



FASTFACTS



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June 22, 2006

Civic Cost over-runs: Are PPPs the Solution?

In response to the news that the City's water treatment plant is \$65 million or about 30 per cent over budget, both the Mayor, explicitly (*WFP*, May 11, 2006), and the *Free Press* Editors, implicitly (May 13, 2006) are arguing that a public-private partnership (PPP) arrangement would have brought the project in on budget and should be the model for the planned sewage system overhaul. Citizens of Winnipeg should be leery of such easy prescriptions, given the track record of PPPs, in Canada and elsewhere.

Labour shortages and associated increased wages are a problem for the whole construction sector, as are the rising costs of construction materials and especially those linked to oil products. It is private contractors working for the City that are incurring these higher costs and billing the City for them. The City does not do its own contracting.

These cost increases would not have been avoided by alternative approaches to construction. For instance, design-build approaches, a common feature of PPPs, including the Charleswood Bridge, put the onus on

the contractor to bring in a project on budget, but contractors build expected cost increases into their bids. Unexpected and unbudgeted cost increases in a design-build project result in a lower quality product being delivered, or in the private contractor going bankrupt or, more likely, as numerous instances around the world show (the most

graphic being the Channel Tunnel), in the private contractor being bailed out by the public sector. One way or the other, the taxpayer ends up paying for cost increases.

Many engineers and architects are also less than enthusiastic about design-build arrangements because they lose some of their independence and objectivity in project design, being answerable to the contractor rather than the ultimate client.

But it seems the Mayor is not just calling for design-build approaches. He appears to believe that problems with the capital budget justify handing over day-to-day operations of water and waste utilities to the private sector. He would like to see the sewer upgrades owned by the private sector and leased back to the City. The most

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common form of PPP in Canada has, in fact, been one in which the private partner finances, builds and operates a facility— a bridge, a road, a sewage plant, a water treatment plant, etc.— and leases it back to government. The benefits to government are said to be lower debt and lower capital spending, easing compliance with balanced budget legislation where this exists, and saving on operating expenses.

In reality, and without exception to my knowledge, the implied cost of borrowing built into PPP leases is higher than the public sector's own direct cost of borrowing. For example, the Charleswood Bridge cost tax payers an extra \$1.4 million in present value terms on a contract of \$11.6 million.

Consultants have also complained about the high 'hidden' costs of bidding on PPPs, in terms of preparing and evaluating requests for quotation and requests for proposals. Such costs have been estimated at \$1.6 million for the Charleswood Bridge (over 10% of the project cost), costs to consultants alone being 6.7 times as high as those incurred in a normal design-bid-build project. These additional costs, together with higher lease costs, have to be factored into the viability of the PPP option when assessing capital costs. In theory, they should be offset by the transfer of different types of risk from the public to the private sector, but this may or may not happen in practice.

Such projects do not reduce public sector debt as the leases have a value today that is exactly the equivalent to debt, regardless of accounting conventions. They are, at best, an expensive way of 'cooking the books', as more government auditors are now revealing.

Winnipeggers should be particularly cautious about handing over the operations of water or sewage treatment to a private, for-profit, company. Profits can result only from higher charges for water or water treatment or from spending less on operations. The first is a form of taxation; the latter usually means pay cuts or layoffs that lead to reduced levels of service. It was layoffs that characterized the Hamilton-Wentworth water and waste facility when it was handed over to the private sector. This exposed the public to higher risks of service disruption and environmental pollution. There were other problems with that PPP. Regional civil servants involved in the privatization deal joined the private partner in senior management positions, and the private partner claimed a portion of savings in costs that resulted from purely public sector initiatives. Eventually, the Hamilton Wentworth facility was so controversial that it was taken back into public hands.

The Moncton water treatment plant, another PPP, is considered a huge success. Certainly it delivers quality water. But it does so at a price. The Mayor of that city likes to claim they saved almost \$10 million or about 30% by

accepting the private bid for the plant. But this was based on a public sector plant that was not comparable, using older technology and having a capacity that was one-third larger. Furthermore, it is claimed that the plant is debt free and, certainly, it doesn't show up in the books of the City. In fact, hidden in the cost of water to the citizens of Moncton is a capital cost component which is a) significantly higher than Moncton's cost of borrowing and b) provides a return to equity of around 25 per cent per annum to the private partner! The whole project is, therefore, debt financed, and is much more expensive than it appears to be. The consumers of water are meeting these entire costs.

Another common feature of PPPs ought to concern Canadians. They lead, uniformly, for reasons of 'competition', to the privatization of information previously within the public realm. This, inevitably, reduces accountability for how public monies are spent. In this connection, we still do not know what the maintenance budget is for the Charleswood Bridge, despite numerous requests.

None of this is to argue that public procurement cannot be improved and be brought in on time and at cost. A thorough examination of the cost over runs of the water treatment plant is needed to show which ones were avoidable and to suggest ways of avoiding them in future. In the meantime, the claimed superiority of the PPP approach needs to be subjected to a close and critical examination.

- John Loxley

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