

“Public-Private Partnerships: The Canadian Experience”

**Presentation to the Oxford School of Project Finance
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Thank you for the opportunity to talk with you today about the developments in Canada in public-private partnerships and in project financing. The sub-title for this presentation might be “Driving with the Rear View Mirror” or “Hind Sight is 100%”. Consider these media reports in Canada over the past two years:

- “Federal government sells air navigation system for \$1.5 billion to private company” (October 1996)
- “Feds left \$1 billion on the table” (October 1997 - reference to Auditor General of Canada's Report)
- “Ontario government rejects private financing for Highway 407” (1994)
- “Ontario considers sale of ETR 407” (1998)

If you believe these headlines suggest some ambivalence toward moving Canadian assets and public sector operations into the private sector, you would be right. Canadians have been more cautious about pure privatization or commercialization than the U.K., the USA, or Australia and New Zealand. This caution arises from our heritage where governments were expected to play a strong role in economic and social development in everything from broadcasting through the Canadian Broadcasting Corporation to transportation through Air Canada and the Canadian National Railway. But times have changed and we are, with some exceptions, embracing the greater involvement of the private sector in delivering and financing the development of our infrastructure and the delivery of services to the public.

We are still more comfortable in Canada with the notion of retaining some role for government, be it policy setting, monitoring and oversight, or sharing financial risk. As a result, you will hear Canadian public officials refer to “alternative service delivery”, “partnering with the private sector” and “public-private partnerships” more often than “privatization”. This applies particularly to financing where risk has often been shared or guarantees provided by governments, at least in the early stages of the project until a track record of usage and acceptance has been established.

The following definition of “public-private partnerships” has been adopted by The Canadian Council for Public-Private Partnerships:

“A cooperative venture between the public and private sectors, built on expertise of each partner, that best meets clearly defined public needs through the appropriate allocation of risks, rewards, and responsibilities.”

This presentation features three Canadian examples of public-private partnerships as they are evolving along a continuum of sharing risk, reward and responsibility. These

examples are Navigation Canada (NavCan), toll highways, and Teranet Land Information Services Inc. (Teranet). Before examining these cases, let me set the stage a little by describing Canada's economic climate and the drivers for change.

Like most Western industrialized nations, Canada has spent much of the 1990's cutting government spending, reducing deficits and dealing with restructuring and unemployment. By 1998, our federal and most provincial governments had balanced their budgets, are paying down debt and some are making tax cuts. Employment levels and productivity are higher than much of the past decade. But the fiscal pressures are now being passed to the local governments along with the offloading of responsibility for services ranging from road construction to social services. The net result is that the ability of governments to build and operate infrastructure continues to be constrained while demand grows with immigration and demographic changes.

Despite our fiscal pressures, Canadians still like the idea of a government role in ensuring fair, accessible and cost effective services to citizens. Research on public opinion and surveys of decision makers indicate strong support for the use of public-private partnerships (or P3's) to build and deliver services. In 1996, The Canadian Council for Public-Private Partnerships identified over 200 examples of such projects and found that 78% of governments across the country had specific projects and plans for using P3's during the next three years, especially in the hard infrastructure areas, such as building roads, bridges, arenas, tourist and recreation facilities.

In June 1998, the Council found the number of projects completed or underway has doubled to more than 400, that the intended level of use of P3's has risen to 85%. Furthermore, the nature of these projects has diversified into information technology, airport development, environment and energy, as well as moving into the "soft services" such as education and health care.

Clearly, there is momentum underway and an increasing number of success stories in the public domain. However, in the area of private financing, despite some successful examples, some ambivalence remains. During 1996-97, a Task Force on Public-Private Financing was struck by the Canadian Council which I chaired, along with representatives from the public and private sector financing community. The Task Force found, not surprisingly, that this was not a new phenomenon in Canada since our railways and seaways have been financed jointly in the past. Typically, this approach has been used for infrastructure and greenfield projects, and where there has been a revenue stream associated with the project, such as user charges for roads, water or gas. Some projects, including technology infrastructure, have shared financing such as Teranet; others have a greater proportion financed or guaranteed by one party such as the Confederation Bridge to Prince Edward Island.

However, the Task Force also identified a common belief that governments could still achieve a "better deal" through public financing since the coupon cost of financing was less because of recourse to the taxpayer and to public debt. In the view of the majority, however the vehicle of public-private partnerships still offers significant opportunities to

transfer risk from the public to the private sector and to mitigate recourse to the public purse. It is critical to success, however, to clarify where and how these benefits might apply and where they do not.

And so we have been working on a risk transfer framework and a series of roundtable discussions with everyone from the Auditor General to municipal finance specialists to flesh out a common understanding. A copy of the risk framework is included with this paper.

The bigger challenge is to develop agreement on the application of the risk framework to specific situations. What is encouraging to note is how this body of understanding is growing and evolving with the use of P3's across Canada. There is a much higher comfort level in looking at private financing for public services in the last two years. Witness the consideration of private financing for tollroads such as Highways 104 in Nova Scotia and 407 in Ontario and the effort to finance the Confederation Bridge privately now that there is a successful track record of use and acceptance.

Let me begin with the classic example of a public-private partnership - Teranet Land Information Services Inc. Teranet's predecessor was the Land Registration Division of the Ontario Ministry of Consumer and Commercial Relations (MCCR). In 1991 a strategic alliance was formed with a private sector consortium, now Teramira Holdings Inc., through a bid process which took almost two years and survived a provincial election and two different government administrations. As the Deputy Minister of MCCR at the time, I can attest to the value of a good business case to ride through such transition. A private corporation was formed with a joint board composed of appointees from both partners. The private members include both equity, management and technology partners including EDS Canada, Intergraph, KPMG and SHL Systemhouse.

Teranet's mandate is threefold: (1) to computerize and operate Ontario's land registration records under the POLARIS program, including textual title index files, scanned document database and digital property maps; (2) to enhance services, products and access to provide a cadastral or land information utility to the province; and (3) to market software solutions and services to other jurisdictions. In so doing, the best of both worlds are harnessed with the following results:

- . the POLARIS system is implemented in 8 years instead of 15 and will be completed by 2000 across Ontario (4 million active parcels of land and backfiles of 100 to 200 million documents, plus conversion to qualified Land Titles from the old Registry Act);

- . the total project cost for the automation will be C\$300 million, shared 50:50 by the provincial government and the private partners;

- . new products and services have been developed without provincial cost including Teraview, a remote access service, and a remote registration system which is being beta tested currently; lawyers are ecstatic;

. more than 2000 person years (new jobs) have been created, adding impetus to Ontario's geomatics industry; more than 1000 people have received training in new technology in the past year;

. Teranet has developed international partnerships with the Czech Republic, Puerto Rico, Shanghai and Lebanon which are creating new sources of revenue. The World Bank is a financial partner with the host country in some of these arrangements.

What is the financial risk/reward framework for this public-private partnership? It is a 50:50 equity investment by both partners, starting with a \$30 million investment each in 1991, with a \$300 million total cost for the automation project. There is an exclusive 10 year licence to the corporation to manage and provide access to the POLARIS database, establishing a reliable and steady cash flow to finance the project. Returns are divided equally between the two partners. The government continues to own the land titles data and to regulate the fees for searching and registering documents. Teranet has an exclusive licence to provide access services to the automated records and establishes the fees for the new, value-added services. This strikes a balance in sharing responsibility for developing and managing systems with critical and sensitive information. The government is receiving a royalty stream from international revenues.

Verdict to date: this project is meeting all domestic targets as well as developing international markets for the future. There is public acceptance and support for the automation from the municipal governments, lawyers and others affected by the project. The staff transferred from the government to the corporation have higher morale, better compensation and benefits, and more diverse career opportunities than before. This track record augurs well for the future of the corporation beyond the year 2000.

The second example, that of NavCanada, is more of a commercialization example in the U.K. style, than Teranet. In late 1996, with a C\$3 billion syndicated bank credit facility arranged by the Royal Bank of Canada, NavCanada acquired the Canadian civil air navigation system (ANS) from the Canadian Government for a purchase price of C\$1.5 billion. With the support of the users, employees and government, NavCanada became the world's first ANS provider without majority government ownership or control. This arrangement is significant in its acquisition and financing, as well as the structural and safety aspects, for the commercialization of essential service monopolies throughout the world.

NavCanada almost followed the more traditional route of becoming a Special Operating Agency or a Crown corporation of Transport Canada. However, the non-share capital corporate model with its "user pay - user say" rationale won out due to the strong urging of the users who would ultimately bear the costs. The principles of a not-for-profit private Air Navigation System (ANS) were set out in the spring of 1995 for discussion stating the government's intent to commercialize the civil ANS to make the operation more efficient and eliminate the need for taxpayer support through becoming a cost recoverable entity. Above all, the system was to continue to exist and safety was not to be compromised. NavCanada was incorporated in June 1995. Bill C-20, the Civil Air

Navigation Services Commercialization Act, received Royal Assent in June 1996. At the end of October 1996, NavCanada assumed full responsibility and control with legal obligation to provide all users with civil air navigation services.

From a financing perspective, the arrangement is noteworthy in three areas:

- . with no government credit support, NavCanada achieved four AA credit ratings:
- . the structure of NavCanada is a balance between public and private entity as a non-share capital corporation - a Canadian compromise between government ownership and pure privatization;
- . with no equity capital, the cost of funds to NavCanada is much lower than a share based private sector utility.

The credit strength is derived from several key factors: (i) offering an essential service; (ii) having a legislated monopoly to provide core services in civil ANS in Canada; (iii) subject to its Board of Directors, setting user charge rates without regulatory approval and levying these charges against all civil aircraft; (iv) able to seize aircraft in order to collect delinquent user fees.

The last two factors made a clear contribution to a strong credit rating. By reducing NavCanada's cost of funds, the travelling public benefits from less expensive ANS. On these fundamentals, the financial structuring was straightforward, with three primary covenants. First, a rate covenant establishes that NavCanada must charge sufficient rates to generate enough revenue to pay all costs including debt service costs, with a coverage ratio of 1.25 times. Second, reserve covenants establish that NavCanada must maintain both a debt service reserve (one year's service costs) and an operating and maintenance reserve (three months' O&M costs). Finally, an additional indebtedness covenant provides that NavCanada cannot increase its borrowings without following a process to ensure it will be able to service the increased debt burden through rates. The four credits fundamentals and the three primary covenants were sufficient to earn AA ratings from every credit rating agency involved.

The non-share capital corporation structure of NavCanada has no shareholders and pays no dividends, so its members have no financial incentive to charge fees beyond those needed for its operation. The governance structure gives users substantial but not majority control with a Board of Directors composed of 10 Directors (5 from users, 3 from government, 2 from unions) who select 4 independent Directors, and these 14 Directors select the CEO who becomes the 15th Director. The objects of the corporation set out its raison d'être and define its activities. Any amendments require government approval of the letters patent and specified by-laws. The government also retains the right to any assets remaining after provisions for liabilities if the corporation is ever wound up.

The greatest reduction in the cost of capital for NavCanada is derived through the absence of expensive equity capital. Even allowing for the cost of carrying reserve funds,

NavCanada's weighted average cost of employed capital is at least 3% less than the cost for a similar share-based corporation and less than 0.40% above Canada's borrowing costs. This represents a further saving to users of \$50 million per year.

This public-private partnership is viewed as a model to be used for Canada's ports and their commercialization. Airport authorities, although they have municipal governance with federal appointees to their boards, have similar principles for user fees as NavCanada. In October 1997, the Auditor General criticized the sale of the ANS to NavCanada, citing weaknesses in the method of valuation used to determine the payment of \$1.5 billion to the Crown by NavCanada for the legislated monopoly to operate the civil ANS in Canada. This amount represented about \$1 billion less than the entity's going-concern value of \$2.4 billion estimated by the Department of Transport's financial advisors. The final purchase price was arrived at based on an adjusted net book value, which took into account the costs of transfer to the not-for-profit corporation. The Auditor maintained that the costs associated with the pension transfers were not taken into account (or identified as such). The message noted by the Auditor is that the intermediate stage of transferring the assets to a Crown corporation would have been the norm, based on other countries. To date, no shift in public policy has been made to meet the Auditor's concern, nor is any change expected.

The third example of public-private partnership is the traditional BOT project (build, operate and transfer) which has been tailored for Canadian highways and bridges. Highway 407 Express Toll Route (ETR) is a design-build project with a fixed construction price of C\$930 million. The all-electronic tolling system cost approximately C\$70 million for a total cost of C\$1 billion. Although the provincial government originally released a tender in 1993 calling for private financing proposals, as well as design/build, the financing was eventually arranged by the Crown agency Ontario Transportation Capital Corporation through the sale of toll revenue bonds on world capital markets. The bonds were guaranteed by the Ontario Government, on the stated grounds that "they could do it more cheaply". The design/build component has met expectations and the toll road usage also met all projections. In February 1998 the Ontario government announced its intent to "sell ETR#407" and to extend the toll road in the future. At present, proposals for financing are being reviewed but no decisions have been made.

This is part of the evolution in having developers take on the risk for toll-based revenue bonds. The Confederation Bridge to Prince Edward Island has just moved down the same road with its financing. Originally this C\$1 billion project was financed through securitization of government bonds. In June 1998, the private developer raised C\$325 million to finance design changes and improvements needed to deal with ice floes. Other highways and construction projects in New Brunswick and Nova Scotia are following a similar route. Schools, arenas, community facilities and airport development are in the offing.

The conclusions you may draw from these examples of public-private partnerships include the following:

(1) Success breeds success

Public-private partnerships provide a broad umbrella which can shelter and protect the public interest while bringing added value from private sector expertise and investment potential. While Canadians have been cautious to embrace project financing in the past, the positive track record is now adding up. Look for more project financing especially where user acceptance and revenue streams are understood and bear the test of time. Building on roads, bridges and gas/water utilities, expect project financing for schools, jails, hospitals, telecommunications and information technology infrastructure.

(2) Look for new areas of project financing

The restructuring of Ontario Hydro and the electricity sector will provide financing opportunities, as will the investments needed in the technology for delivering health care, education and social services. The municipal government sector will provide future growth for project financing challenges. A number of provinces are looking at municipal legislation which will increase the flexibility of municipal governments to use project financing instruments and undertake partnership initiatives.

(3) Export Canadian expertise and successes

The models which have been developed in Canada are being applied abroad - from the Canadian Highways International Corporation which is applying its toll highway expertise in Israel to Teranet Land Information Services as a data utility and NavCanada.