SUMMIT
CANADA'S MAGAZINE ON PUBLIC SECTOR PURCHASING

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Crunching P3s

delivering transportation infrastructure and the credit crunch

by Ian J. Houston

“It’s like when you look at British Columbia or other places where they have a public-private partnership, where everyone is happy … Businesses are happy, the people are happy, labour is happy, the politicians are happy. I mean, everyone is happy.” Governor of California, Arnold Schwarzenegger

WHILE EVEN THE most ardent supporters of public-private partnerships (P3s) do not share Governor Schwarzenegger’s utopian view, Canadian governments have increasingly turned to infrastructure spending as a means of providing economic stimulus to a troubled economy. For those who have warned that a failure to address Canada’s growing “infrastructure deficit”[1] could cripple

[1] There has been increasing recognition during the past decade in Canada, supported by research performed by various associations, that Canada is experiencing what has variously been called an “infrastructure deficit” or “infrastructure investment deficit.” It is generally recognized that the infrastructure deficit is growing and has principally been caused by a protracted period of under-investment in the underlying infrastructure assets.

municipalities and lead to catastrophic failures in vital transportation infrastructure such as roads and bridges, this development is welcome, if not long overdue. However, this heightened level of government attention comes at the same time as the momentum for some P3 projects within Canada appears to have slowed as a result of the current credit crunch. The combination of these factors has served to intensify the debate regarding the use of the P3 delivery method for transportation infrastructure.

In August 2008, the Institute for Research in Public Policy released a study that estimated the cost to upgrade Canada's existing deteriorated municipal infrastructure to an acceptable level at $200 billion. According to another noted commentator, Professor Saeed Mirza, Professor Emeritus of Civil Engineering and Applied Mechanics at McGill University, the estimated cost as of November 2007 to repair and upgrade existing transportation infrastructure was approximately $21.7 billion. Professor Mirza's research confirmed what many Canadians have experienced for a number of years: crumbling roads and outdated bridges in dire need of repair or replacement.[2] This need is especially acute within Canada's major cities, and it was brought into stark relief in September 2006 when the de la Concorde Overpass between Montreal and Laval, Quebec gave way and an entire section collapsed onto the highway killing five people. This represented the second overpass collapse in six years in the Province of Quebec.[3]

There is no simple explanation for why various levels of government have, historically, failed to properly invest in and maintain infrastructure assets. In part, it may be due to competing priorities in government. As well, one cannot overlook the practical influence election cycles have over government policy. In any event as Professor Mirza pointed out in a recent interview conducted by The Canadian Council for Public-Private Partnerships,[4] Canada's infrastructure needs are "way beyond what can be afforded by all levels of government." In an attempt to find innovative sources for funding to help address this issue, Canadian governments have increasingly looked to the use of P3s.[5]

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P3s represent an innovative source of funding and a viable delivery method for transportation infrastructure.[6] With transportation projects,

[2] For example, Toronto's estimated cost for repairing its streets, viaducts and highways is currently $300 million, and growing. The City of Montreal has identified $620 million of roadwork to be done by the end of next year, and the City of Calgary's transportation infrastructure improvement list includes approximately $880 million worth of major roadway projects in the next decade. Elsewhere, Ottawa needs at least one more bridge spanning the Ottawa River and another over the Rideau River, and Halifax is looking to build a new bridge over the harbour or a tunnel underneath to ease its traffic congestion problems. Edmonton and Saskatoon have identified major projects to address their respective traffic issues, and the City of Vancouver has noted that traffic and bridge congestion problems, along with shipping delays, lost work hours and work pollution cost the region an estimated $1.5 billion.

[3] November of 2007, Professor Mirza report for the Federation of Canadian Municipalities. "*Danger Ahead: The Coming Collapse of Canada's Municipal Infrastructure.*"

[4] The Canadian Council for Public-Private Partnerships, "For the Record *Canadian Infrastructure Crisis Still Critical,"* p.2.

[5] Sometimes referred to in Ontario as alternative finance and procurements or AFPs.

[6] For a general discussion of the use of the P3 approach for the delivery of transportation infrastructure, please see *"Understanding Public-Private Partnerships Delivery Methods for Transportation Infrastructure,"* Richard H. Shaban and Ian J. Houston, Construction Canada, Sept 2008, p. 108.

potential private-sector partners often consider the underlying asset to be particularly attractive as an opportunity to generate long-term revenues through tolls and other 'user-pay' options. Having users pay a higher percentage of the costs associated with their use of publically owned infrastructure such as roads and passenger rail has long been recognized in Canada as being crucial to the development of an efficient transportation system. The private sector component of P3 projects appears less influenced by public resistance and the reluctance of politicians to embrace user-pay options.[7] Further, transportation projects often provide an appealing risk profile for the private sector, since items like occupancy risk and obsolescence are not ordinarily issues for transportation projects. However, there are often unique risks such as traffic and volume.[8]

In response to the need to address the infrastructure deficit, both the federal and provincial governments in Canada have recently embarked upon accelerated spending programs for public transportation infrastructure, which include both P3 and conventional initiatives. At the federal level, and as part of its 2007 budget, the federal government introduced a seven-year $33 billion Building Canada plan which consisted of a number of programs designed to meet the varying needs of infrastructure projects across Canada.[9] In its 2009 budget, the federal government introduced almost $12 billion of new infrastructure spending over two years, which was designed to provide timely economic stimulus by creating jobs in the construction, engineering and manufacturing sectors. Certain specific transportation projects are identified as being ones that can be expedited over the next two construction seasons.[10] Further, the 2009 budget also addressed the issue of the need to rehabilitate and repair federal infrastructure assets.[11]

At the provincial level, the Ontario Liberal government's recent budget promised to tackle the province's serious infrastructure deficit through the injection of $27.5 billion over two years to help fix, among other things, roads and transit.[12] In Saskatchewan, the Saskatchewan Party recently announced that it is setting up a secretariat to explore the possibility of private sector companies being involved in large infrastructure projects for, among other things,

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[7] User-pay options have been adopted as part of recent P3 transportation projects across Canada, including the Confederation Bridge project in Atlantic Canada, the A25 Bridge expected to be built between Montreal and Laval, Highway 407 in Ontario and the Golden Ears Bridge in Greater Vancouver. Canada Transportation Act Review Panel, Vision and Balance, Ottawa (June 2001), p.19.

[8] p. 109 *Supra,* at note 6

[9] It included the Gateways and Border Crossings Fund and the Asia Pacific Gateway and Corridor Initiative to strengthen trade-related infrastructure, as well as the establishment of the Public-Private Partnerships (P3) Fund, which is the first national infrastructure program in Canada dedicated to public-private partnerships.

[10] Such projects include the Trans-Canada Highway improvements in Newfoundland and Labrador, major bridge rehabilitation on the national highway system in Nova Scotia, road upgrades in the Quebec City metropolitan area, Union Station revitalization in Toronto, the Highway 39 truck by-pass in Estevan, Saskatchewan, and the Evergreen Transit Line in Vancouver.

[11] Specific projects include providing $407 million to Via Rail Canada to undertake infrastructure and other capital improvements, $130 million to Parks Canada to complete the last phase of the Trans-Canada Highway Project, funding on a cost-share basis with the provinces of Ontario, Quebec, Nova Scotia and Manitoba in respect of the twinning of certain sections of the Trans-Canada Highway, and investing an additional amount of approximately $270 million to rehabilitate and upgrade certain federal bridges such as the Champlain Bridge, the Bluewater Bridge and Peace Bridge.

[12] While the budget was not long on details, the Ontario government indicated that the funds were in addition to the government's existing $30 billion ReNew Ontario Infrastructure Investment Plan. Of these funds, $648 million will be spent in 2009-2010 on Northern Ontario highway projects. Further, the Ontario government announced that the Windsor Essex Parkway Project would be the first large road project to be delivered using Ontario's alternative financing and procurement ("AFP") delivery method. It is not clear yet, what the specific model will be.

roads. The government committed $1 billion in this year's budget for infrastructure. It has also pledged $1.5 billion for the following year, and it has pegged $25 million as the minimum cost of projects for which private sector involvement will be considered.[13] In the Province of Quebec, Transport Quebec has announced that it will invest a record $3.7 billion this year to repair and improve the highway network across the

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province.[14] On March 2, 2009 the Province of Alberta announced the biggest and most expensive road project in Calgary's history, the southeast connector estimated to have a cost of between $1 billion and $1.5 billion. The construction is expected to start next spring, and it coincides with the work on the west LRT line, which means that there could well be approximately $2 billion worth of public works proceeding in tandem.[15] In New Brunswick, on December 10, 2008, Transportation Minister Denis Landry released a capital budget of almost $386 million for investment in highways and bridges. This amount brings the government's investment to improve and maintain New Brunswick's transportation infrastructure to $908 million since 2006.[16]

Most of the noted programs were already established when the recent financial crisis took hold in 2008. While government reaction has been to accelerate and expand spending initiatives, the reality is that the crisis has caused significant changes to the P3 landscape. Previously, long-term loans formed the basis of financing for many P3 projects. Such loans, often granted by European banks, typically spanned the entire lifetime of the deal. These long-term loans no longer appear to be available as the spread between government and corporate borrowing costs increase.

Recently, key long-term lenders such as Royal Bank of Scotland and Dexia Group have exited the Canadian P3 market. Other major P3 players have similarly shown that they are not immune to the current crisis. For example, in Australia, the McQuarrie Group, which operates more than 30 roads worldwide, slashed the value of its toll road portfolio from $10.2 billion to $6.5 billion in the last four months of 2008.[17] Another Australian-based firm, Babcock & Brown, lost 98 percent of its market value in the latter part of 2008 due to the credit crunch.

One of the more dramatic examples of the negative effect of the credit crunch on current P3 projects was the announcement in February 2009 by the BC government that the Port Mann project's P3 financing (previously to be shared by the province and a private sector consortium that includes engineering firm Peter Kiewit Sons Co. and the McQuarrie Group) had collapsed leaving the BC government to finance the entire amount. Meanwhile, in Quebec, the province's health minister recently expressed concern regarding the P3 financing for two Montreal mega-hospitals. One consortium bidding on the projects lost British financier John Laing Investments in November 2008, and the other

[13] James Wood, *The Star Phoenix*, Jan. 2, 2009, Saskatoon, Sask. PS A.5

[14] The province spent approximately $3 billion on highway projects last year as part of a 15-year program to rehabilitate its roads and bridges, which was spurred by recommendations of former premier Pierre Marc Johnson following the 2006 collapse of de la Concorde Overpass.

[15] Don Braid, *The Calgary Herald*, Mar. 3, 2009 PA 4

[16] Province of New Brunswick News Release, NB 1797, Dec. 10, 2008

[17] "Golden Ears Bridge, An $800 Million Crossing between Langley and Maple Ridge," L. Culbert and J. Fowlie, *Vancouver Sun*.

consortium included troubled Australian infrastructure corporation, Babcock & Brown.[18]

Aside from influencing the availability of financing, the current economic crisis has also negatively impacted western port projects as a consequence of the severe slowdown in trans-Pacific shipping volumes. For example, in December of 2008 the BC government announced that the Port of Prince Rupert was delaying the expansion of its container terminal by at least 18 months. The decline in shipping volumes and the Port Authority's limited cash flow meant that it could not support an increased debt burden and would not be able to borrow the $200 million it needed for its portion of the financing for the Phase 2 expansion.[19]

For critics of the P3 model, the collapse of the P3 financing for projects such as Port Mann raises serious questions about the viability of the entire P3 approach. For example, Bruce Rawlston, the New Democratic finance critic in British Columbia, was quick to state subsequent to the announcement of the collapse of the Port Mann P3 deal, "If you can't get financing for this kind of a project, where there is a guaranteed source of revenue over a lengthy period of time, what project can you get financing for?"[20]

In arguing in support of the need to abandon Nova Scotia's P3 plans, CUPE Nova Scotia president Danny Cavanaugh pointed to the recent difficulties experienced by certain P3 transportation projects as "clear cut evidence that public financing, operation and delivery works best for services and infrastructure."[21]

While most commentators agree that Canada's infrastructure market is undergoing a radical makeover in response to the economic crisis, few appear ready to support the notion that the P3 approach is no longer viable in Canada, and no government has yet adopted a policy shift away from P3s. Rather, it is more likely that certain elements of the evolving Canadian model for P3 projects will change. For example, economists expect future P3 deals to be characterized by more complex funding arrangements involving a variety of parties, rather than long-term bank loans. Many point to the Alberta schools project phase 1, one of the last major P3 deals to close in Canada, as providing some indication of the direction the market is taking. That project, which closed in September of 2008, was a $650 million deal that was financed by a mix of both long and short bank loans and bonds. Some refer to this as "hybrid financing."[22]

Like the Alberta schools hybrid model, indications from the financial community suggest that future P3 transportation projects will include a mix of short term loans, bond issuances and equity-fund investments.[23] Most expect the bond market to play a major part in future funding and, as evidenced by the recent federal and Ontario provincial governments, an increased role for public funding.

While Canada's infrastructure deficit remains a significant issue for Canadians, and Canada's transportation needs continue to extend far beyond what can be afforded by government, it

[18] Although Premier Jean Charest has stated that although project costs have greatly increased, he continues to support the projects as P3s. *Superhospital Costs Soar; Up by $1.6 Billion but Charest insists he supports both projects.* Mar. 31, 2009, the Gazette (Montreal), Aaron Derfel, p. A6

[19] Patrick Brethour, Globe and Mail, December 19, 2008, p. B.1

[20] Peter Rawlston, Globe and Mail, February 28, 2009 from Wendy Steuck, Vancouver

[21] *Canadian Corporate Lawyer* article, March 6, 2009.

[22] Lorraine Millendar, National Post, March 26, 2009, FP Infrastructure, p. FP15

[23] Lorraine Millendar, National Post, March 26, 2009, FP Infrastructure, p. FP12

appears that all levels of government, as a matter of policy, are committed to pursuing P3s as a viable delivery method for transportation infrastructure. However, the challenge for P3 proponents will be to justify, on a project by project basis, the rationale for the P3 approach as borrowing spreads increase and long-term loans remain unavailable. These are clearly experimental times for the sector.

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