In contrast, the P3 approach encourages a "life cycle" approach to planning and budgeting through the use of a long-term contract, the inclusion of maintenance costs in the overall costing of the proposal, and the requirement that the asset remains in a state of good repair or financial penalties will be imposed. Further, private sector companies with at-risk investment are likely to carry out strong due diligence, including the early detection of problems.



Maintain service quality partly through innovation

In the traditional procurement method, maintaining public assets and ensuring service quality is dependent on governments continually making new funds available in their annual budgets. In a P3, long-term service quality can be preserved through the output specifications and payment structure written in the contract. In other words, the private sector will only be paid in full if the pre-established outcomes or standards set out in the original P3

TRADITIONAL PROCUREMENT VERSUS P3

TRADITIONAL PROCUREMENT	TO	P3 PROCUREMENT
Less competition and innovation	→	More private sector involvement
Government bears most risks	→	Risk is shared with the private sector
Public borrowing for new assets	→	More private capital
Taxpayers purchase assets	→	Taxpayers purchase a bundle of services
Inefficient procurement	→	On-time delivery of assets
Government responsible for the public interest	→	Government responsible for the public interest

Source: Yukon Economic Development, Overview of Public-Private Partnerships

contract are achieved.

An advantage the private sector enjoys over the public sector in ensuring quality service delivery is through its experience in innovation. Spurred in part by the process of competitive tendering, governments can benefit from creative private-sector solutions to infrastructure delivery, design, construction and facility management. Furthermore, private-sector innovation can be applied to future projects, facilitating the spread of best practice within the public service. Lastly, the private sector is motivated to most fully capture a project's potential, which can result in higher levels of service and lower the project's costs. One example is the development or expansion of a transit system, which opens the door to capturing the economic benefits of rising commercial real estate values and flourishing business opportunities along the line.

Transferring risk to private sector can pay dividends

Undeniably, the most significant benefits of P3s are generated from the shifting of project risk off the backs of taxpayers to the private sector. There are a series of risks facing any large capital project – ranging from the possibility of cost over-runs to force majeure to uncertainty about demand projections – that could substantially raise the cost of a project. A golden rule of project management is that a risk should be transferred to the party that is best equipped to deal with it. As importantly, the transfer of the risks should be accompanied by an appropriate allocation of reward. For instance, consider the development of a government office building. The public-sector body may be well-positioned to manage the risk of, say, a future change in government legislation or a change in project scope, but the risk of changing conditions and/or demands for commercial real estate is likely better dealt with by a private company with expertise in office management. Some risks where no partner holds the comparative advantage, such as the likelihood of catastrophic events, should be shared between parties. In the traditional procurement model, the taxpayer bears most, or all, of the risks, regardless.

An additional benefit from appropriate assignment of risks to the private sector is that it can improve government budget certainty by reducing the potential for unforeseen increases in project costs and thus, large swings in annual budget spending. In a P3, services are provided at highly predictable costs as set out in contract agreements.

Synergies produced by combining functions

There may be synergies gained from combining the components of a capital project, what is often referred to as "bundling". In the past, the synergies of contracting out a project's design and build phases to a private sector consortium have been well-recognized and applied by the public sector. A single contracting private party often has greater flexibility in integrating detailed design and construction management and in meeting project schedules. Less commonly known, however, is the potential payback from extending the bundling process to both operations and finance activities. Control over finance and operations decisions will usually avoid the cost and timetable slippages that have been common under traditional procurement. This approach encourages bidders to focus on the whole life costs of the asset over the project life cycle because those responsible for the building of the asset are also responsible for the long-term maintenance and operation.

Private sector also in line to benefit

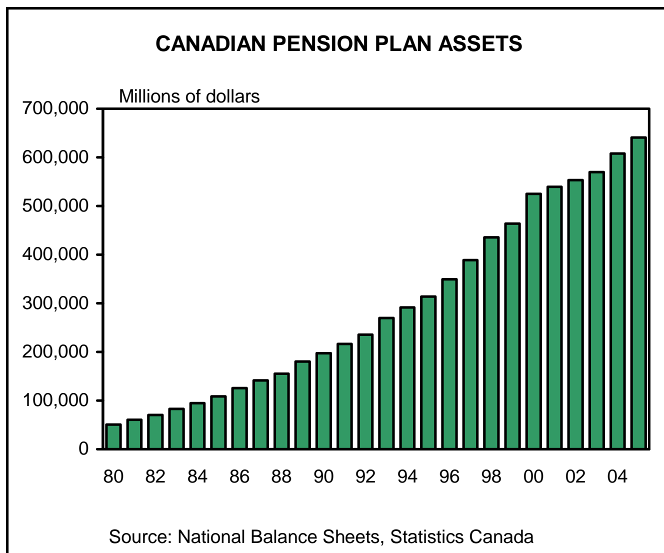
The benefits of P3s would not only accrue to taxpayers. Under a flourishing P3 market, the private sector would get access to secure, long-term investment opportunities under the relative security of a government contract. Taking on risks that were traditionally borne by governments and putting into practice their innovative spirit, businesses have the potential to reap attractive profits.

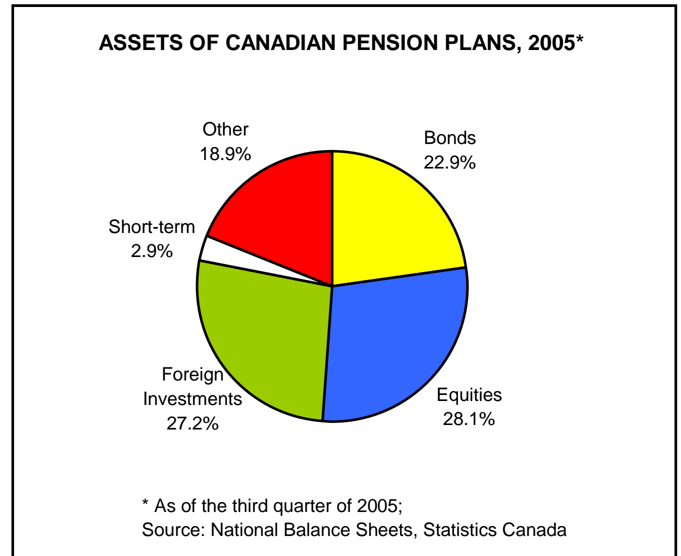
APPROPRIATE ALLOCATION OF RISK		
PUBLIC	**SHARED**	**PRIVATE**
· Legislative changes	· Inflation	· Design
· Changes to project scope	· Taxation	· Construction costs
· Land acquisition	· Permitting	· Operating and maintenance costs
· Governance	· Catastrophic events	· Operating performance
· Sustainable political support		· Technological obsolescence
		· Financing
		· Commissioning
Source: Yukon Economic Development, Overview of Public-Private Partnerships		

Happily, Canadian players have been making inroads in the highly-competitive international P3 market, including the likes of SNC-Lavelin, Dessau-Soprin, EllisDon and Aecon. In addition to being highly productive, these firms have a reputation abroad for their expertise in complex and specialized project management and the development of projects in harsh climates. Still, their ability to compete abroad is impeded by a number of barriers. Compared to entities in the U.S., Asia and Europe, Canadian companies are small, with more limited financial capacity and access to qualified people. As such, Canadian firms face limits as to the size of project that they can bid on and undertake. In light of these constraints, it will be important for Canadian companies to continue to work towards carving out a niche. This achievement could be facilitated by governments' creating more P3 opportunities in this country. And, to the extent that firms continue to build on past successes in the global marketplace, some of the income generated would migrate back home, thus stimulating employment.

Investors can enjoy steady and predictable returns

Investors – including the millions of Canadians participating in pension and endowment funds – also stand to reap benefits from P3s. The country's large pension funds, which are armed with a whopping $800 billion in invested assets, are now taking a longer look at diversifying their asset holdings into long-term investment-grade infrastructure investments. This move has been fuelled by a combination of a ratcheting down of expectations on long-term equity and bond returns since the start of the decade, an





aging population and a significant increase in unfunded pension liabilities. And, not surprisingly, pension funds whose members are retired public servants have shown particular interest in investing in public infrastructure. For example, both OMERS and the Ontario Teachers Pension Plan have indicated that they would like to allocate up to 10 per cent of their pension assets in this area in the future. Quebec's Caisse de Depot is another active player in infrastructure investment.

Indeed, infrastructure assets are particularly well-suited to pension plans, since real asset returns provide an excellent match to pension benefits, which are indexed to inflation. Moreover, P3 projects generally provide stable and predictable cash flows because they are often natural monopolies that satisfy a relatively inelastic demand. Nevertheless, pension funds will not just be looking at domestic opportunities, but those abroad. Thus, competition for this capital will be fierce.

P3s a tough sell in Canada

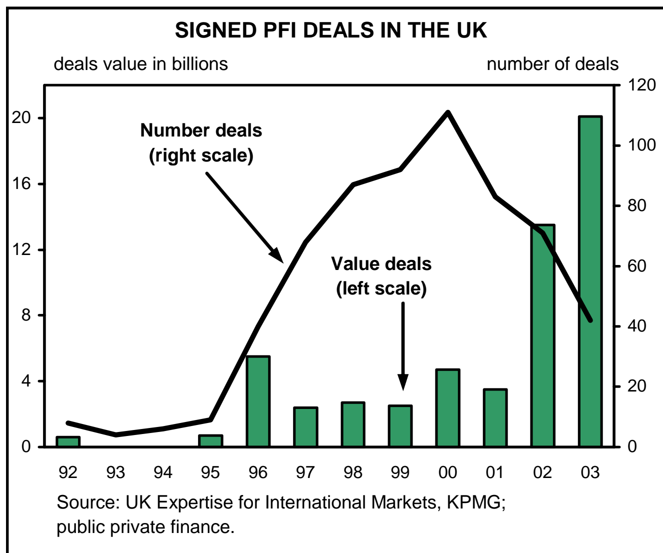
Around the world, the use of public-private-partnerships as a procurement model for infrastructure delivery has been expanding rapidly, with some 60 countries taking practical steps toward the development of their own P3 programs. Canada, too, has started along the same path, with the completion of a number of high profile projects, including P.E.I.'s Confederation Bridge and the Fredericton-Moncton Highway in a first wave of P3s some 10 years ago. Yet, since that time, the P3 model in this country has faced a bumpy ride. Over the past few years, fewer than 20 P3 deals have reached financial close across

the country, of which a large chunk were in British Columbia alone. This represents a growing number compared to the late 1990s, but still pales in comparison to the turnout in several other countries. In the United Kingdom, which has been the global leader in P3 development, there have been some 600 P3 projects since the mid 1990s that have accounted for about 15 per cent of total public sector capital investment.

Public opinion holds back P3 development

While hardly a circumstance unique to Canada, a general lack of public support for the P3 concept has arguably been the greatest barrier holding back the development of the market. For one, these complex arrangements are running up against a lack of understanding of how they work and a general wariness of the part of Canadians about private-sector involvement in area of public service delivery. This environment has also provided fertile ground for the voices of P3's staunch opponents to resonate, including public-sector unions, whereas counterarguments by advocates have largely fallen on deaf ears. As such, there has yet to be a truly fulsome debate on the advantages and risks of the P3s in the country.

Meanwhile, faced with this public skepticism, governments have either tended to shy away from using P3s or have pulled back at the first signs of controversy. High-profile P3 contracts arranged to develop 33 schools in Nova Scotia, a water filtration plant in Vancouver's north shore, and the 407 ETR in Ontario were later cancelled or, in the case of the latter situation, were faced with changes in the provincial government commitment to the project. There are examples when the abrupt change in policy was not caused by public outcry. For instance, a courthouse in Alberta was to be procured using private financing until the members of the judiciary demonstrated their opposition to the building, believing that it would constitute a threat to judicial independence, so the government ultimately abandoned the plan for P3-financing. Moreover, P3 projects have fallen by the wayside due to a host of other factors such as the inability of public and private partners to reach an agreement on risk sharing. However, for the most part, public opposition has been the number-one driver of government about-faces.



Source: UK Expertise for International Markets, KPMG; public private finance.

P3S ADD VALUE
APPROPRIATE ALLOCATION OF RISK + INNOVATION, COMPETITION, AND EFFICIENCY = VALUE FOR MONEY
Source: Yukon Economic Development, Overview of Public-Private Partnerships

ANSWERING PUBLIC CONCERNS ABOUT P3s

The successful communications strategy of opponents to P3s has been built on a number of oft-repeated assertions that have resonated with the public at large. Yet, despite their effectiveness, these same arguments tend to oversimplify matters or tell only part of the story. We count six in particular:

- P3s equal privatization
- P3s are more costly than traditional procurement, especially financing
- P3s are a way for governments to avoid reporting debt
- P3s are weak in accountability and transparency
- P3s lead to public-sector job losses and lower benefits
- Private companies will sacrifice quality for sake of profit

We have already addressed the first of these assertions. As we argued on page 8, the term "privatization" has been used synonymously with P3s, implying a loss of government ownership and control of a public asset in all partnership situations. However, this ignores the fact in the

bulk of cases the government retains ownership, control and continues to carry out an ongoing business relationship with the private-sector partner over the life of the agreement. We now take aim at the cornerstone of the anti-P3 camp, the view that P3s are costly to taxpayers and, hence, uneconomical.

Concern 1: P3s are too costly

The case that P3s come at too high a price tag is based on three convictions. **First,** the public sector can always borrow at a cheaper rate than the private sector. Indeed, government borrowing is backed by tax revenues and considered to be virtually risk free, which in turn can lead to borrowing costs several percentage points below that of the private sector. And, given that about one-third of a project's costs are financing alone, these costs are not insignificant. **Second,** in contrast to the public sector, the private sector will require a rate of return on its investment, exacerbating concerns that the financial benefits that accrue to the private sector will be more generous relative to the publicly-funded model or relative to the benefits the public derives from the delivery of the good itself. And, **third,** the higher upfront transaction costs incurred by parties to prepare for the bid, the time required to negotiate a commercial agreement and the ongoing costs of oversight.

These concerns can be valid, but only tell part of the story. For one, the cost issue is over-simplified, since other, less apparent costs, such as the opportunity cost of the government tying up scarce resources to a particular cause, are ignored. But, even more importantly, comparing costs between procurement options is like comparing apples and oranges, since no effort is taken to factor in which party bears the risk. In traditional government procurement, the lower government borrowing rate assumes the project is risk free, which it isn't, and is only achieved because of the public sectors' ability to increase taxes if problems arise with the project. As such, the potentially sizeable costs associated with unforeseen events are effectively underwritten by the taxpayer. In a P3, however, these risks – and potential costs – can be transferred to the private sector, but only when compensated by an appropriate return. This protection is similar to an extended warranty on a car or any other insurance premium. *Hence, it is not the cost, but the net benefit, which is the most relevant benchmark in considering which is the best route to go. And, on this count, P3s have the potential to provide significant value for money.*

Public Concerns About P3's

- Equals privatization
- Too costly
- Allow governments to avoid debt
- Hinder accountability
- Lead to public sector job losses
- Companies will sacrifice quality for profit

Consider the risk of cost overruns and delays during the construction phase of a capital project. Transferring these risks to the private sector would push up the initial cost of a project, since the private sector would demand offsetting compensation up-front. But, as we discuss in the text box on page 14, this practice of risk transfer has proven to generate a bang for the buck to taxpayers. Although Canadian experience with P3s has been too limited to get an accurate reading, reports commissioned by the U.K. Treasury in 2000 and 2001 showed that among the projects assessed on an ex-post basis, the P3 model delivered an average *saving* of 17-20 per cent compared to conventionally publicly-procured schemes.

These results from the U.K. were registered despite a higher cost of borrowing on the part of the private sector. This raises the question of why the public sector would even consider transferring capital-raising responsibility to the private sector. The usual explanation that follows is that the rapid growth in infrastructure needs is coming at too high a price tag for governments. However, as we discuss in the next section, this argument is becoming somewhat less compelling in view of recent changes in accounting practices. Still, there are some other benefits of private financing that deserve close attention:

- Just as there are benefits from combining the construction and operations components of a project, there are often synergies to be gained from combining control of financing activities with, say, those of planning.
- Private financing can be viewed as the "glue" that holds a partnership together, since it brings all interested parties – including investors – together under one common goal, which is to see a project carried out successfully.

Risk of Cost Over-runs and Schedule Delays Better Managed by P3s

Among many considerations of procuring a capital project, two key risks that stand out are cost over-runs and meeting deadlines. This is owing to a combination of factors, including the significant labour and capital resources involved in a project, forecasting uncertainty, the likelihood of leaving items out of the original budget, and changes made to the project after the initial planning stage. While there is no shortage of historical examples of missed budgets and timelines across Canada, consider the following Ontario illustrations:

- Thunder Bay Regional Health Centre – this facility was developed under the traditional procurement model in the late 1990s. The project cost estimate that accompanied the ministry's approval for a new hospital development was $126 million. Over the design and construction of the project, cost estimates began to soar. Upon opening, the final price tag was ultimately determined to be $284 million for a hospital almost one-fifth larger than initially planned. Worse, it was completed one year behind schedule.
- Pickering (Ontario) A Nuclear Units – Pickering A's four generating units were taken offline in 1997. In 1999, the government and the board of Ontario Power Generation (OPG) estimated that it would cost $1.1 billion over 3 years to return all units to service using the traditional procurement model. At present, only one of four units has been restarted, at a cost of $1.25 billion alone. Estimates provided by a recent review panel indicate that the costs of returning all units to service would be in the $3 billion-$4 billion range, with timeline estimates ranging from October 2006 to August 2008.

Although it is the case that examples could be found to show a similar outcome using a P3 model, there is good reason to believe that the private sector is better able to manage these risks. This is because private-sector partners often enjoy a comparable advantage in expertise, available resources and flexible scheduling. This does not even take into account the fact that transferring risk would help to ensure better outcomes, since penalties levied by governments for missed timetables and spending targets would reduce the bottom lines of the private sector.

Further illustrations highlight this last point. Recently, two similar casino projects were built in Ontario, one using the traditional government procurement method and the other using private-sector financing and project management. The cost of the traditional project rose from approximately $350 million to a final cost of $570 million; the casino built using alternative financing and procurement (AFP) opened on time and on budget. And, in the United Kingdom, the central government's Audit Office found that only 24 per cent of P3 projects were delivered late to the public compared to 70 per cent in the public sector. Moreover, cost over-runs occurred only 22 per cent of the time under P3s compared to 73 per cent in the public sector.

- Private sector financing through the market tends to lead to better assessment of risks of the investment, because financial markets are better able to measure and price risk.
- As more P3 projects are carried out in Canada, the spread in yields on private financing is likely to narrow. This has been the experience in the United Kingdom, although the gap remains typically 1-3 percentage points.

Despite these "offsetting" efficiencies, governments still enjoy a relative advantage over the private sector on the borrowing side. For a P3 project to achieve value for money, the savings over the life of a project must outweigh any additional margin on financing costs, the private-sector's required return, and additional costs from project bidding and oversight.

Concern 2: P3s allow governments to avoid debt

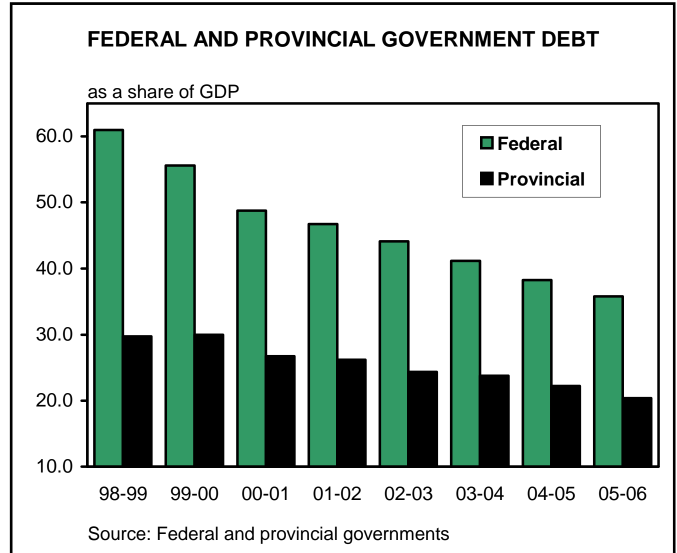
There is a legitimate concern that P3s will not be considered for their potential to generate value for money, but merely as a remedy for cash-strapped governments. By transferring financing responsibilities to the private sector, governments are perceived to benefit from lower borrowing requirements. But, the public worry runs much deeper than that. Even in cases when the public sector is making regular payments to a private sector partner and is ultimately on the hook for a project's liabilities, there have

been international examples in countries such as the U.K and U.S. where a P3 has been carried out completely "off book, which acts to distort the government's true fiscal health.

In Canada, this concern is not unwarranted, especially in light of the debt challenges of many governments. At the same time, however, this risk of governments pursuing P3s simply to "window dress" balance sheets appears to be falling in response to recent accounting changes. In particular, the increasing use of accrual accounting rather than cash accounting has reduced the upfront budget impact of traditional public-sector procurement, hence lessening the incentive for government to avoid borrowing. Even more importantly, under emerging accounting rules, any accounting advantage of P3s versus traditional asset procurement appears to be disappearing altogether. This reflects the "leaseback" nature of most P3s under the DBFO model. And, under the guidelines proposed by the Public Sector Accounting Board (PSAB), inclusion of the assets and liabilities will be required if the transaction is deemed to be a *capital* rather than an *operating* lease:

- In a capital lease structure, there is reasonable assurance that the lessee (government) will obtain ownership of the leased asset by the end of the term, that the lease term is of such a duration that the public sector will receive most of the economic benefits, and that the private sector would be assured of recovering its investment. As a result, in addition to recording the annual lease payment on the income statement, the lessee would book the asset and an obligation equal to the present value of the minimum lease payments over the entire term on the balance sheet.
- Conversely, in an operating lease situation, the private sector retains most of the benefits and risks of ownership. No long-term obligations need be recorded, although annual lease payments would be booked in the year that they occur.

P3S VALUE FOR MONEY	
P3 COSTS	**P3 BENEFITS**
· Financing · Profit · Bid/Transactional Costs	· Risk Transfer · Competition · Innovation · Asset maintenance and rehabilitation pre-defined prior to construction
Source: Yukon Economic Development, Overview of Public-Private Partnerships	



Most DBFO arrangements would appear to fit the definition of a capital lease, although admittedly, there is some room open for interpretation. At the very least, however, annual lease payments of P3s (which include all life cycle costs) would be included as an annual expense. Meanwhile, with the change to accrual accounting, governments are now required to consider costs for maintenance, replacement and other life-cycle costs into its annual budget expense calculations. Still, given the government's track record in terms of asset management, the jury will remain out on how accurately these life-cycle costs will be factored in.

We see good reason for optimism that P3s will be treated appropriately on governments' books. In response to the recommendations of auditor generals, the federal and provincial governments in Canada have been turning their attention to improving transparency in their budget process in recent years. In many cases, provincial auditors' roles and budgets are being beefed up. In addition to the move to accrual accounting, more jurisdictions are increasingly consolidating public institutions such as schools, universities, colleges and hospitals into one set of books. Lastly, bond rating agencies recognize project company debt as a contingent liability for governments during the construction phase.

Concern 3: P3s hinder accountability

The thrust of the argument is that once a government body turns over operational control of a public asset or service to a private company, accountability to elected officials and the public is lost. No doubt, when a private-

sector partner enters into a long-term relationship with government, some business practices geared to its profitability objective could be in conflict with the government's goal of a high level of public accountability. For example, the government wants to be transparent and open to public scrutiny, but in order to remain competitive, the private sector might seek confidentiality. In some instances, this concern could dampen a company's desire to provide innovative solutions during the RFP stage.

These challenges need to be recognized, but it is important to keep some perspective. A range of scrutiny mechanisms exists to mitigate the threat of greatly-reduced accountability. In addition to answering to its shareholders, the private partner must answer to the government agency that hires it and to various provincial and federal regulators. In very visible partnerships, this accountability will extend to an increasingly "watch-dog" like news media. Other vehicles to foster P3 accountability include results- and outcomes-based P3 agreements, reports to Parliament/legislatures and access to information. In any event, governments need to continually strive to seek a balance between the need to be transparent and the desire to protect proprietary information.

MAIN SECTORS IN INTERNATIONAL DEVELOPMENTS OF P3s

COUNTRIES	Sectors with P3s in progress
Finland	Road concession (shadow toll) School and higher education
France	Autoroute concessions (real toll) Water concessions
Greece	Road concession (real toll) Thessaloniki light rail
Ireland	Transport, Education, Water Waste management
Italy	Hospitals, Transport, Waste management
Netherlands	Water, High speed rail rink
Portugal	Airports, Road concessions (shadow toll)
Spain	Autoroute concessions (real toll) Regional road concessions (shadow tolls)
Japan	Healthcare, accomodation, IT and transport at regional level
Australia	Roads (Melbourne) Hospitals (Victoria and NSW) Prisons (Victoria and W. Australia)
South Africa	Prisons, Water, Healthcare and education

Source: UK Expertise for International Markets, KPMG

Concern 4: P3s lead to public sector job losses

When a private sector partner takes on the responsibility of delivering a public service, concerns will be raised about the potential for the company to lay-off government employees, cut wages and reduce pension entitlements and other benefits. However, there is little evidence that this is indeed the case. In fact, a U.S. Department of Labor study in 2001, which examined partnerships in 34 cities and countries, found that virtually all affected public employees were either hired by private contractors in order to benefit from their institutional knowledge and expertise or transferred to other government positions. In the cases where there have been layoffs, these job cuts have usually occurred through attrition. Lastly, in the United Kingdom, high levels of satisfaction have purportedly been recorded among transferred employees on signed deals.

Concern 5: Companies will sacrifice quality for profit

Notwithstanding the concern that businesses will trade-off quality of service for the sake of profit, the truth of the matter is that these goals are not mutually exclusive. In competitive industries, the quality of a service is a key driver of financial success. And, to the extent that fears persist about public services being maintained in a monopoly situation, the government can continue to retain some control through clearly defined contract specifications and monitoring. Private-sector profit opportunities within a P3 framework will emerge from the potential to introduce sound business techniques and practices, ranging from improvements in management efficiency, application of new technologies, cash flow management, personnel development and shared resources.

Risks of P3s can't be pushed under the carpet

Up until now, we have focused on the potential benefits of P3s while putting many of the criticisms into perspective. Still, we must be very careful not to present P3s as a miracle solution to a daunting challenge. The fact of the matter is that the private sector in not *always* more efficient than government. The ability of business to generate efficiency gains will depend heavily on the product or service, the competencies of the private partners and government in question and whether there is a competitive environment in the private sector. In the same vein, it is clear from international experience that P3s may not only fall short in the goal of providing value for money,

but can leave taxpayers even worse off. We have already referred to the risk of weakened transparency and accountability if the need of the private sector to protect proprietary information is not balanced with the public's need to know. Here are some other risks of P3s that should not be overlooked:

- *Long-term nature of the transactions* – long-term contracts give rise to uncertainty about the effects of future events on the outcome of the P3. A takeover, merger or other significant restructuring that changes the partners' ability to perform, inability to deal with changes in the economy, or an inadequate dispute resolution process are all risks of long-term contracts.
- *Complexity of transactions* – the private-sector consortium may include multiple partners that raise the risk that respective responsibilities and roles will not be well understood and that the government will not be able to provide accountability for services.
- *Proper monitoring of service quality* – the government is not delivering the services directly, which puts considerable importance on continuous oversight in order to ensure some degree of control over the asset.
- *Different cultures* – as is the case with any business relationship, there must be synergies in working closely together. And, to the extent that the private and public sector parties have different cultures and attitudes, there may be a leakage of the potential rewards of a P3.

Risks of P3's

- Long-term nature of transactions
- Complexity of transactions
- Proper monitoring of service quality
- Different cultures of public & private sectors
- Ineffective risk assessment & project analyses
- Poor contract

It's all about the contract ... and solid risk assessment

Most importantly, receiving value for money from a P3 is largely contingent on transferring risk to the private sector. That might sound easy. But, in actuality, effective risk assessment and project analysis demand strong abilities to appraise long-term options and negotiate contracts, which are skills that are often lacking within the public sector. And, if risks are underweighted/improperly evaluated or if problems develop because of a poorly-negotiated contract with an inadequate dispute settling mechanism, then the result can be excessive private returns at the expense of a taxpayer.

NEEDED: A ROBUST MODEL FOR P3s

Ultimately, the success of P3s in overcoming these important risks boils down to the strength of the public procurement approach adopted. Indeed, a major reason why the United Kingdom, along with countries such as Austraila, New Zealand and the Netherlands, have achieved success on the P3 front is that governments there took action early to put into place the all-important building blocks of (a) a standardized assesment and selection process (b) higher levels of expertise across the public sector (c) an open, transparent and accountable environment and (d) a strong commitment behind the process. But, even those pillars may not be enough on their own. As importantly, government approaches must remain highly flexible, with a willingness to fine tune procedures as certain issues surface through audits and project monitoring. Even the model itself must be adaptable to differing circumstances. For example, some approaches may work more effectively than others depending on, say, the stage of an asset's life cycle.

In contrast, Canada remains at the early stages of the learning curve. Thus far, the general approach to P3s in this country can only be described as piece-meal, with policies and a political appetite that have varied widely from coast to coast. The tide may be starting to turn, however. In particular, British Columbia has been hard at work developing a P3 model that holds considerable promise. In fact, over the past few years, a number of P3s in the province have reached financial close. What's more, Ontario, Quebec and Alberta have also begun to move forward with models of their own not unlike that of British Columbia.

B.C. model worth looking at

The use of P3s as a tool to deliver public capital assets in British Columbia took a major leap forward in 2001, when the newly elected government under Gordon Campbell embarked on a Core Services Review aimed at identifying ways to deliver public services more effectively. Along with that review came a commitment by the government to develop a model that would be based on an

open, competitive and fair process as well as protection of the public's interest. And, over the past five years, there have been steps taken in the province to bring together these four key ingredients, partly by borrowing heavily from best practices around the world.

Partnerships BC a centre of expertise

Partnerships British Columbia (Partnerships BC) was formed as an arm's length organization with a mandate to provide expertise to public-sector clients on matters related to P3s and other non-conventional approaches to delivering capital assets. Partnerships BC, which was modeled closely after Partnerships U.K., works closely with the public sector throughout the procurement process. This includes the preliminary assessment of whether a P3 is the best way to go, the development of a business plan, the approval stage, and the project implementation phase. At a minimum, Partnerships BC assists client agencies to manage changes in risk profile, and becomes involved in material changes in project scope to ensure that the project's economics are maintained.

It is important to note what Partnerships BC is not. It is not an approval organization, does not enter into agreements with the private sector, does not serve as a facilities manager, is not a capital-planning agency and is not a funding agency. B.C. Treasury retains its roles as approver and overseer of capital projects within the government. Rather, Partnerships BC facilitates P3 projects by bringing together a mix of private-sector, deal-structuring expertise on the one hand and a high level of public-sector stewardship on the other. And, "expertise", in particular, has been sorely lacking from the traditional model of public procurement. This is because departments or ministries – such as transportation, health and education – have managed their capital procurement internally and somewhat in isolation of the capital decisions of other ministries. This has often resulted in a dilution of expertise and a slower standardization of procurement processes.

CANADIAN PPP/AFP PROJECT SUMMARY	
Reached Financial Close	
BC	Abbotsford Regional Hopital and Cancer Centre
BC	Academic Ambulatory Care Centre
BC	Britannia Mine Water Treatment Plant
BC	Sea-to-Sky Highway Rehabilitation and Expansion Project
BC	Richmond-Airport-Vancouver Rapid Transit
BC	Kicking Horse Canyon Phase II
BC	William R. Bennet Bridge, Okanagan
ONT	William Osler Hospital Corporation
ONT	Royal Ottawa Psychiatric Hospital
AB	Anthony henday Drive: Edmonton Ring Road
NB	Trans-Canada Highway Project

Souce: Canadian Public-Private Partnerhip Financing Gaining Traction, Standard & Poor's

CAMF framework helps to evaluate risks

At the heart of any successful P3 model is the condition that any public body contemplating a public-private venture first carry out a detailed and standardized analysis of all of the options. In the United Kingdom, the Public Sector Comparator (PSC) has been the critical tool in assessing and comparing P3 options with traditional public procurement models, which begins and ends with a rigorous examination of the "in house" costs of implementing a project and assigning the various types of risks to the appropriate party that can best handle them. And, in 2002, B.C. released it version of the PSC – the Capital Asset Management Framework (CAMF).

In order to assess relative value for money between the public-sector model and one or more P3 business models, the CAMF looks at both quantitative and qualitative measures. On the quantitative side, the present value of the future stream of life-cycle costs under each option is calculated using a common discount rate, which is set at a level that is believed to reflect the inherent risk of that project. Risks are identified and quantified in the evaluation, while sensitivity analysis is applied to test the rigour of the results to varying assumptions in discount rates, inflation rates, et cetera. In addition to the quantitative assessment, the public-sector body also considers a number of other factors between options – including safety, environmental impact, project schedule, service delivery outcomes and environmental impact – prior to rendering a decision on which option provides the best value for money.

The CAMF exercise is designed to encourage public-sector employees to ask the following all-important questions:

- Is there another way to meet service delivery needs that could avoid new capital?
- Is there a way to better manage or use existing assets

that could reduce the need for additional expenditures?

- Is there a way to share the cost and risk of capital acquisition with, for example, a private sector partner or another public sector agency?

The CAMF is not a perfect tool by any means, as it is complex to administer and does not easily accommodate non-financial factors. Moreover, there is also far from a universal consensus on which discount rate should be used. A criticism that has been levelled at Partnerships BC's practice of using the private cost of capital (rather than the government's lower borrowing rate) in computing the discounted costs is that it unfairly discriminates against the public-sector procurement option. As noted earlier, this gap in borrowing rates can be as high as a few percentage points, and thus can have a major impact on the analysis. Keep in mind that Partnerships BC's approach is not out of line with international practices. In British Columbia, the nominal discount rate applied to project costs is 5-8 per cent, which is identical to that used in Australia. In the United Kingdom, the government applies a real (inflation-adjusted) rate of 3.5 per cent, or just over 6 per cent currently in nominal terms.

The justification for using the higher borrowing rate in the PSC calculation is that it more accurately reflects the true public cost of obtaining the capital than the government's "risk free" rate, since the price of the project's risk – which is ultimately borne by the taxpayer – is effectively hidden under the safety of guarantees from the public purse. But, while this issue will continue to be debated, the importance of a CAMF analysis cannot be overstated, as it is a necessary step that imposes rigorous financial and costing discipline on the public sector, requires a full life-cycle approach and compels consideration and management of risks.

STATUS OF B.C. PPP PROJECTS VALUE FOR MONEY

PROJECT	Life-cycle cost savings	% of project cost
Sierra Yoyo Desan Resource Road	Completed 3 months ahead of schedule	
Acedemic Ambulatory Care Centre	$17 million	15%
Abbotsford Regional Hospital and Cancer Centre	$39 million	10%
Britannna Mine Water Treatment Plant	$10 million	30%
Sea to Sky Highway Improvement Project	$131 mn. In user benefits	26%
William R. Bennett Bridge	$25 million	16%
Canada Line (RAV)	$92 million	6%
Golden Ears Bridge	VFM Report Under Development	
Northern Sports Centre	VFM Report Under Development	
Kicking Horse Canyon	VFM Rport - June 2006	

Source: Partnerships British Columbia: June 2006

BC P3 PROJECTS UNDER DEVELOPMENT

Health
- Long Term Care
- Primary Care and Medical Equipment
- Acute Care

Advanced Education/Education
- Universities/Colleges

Transportation
- Pacific Gateway

Real Estate

Recreation

Source: Partnerships British Columbia: November 2005

Focus on transparency and accountability

Having the proper selection process and formal value for money criteria as laid out in the CAMF is crucial from an accountability and transparency standpoint. But, these conditions alone are not sufficient. As importantly, clear and coherent documentation needs to be released in a timely manner in order to clearly explain the processes the government manages and the decisions it takes. And, on this count, the B.C. government appears to have struck a good balance between satisfying the public's desire to know with the company's desire to protect proprietary information.

As the accompanying chart shows, the government has set out a list of disclosure milestones with each project, including the value for money (VFM) report and post-concession agreement among others. The VFM report, which is released within 60 days of financial close, includes a review by the provincial auditor general. Other audit information, including fairness reports and peer reviews of the project during the planning stage, is also made available to the public. Perhaps most importantly, this information is easy for the public to track down. B.C. Partnerships' website has a page set up for each P3 project, which

includes press releases, value for money reports, other audit information as it is made available to the public.

B.C. government has demonstrated commitment

The B.C. government has backed up these steps with a solid commitment to P3 development, which if continued, will pay off enormously down the road in terms of greater private sector confidence, rising deal flow and reduced transactions costs for partnership arrangements. Indeed, without steady political commitment, firms will be reluctant to develop the necessary resources that are required to bid for and carry out contracts. This is not even to mention the fact that bidding on government projects is a complex and costly venture for private firms, so if the government decides to pull the plug under political pressure, the private sector is left holding the bill. As a result, firms may adopt a "once bitten, twice shy" mentality, which would reduce the pool of competitors and/or require greater government compensation to private firms due to greater risks and costs incurred in the bidding process.

B.C. model has received international recognition

With these key ingredients in place, B.C.'s P3 program has recently launched into high gear. As we present in the table, one project is already in the operational stage – the Sierra Yoyo Desan Road – while seven have recently reached financial close and are currently in the development stage. Furthermore, five other P3 projects have reached approval and are currently in the procurement stage. Thus far, the provincial government has been focusing on addressing pressures in the health and transportations sectors, with the latter area partly reflecting the needs for the 2010 Winter Olympics. Nevertheless, a P3 to build a sports centre in Prince George show that there is also an interest in applying this model to a broad range of public services.

With most of the projects still in their early stages, the jury remains out on how much bang for the taxpayer buck these P3 projects will ultimately deliver. However, there is a growing consensus in Canada and abroad that the province is on a solid track. Early evidence is showing expected savings or additional benefits in the projects completed to date. A recent poll showed that two-thirds of B.C. residents were in favour of the province's foray into P3s. And, in 2005, the Canadian Council of Public Private Partnerships (CCPPP) granted awards in the project finance category to the Sea-to-Sky Highway (S2S) Improvement Project and Abbotsford Regional Hospital and Cancer Centre for innovation and excellence in P3 design. It was the second award for the Abbotsford facility, after it won for North American Partnership of the year by the prestigious Project Finance Magazine. The Sierra Yoyo Desan project had also won a CCPPP prize in 2004.

As importantly, investors are warming up to the province's P3 market. Not only have two global players in the area of P3 financing – ABN AMRO Bank and Macquarie Bank – set up offices in Vancouver, but financing of recent projects has been carried out smoothly. For example, the $600-million S2S Highway Improvement Project was two times oversubscribed and priced at 100-120 basis points over the Canadian Dollar Offered Rate (CDOR) during both construction and throughout the 24.5 year concession period. The $1 billion Golden Ears Bridge toll project is reported to have been priced even lower, at 70 basis points above CDOR. These favourable rates, which are highly competitive with institutional debt, partly reflect the solid structure of the deals and the significant investor interest in transportation-related projects. Still, while foreign banks have provided most of the private funding for projects such as S2S – highlighting the fact that domestic institutions remain cautious – each deal closed to date has managed to introduce new participants into the Canadian P3 market.

PBC VALUE PROPOSITION
Business Planning
· Risk analysis
· Procurement analysis
· Quantitative analysis
· Project management and governance
Approvals
· Knowledge of government processes
· Submission templates (e.g. Term sheets)
· Shareholder relationship
Procurement Process
· Standard procurement documents
· Evaluation approaches
· Alternatives models
· Procurement management
General P3 Best Practices and Policies
· Conflict of interest
· Honoraria
· Strategic communications
· Value for money

Source: Partnerships British Columbia: November 2005

Other provinces also moving forward with P3 models

While B.C. has moved into the lead on the P3 front, other provincial governments are beginning to jump on the bandwagon. In the past year, the Alberta government has opted to develop the Edmonton Ring Road as a P3 and has plans for the same model to be applied to other transportation projects. Moreover, Quebec recently established an agency to focus on the development of a whole range of infrastructure projects, and appears poised to apply the DBFO model to at least two major highway projects in the coming year. P3s may also be used for the development of hospitals in Quebec as well as a new symphony facility in Montreal. Still, if there is one province that is a close second to British Columbia in terms of P3 development it is Ontario. Managed under the Ministry of Public Infrastructure Renewal (PIR), the province has designated over 40 projects to be delivered under the AFP model, of which the bulk will be in the area of health care. Interestingly, while Ontario has been slower coming out of the gate, it may soon surpass B.C. in terms of the number of completed projects.

Ontario moves ahead with more than 30 AFPs

In many respects, the Ontario government is moving down the same path as B.C. In 2004, the province released its framework strategy for Alternative Financing and Procurement (AFP), "Building A Better Tomorrow", which is underpinned by a similar set of principles as in the B.C. P3 model. In short, both jurisdictions will be only looking at projects that allow for a meaningful risk transfer and demonstrable value for money within a fair and open bidding process. Further, the Ontario government established Infrastructure Ontario, which will have a function similar to that of Partnerships British Columbia. Lastly, in line with B.C., Ontario has indicated that "off-balance-sheet" financing will not factor into the selection criteria in determining the best way to go between a AFP and traditional procurement.

At the same time, there is one important difference between the two approaches, namely the way AFP/P3 projects are originated. In Ontario, government determines policy priorities and project delivery objectives and assigns projects to Infrastructure Ontario. In British Columbia, the flow is in the opposite direction, with projects originating from Partnerships B.C., who then markets them to government ministries.

CANADIAN PPP/AFP PROJECT SUMMARY

Pending or Under Consideration	
BC	Golden Ears Bridge
BC	Northern Sport Centre
ONT	North Bay Regional Health Center
ONT	Montfort Hospital
ONT	Halton Healtcare Services Hospital
ONT	Toronto's Centre for Addiction and Mental Health
ONT	Durham Consolidated Courthouse
ONT	Sault Area Hospital
ONT	Niagara Health System hospital project
ONT	Trillium Healthcare
ONT	Credit Valley Hospital
ONT	London Health Sciences Centre
ONT	London St.Joseph's Health Centre
ONT	Royal Victoria Hospital
ONT	Sunnybrook Hospital
ONT	Bluewater Health Center
ONT	Waterloo Region Courthouse
ONT	Quinte Healthcare
ONT	GTA Youth Detention Center
QC	A25 highway Project
QC	A30 Highway Project

Souce: Canadian Public-Private Partnerhip Financing Gaining Traction, Standard & Poor's, 2005

Health care at top of Ontario's AFP list

Under the former Conservative government, two hospitals had been set up as P3s – namely, the William Osler Hospital and Royal Ottawa Psychiatric Hospital. The governing Liberals have redefined these projects under their AFP model, meaning that the private ownership provisions have been renegotiated to ensure public ownership, control and accountability. Meanwhile, the government is planning to build on these projects with a host of AFP initiatives in health care across the province over the next several years.

This push towards alternative financing of health care facilities in Ontario represents a dramatic change in position for a government that had been opposed to any private-sector participation in the delivery of hospital services during the last election campaign. This shift reflects two factors. First, with its hands on the purse strings, the government can more appreciate the extent of pressures

on the health care system and the need to look for more efficient ways of delivery. And, second, that private involvement in the health-care sector does not represent a selling out of Canada's single-payer public model. In fact, in this new model, private contractors – which already provide services in hospitals such as catering – will merely supply the "bricks and mortar". Consistent with the AFP framework, these hospitals will also remain under public ownership and control, while the government will continue to provide clinical services. In addition to health care, the Ontario government is also looking at AFP projects in other sectors. For example, a courthouse in Oshawa and a youth detention centre in the GTA are two projects currently on the table.

Further progress needed for P3 market to blossom

While governments have continued to make strides, there is no disguising the fact that the Canadian P3 market remains in the early stages of development. As such, the next few years will be under a microscope to, first, demonstrate to taxpayers that P3/AFP projects can provide net benefits and, second, to show the private sector that these projects are worth investing in. Even in the case of B.C., which is the furthest along the learning curve, ongoing refinements to the process will no doubt be required, especially in the area of public communications. Reporting on P3s in a timely manner, continued efforts to raise public awareness of the benefits and risks of these arrangements in ways that individuals can understand, and anticipating public attacks before they occur are some of the areas where further progress is required. In additon, focusing on areas that more easily accommodate P3s would be a wise strategy until Canadians become more comfortable with the approach (see text box on next page). Hopefully, as this process becomes easier, other governments that are currently reticent to adopt P3s will change their tack.

Federal government needs to be a champion for P3s

Internationally, there has been growing recognition that a strong federal or central government role is an important contributor to the "winning conditions" for P3s. For example, in the United Kingdom, the central government's leadership has helped to foster a national P3 market, where guidelines, regulations and processes are consistent across the country. And, with this higher level of consistency has come increased certainty, economies of scale, lower private-sector bidding costs and a better functioning market. In contrast, Canada's P3 market is at risk of becoming even more fragmented in the future as provincial models are shaped along different lines and at different speeds. We would encourage provinces to work together in order to ensure the most uniform Canadian P3 market possible.

Efforts to better allign provincial procedures would be further supported if the federal government stepped up to take on a leadership role in the area. There is no denying the fact that the federal government, through Infrastructure Canada, has made significant contributions to strengthening the nation's infrastructure in recent years. Yet, the federal government's role has been a cost-sharing funding partner in P3 projects across the country.

The first big step for the federal government to become a national "champion" in the area of P3 development would be to focus on its own backyard. For one, it should undertake P3s in its own jurisdiction rather than merely fund projects at the provincial and municipal levels. That way, it would learn by doing. Second, conditions surrounding most federal programs are currently too rigid and access to funding too untimely to encourage the use of P3s. These issues must be addressed. For instance, providing conditional approvals would help to expedite negotiations among the partners. Above all, implementing a government-wide framework on P3s would be a significant step forward in embracing the whole notion.

On a bright note, the federal government is now taking a closer look at its role in Canada's P3 market. Similar to the joint efforts of the Canadian Council of Public Private Partnershops and Partnerships BC, Infrastrucure Canada has held workshops on the use of P3s as a mechanism for financing and developing infrastructure with participants from all orders of government, pension funds, academia and public sector unions. The department has identified financing as a priority area for its in-house and funded external research, collaborating on projects with the OECD, the Canada West Foundation and other partners. These various activities are addressing the issue of identifying the winning conditions for different types of models for infrastructure financing, including lessons learned about the roles of governments.

Australia creating a Pan-National P3 market

Canada would be wise to monitor the current events taking place in Australia, which is another decentralized market. While early development of the P3 market was

What types of projects are most amenable to P3s?

Governments around the world have been applying the P3 model to virtually all areas of public service, including transportation, health care, water and wastewater, electricity, and education. But, does this mean that all areas accommodate P3 projects equally well? Research has shown that the answer to the question is no. In general, projects that have the following characteristics are more amenable to P3-type arrangements:

- large in scale and capital intensive
- require technical challenges, innovation or capabilities which exceed that inside government
- have an identifiable revenue stream and measurable results

These criteria would appear to be conducive to a significant number of projects, including roads, bridges, highways, water and wastewater and electricity infrastructure. First and foremost, the large amount of capital required for these sectors makes them more commercially viable, especially given high up-front bid costs. In fact, it is not unusual for bid costs to exceed $2-3 million. In these circumstances, the all-up cost of the bid process will exceed 10% of the capital cost if the project is below $100 million. Hence, in the UK and Australia, governments have focused on projects roughly C$100 million and higher. Given Canada's less developed P3 market, projects of less than $250 million are generally deemed to be too small.

Further, an identifiable revenue stream (third point) facilitates project assessment, since costs and risks are easier to measure. Technological advances have made monitoring and metering of demand more economically viable in recent years in areas such as transportation, water and electricity.

Still, all sectors can't be painted with the same brush. UK reports by Mott MacDonald and the National Audit Office examined the performance of traditionally procured models as well as projects financed through the Project Finance Initiative (PFI) program. Their findings conclude that the traditional procurement had a better performance for "standard" projects while P3s reaped moe benefits in those projects that were deemed to be "non-standard". Non-standard buildings were defined as those with special design considerations and may include specialist hospitals, innovative prisons, high tech facilities and other unique buildings. This result was attributed to the fact that the innovativeness of the private sector could be better captured. Hence, the characteristics of a specific project do matter.

Try your hand with easier projects first

Given that the Canadian P3 market lacks depth, governments may be wise to first try their hand at projects that are the most amenable to these arrangements. And, this would also entail placing special focus, at least initially, on balancing those that meet the business case with those that have lower public sensitivity.

Case in point is water. Even though water and wastewater projects in the United States often meet the three criteria above, which has been evidenced in realized savings of 10-40 per cent on projects, Canadians are still reeling from the Walkerton experience in 2000. Interestingly, the private sector, which had taken over laboratory testing from the government in 1996, was ultimately not responsible for the tragedy. Still, many Canadians are still deeply opposed to private involvement in water and wastewater management. Hence, until the public becomes more comfortable with the P3 approach, governments may want to first set their sights on other areas which are more publicly palatable.

initially fragmented across states, efforts are now underway to create a Pan-Australian market. Led by leadership of both the federal government and the State of Victoria, the country created a National Public Private Partnerships Ministerial Forum in 2003 with participation from all levels of government and the private sector. The over-riding goal of the Forum is to promote synchronized approaches, share information and provide an arena to solve key industry concerns. In addition, through the efforts of the organization, a regular list of pipeline of P3 projects right across the country is published, giving forewarning to the market of current and future projects and indicating the sectors in which business opportunities are likely to arise.

Private sector needs to ramp up participation

Finally, for the P3 model to continue to flourish it will not just be winning support over taxpayers – the private sector will need to show increased participation to make

the system function well. As already noted, private-sector involvement both in project management and financing has been largely dominated by European and international players with a few exceptions. And, while pension funds have shown interest in investing in long-term, high-grade financial assets, overall, Canadian capital markets have lacked depth. Many financial institutions do not typically lend on a long-term project basis, largely reflecting the inherent risk. Unlike other more mature P3 markets, financial guarantee companies (i.e., monoline bond insurance firms) are not currently operating in Canada. Moreover, the extent of the deal flow has allowed for a secondary market for P3 equity to develop in countries such as Australia. On the plus side, Canadian banks have quietly been moving into secondary roles in the P3 market, including buying bank debt from existing P3 projects and selling it to institutional buyers.

Bottom Line

The potential for P3s to become a useful tool in Canada's infrastructure procurement and management warchest essentially boils down to the how effectively the "winning conditions" are put in place. A standardized assessment and selection process, a higher level of expertise, an open, transparent and accountable environment, a strong commitment from political leaders and federal leadership are all key building blocks. At the same time, "flexibility" in the approach taken needs to be the watchword. Canadian governments are in a fortunate position to benefit from best practices in many jurisdictions around the world. And, in our view, British Columbia's emerging P3 model is one that deserves attention.

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