



VALUE FOR MONEY?

CAUTIONARY LESSONS ABOUT P3s FROM BRITISH COLUMBIA

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Summary

Public-private partnerships, or P3s, are an increasingly popular infrastructure development model with governments in many provinces and countries. In BC, they are now strongly encouraged for most new capital projects.

This study examines BC's experience with P3s, as well as evidence about their effectiveness from other jurisdictions, in particular the United Kingdom. The research focuses on the financing, bidding and evaluation processes for P3s. It does not explore in detail issues that arise from the private operation and maintenance of P3 facilities.

Key Findings

- P3s are being aggressively pursued in BC in spite of a lack of objective evidence that they are a superior option.
- P3s are less cost-effective, timely and transparent than traditional government procurement processes.
- Partnerships BC, whose mandate is both to promote P3s and evaluate whether they are appropriate for use on specific projects, is unable to adequately protect the public interest due to its inherent conflict of interest.
- The normal deliberations that go into making sound decisions about infrastructure projects are being influenced by "Value For Money" assessments (produced by Partnerships BC) that have limited use. These reports are so subjective, so susceptible to manipulation by vested interests, so complicated, and so consistently withheld from appropriate public scrutiny that they must be done by the Auditor General's office to be of any legitimate use.

Higher Costs are Built Into the P3 Model

Cost of private borrowing: In P3s, the private partner typically takes on the debt. Interest rates are higher for private borrowers than for government.

Profits: Private companies do not embark on P3 projects as a goodwill gesture; they do so to generate profits, which must be built into the cost of P3 contracts one way or another. Investment advisors estimate P3 profit margins at 10 to 15 per cent.

Time-consuming and costly procurement process: Proponents, including Partnerships BC, argue that P3s are more likely to be completed “on time and on budget.” However, the scope and complexity of P3s more often leads to delays and greater costs:

- With the design-build-finance-operate functions of infrastructure projects bundled together into multi-decade contracts, P3s involve extremely complex and time-consuming bidding and negotiation processes. This is more expensive for both government and private partners than traditional public procurement.
- The complexity and cost of bidding also reduces competition from potential partners. P3s with only two or three bidders are common; in the case of the Abbotsford Hospital, a contract was awarded to the sole bidder.
- The complex process can lead to significant delays before a contract is even signed. For example, the 10 Mile Bridge project in Kicking Horse Canyon was announced in March 2003; Partnerships BC then initiated the P3 process, adding nearly three years. The project is scheduled for completion in 2009. With public procurement, it would likely be finished by now.

What are “Public-Private Partnerships”?

P3s are a form of privatization in which a private company (or consortium) takes over the design, building, operation, and in many cases financing, of public infrastructure projects (hospitals, bridges, etc).

P3s are quite different from direct public procurement, where government finances a capital infrastructure project (using either existing tax dollars or by borrowing), contracts with one or more companies to design and build it, and hires public employees to maintain and operate the physical structure once it is complete.

In contrast, P3s use “Design-Build-Operate” and “Design-Build-Finance-Operate” arrangements to bundle all or most of the infrastructure development and operation processes into a single contract with one company (usually a consortium formed specifically for the purpose of bidding on a P3 project). The government pays the company monthly fees for its services over the lifetime of the contract, which is usually multi-decade.

This study focuses on “Design-Build-Finance-Operate” P3s, which are increasingly common in BC.

- These pre-contract delays tend to be overlooked by P3 proponents when they characterize projects as “on time and on budget.” Such is the case with both the Canada Line and the Abbotsford Hospital—both experienced delays and cost increases before the contracts were finalized that were directly related to the nature of the P3 process.
- Private partners are willing to provide contractual guarantees that they will deliver on time and on budget, but for a price. This can result in inflated bids by developers who anticipate potential contract penalties in advance.
- A UK Association of Chartered Accountants study found that public health bodies were paying a premium of 30 per cent on construction costs to ensure P3 hospitals were completed on time and on budget. However, because it is debatable whether P3s actually achieve cost or time savings, paying a 30 per cent premium for those dubious savings makes little sense.

Flawed Value For Money Reports are Being Used to Justify P3s

“Value For Money” (VFM) reports are a specialized analysis that compares the predicted costs of a P3 project and traditional public procurement (referred to as a “public sector comparator”). The VFM process relies on two problematic tools—discount rates and the value of risk transfer—that can be manipulated to favour P3s.

Discount rates: Value For Money analysis uses a “discount rate” to calculate the current value of future payments to be made by the government to a P3 contractor. This is to some extent reasonable, because factors such as interest rates and inflation change the value of money over time. Just as \$100 has less value as each year passes, and was at one time a small fortune—likewise, a monthly payment of \$10,000 by government to a private partner becomes less costly, in real terms, as time passes.

The way discount rates are used in Value For Money analysis is flawed:

- Value For Money reports use discount rates that are inappropriately biased in favour of P3 contracts. The reports compare a series of P3 contract payments to the upfront capital costs government would face with traditional procurement. The discount rates applied to P3s greatly understate the current value of future P3 contract payments, making them appear less costly. In addition, the assumption that government would pay for a project up-front in the case of traditional procurement (instead of financing it over time at the government’s borrowing rate) greatly overstates the relative cost of traditional procurement.
- Small variations in discount rates result in large differences in the total estimated costs of projects. In BC, the discount rates being used in VFM analyses are quite varied and arguably higher than appropriate.
- The UK Treasury now requires that Value For Money comparisons use a standardized discount rate in a consistent and transparent manner. This rate is lower than those used previously. BC has not followed suit, but if it did, P3s would look less favourable than Partnerships BC’s analyses suggest.

Risk transfer: In a P3, the private sector is allegedly responsible for taking on several risks that would otherwise be carried by government. There are costs associated with those risks, and P3 advocates claim that government gets additional “value for money” by paying extra to take such risk out of the government’s hands. However, the benefit to government is questionable:

- It is debatable whether there is in fact a meaningful transfer of risk. A P3 consortium typically exists for only one project. If the project goes awry the consortium can simply go bankrupt. To complete the P3 project, or continue its operation, the government has to step in to cover remaining costs. (This obligation is established by the legal concept *force majeure*.) There are several examples of governments having to step in and cover the remaining costs of a P3, including the La Trobe and Modbury hospitals in Australia.
- The private sector is skilled at evaluating risks, and will charge the government the full cost of the risks they take on. The healthy profit margins of P3s reveal that firms are not taking on risks at a loss—if anything, the private sector is likely charging a premium for risk transfer.
- After the construction phase is completed, the multi-decade operating agreements provide the contractor with a guaranteed client who will not go bankrupt. This makes the post-construction P3 an extremely low-risk investment, which enables P3 contractors to refinance at much lower rates and increase substantially the profit they earn.
- P3s are generally more expensive in cash terms than traditional public procurement. Value For Money analysis typically relies on the arbitrary “quantification” of risk transfer to make up the difference and position the P3 option as favourable.

Three BC Case Studies

This study includes a detailed look at three P3s in BC: the Abbotsford Hospital, the Canada Line (known as “RAV”) and the District of Maple Ridge Core Project.

A recurring theme in these projects is that the normal deliberations that go into making sound decisions about public expenditures and infrastructure projects are being influenced by questionable Value For Money reports. In all three cases, the VFM analyses were not prepared by an independent third party, nor were they released to the public before the contracts were finalized. Instead, Value For Money analyses were produced at the wrong time, by the wrong people, and with limited transparency.

In the cases of the Abbotsford Hospital and Canada Line projects, the Auditor General has been limited to providing “reviews” of the VFM reports, while the scrutiny assumed to be inherent in his office’s role as auditor is used to whitewash the credibility of P3s. Projects are proceeding at times when they need to be stopped and reconsidered, such as when there are major changes in scope, or when competitive bidding is reduced to a sole bidder. The Maple Ridge project was cancelled after major problems in the P3 process.

The case studies find that in all three projects, the P3 approach leads to delays and higher costs.

Accountability and Transparency are Lacking in P3 Decision-Making

The aggressive pursuit of P3s by the BC government compromises due process and the public interest.

- If Value For Money reports are to be of even limited use, they must be undertaken by an independent public body mandated to uphold the public interest. In BC, VFM reports are typically produced by Partnerships BC, which has the dual and contradictory role of both assessing the value of P3s and pursuing and implementing them. The CEO of Partnerships BC is partially compensated based on his ability to secure and advance P3 contracts.
- Several VFM reports have been produced *after* a contract has been signed with the private sector (for example, the Abbotsford Hospital) or withheld from public scrutiny until after a P3 has passed the point of no return (for example, the Canada Line).
- Currently, BC's Auditor General provides opinion letters on Value For Money comparisons created by Partnerships BC based on a "review" instead of a full and proper audit. (Audits can look only at real past transactions; Value For Money reports are forecasts.) Reviews are limited in scope and do not provide the scrutiny that P3s warrant—they do not question the underlying assumptions, only how they are used. A review could provide a positive opinion of a Value For Money analysis that has faulty assumptions.
- P3 proponents have used the Auditor General's reviews to imply that P3 projects have his stamp of approval, which is highly misleading.
- P3s are stimulating private sector activity by diverting public funds into overpriced projects. If government is paying more for something than it is worth, it raises the question of whether the new industry is adding to the public interest.

Recommendations

- While P3s may be appropriate under some limited circumstances, in general they are unnecessarily costly and do not serve the public interest. The government should abandon its ideological commitment to P3s and take a more objective approach.
- All major public infrastructure projects should undergo a cost-benefit analysis that assesses the value of undertaking a project in the first place.
- If the government then wishes to consider a P3, the Value For Money process should be carried out by an independent public body such as the Auditor General's Office.
- Value For Money analysis must do a better job of measuring a P3's worth compared to traditional public procurement. Use of a standardized discount rate, and a critical review of the true value of risk transfer, including separating risk transfer from interest rates and discounting, should be a priority.
- The Office of the Auditor General must be sufficiently funded to ensure its ability to effectively and independently scrutinize the P3 model of infrastructure development, and individual P3 projects.
- The Auditor General's Office should evaluate the role and mandate of Partnerships BC.