SUMMIT online
CANADA'S MAGAZINE ON PUBLIC SECTOR PURCHASING

MUNICIPAL MATTERS

P3, PFI & AFP

De-cluttering the terms used regarding capital asset procurement

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In recent years, governments around the world have experimented with a variety of different approaches towards purchasing capital assets. Terms such as P3 (public-private partnership), PFI (private finance initiative), AFP (alternative finance and procurement) and numerous others are bandied around as if they had a clearly settled meaning. Each is used to deal with a range of different types of roles that private sector entities may be asked to play within the context of a specific project. Ah, but what role? Here, there is no ready answer.

In truth, none of these terms enjoys a generally accepted definition. Sometimes, the terms are used interchangeably, while other times they describe widely different types of procurement arrangement, but most often they are used indiscriminately. All of these various approaches entail some effort to secure long-term private sector involvement in the provision of government capital facilities.

Much of the discussion relating to the various types of initiatives is highly politicized. Proponents of such approaches make broad claims as to their potential to achieve value-for-money in public procurement. Opponents argue that they constrain government policy freedom, and that they are anti-labour devices intended to strip public sector workers of their rights, and to drive down the wage rates of low and medium-skilled workers in particular. While advocates claim that these arrangements result in huge savings, opponents counter that they drive up the cost of procuring capital assets. In this article we hope to move away from such polemical positions and to present relatively neutral background information relating to the strengths and weaknesses of the various approaches, so as to allow you to engage in a more informed level of discussion regarding benefits and costs of these approaches.

We begin by making two basic points. First, governments have always relied on the private sector, to at least some extent, in the design and construction of public capital infrastructure. Second, whatever approach may be adopted for the procurement of the capital assets required to deliver government services and programs – whether it be full government ownership and production, or whether the delivery mechanism will be transferred entirely to the private sector – there will necessarily be some people who gain and others who lose as a result of the change that is made. In many cases, the actual outcome cannot be predicted in advance.

The traditional model of construction employed by government has been design-bid-build. Under this approach, the government commissions a design for a proposed public facility. This work may be carried out internally, or it may be contracted out to a private sector design company, such as an architectural firm. Once the design is approved, the government then puts the construction contract up for tender, with bids being sought from private sector construction firms. The winner builds the facility.

However, many government capital facilities have long had private sector involvement over the long term. Many court facilities, for instance, operate out of rented property, as do government offices. Even in the medical sector, government health clinics and other similar organizations have often shared accommodation with private sector operations. Hospitals, in contrast, are almost always purpose built facilities, as they have unique design requirements.

In a genuine public-private partnership, both the government and the private sector enjoy both upside and downside risk of roughly equal magnitude.

AFP and PFI transactions are essentially an outgrowth of the public-private partnership (or P3) model, but even this basic concept lacks kind of clear definition. In a sense, any arrangement which involves a government player and a private sector player may be described as a kind of public-private partnership. However, if the term is given such a broad definition, it is difficult to identify any kind of supply arrangement that would not satisfy the requirement. In commerce and law, the term "partnership" has long had a clearly settled meaning. It describes the conduct by two or more persons of a business in common with a view towards profit. Relatively few P3 arrangements come close to meeting this definition.

In a genuine public-private partnership, both the government and the private sector enjoy both upside and downside risk of roughly equal magnitude. For instance, a municipality may wish to build an office complex as part of a downtown renewal scheme. The municipality enters into an agreement with a private sector developer to meet a portion of the design and other soft costs of the complex, and to rent a portion of the space for a fixed term. The developer undertakes to arrange the overall financing, and builds a facility considerably larger than what the municipality requires. Both parties hope to rent the surplus space at market rents to other tenants. The prospective revenues are to be shared in some way, so that both the private sector partner and the government partner enjoy a chance of profit, whereas the government assumes part of the risk if the facility is not rented out. The private partner also bears a share of that risk. Even the party providing the financing may be brought to share in the risk and profit.

Arrangements of this kind are relatively rare – and with good reason. Very often the types of project that governments wish to see constructed offer little upside profit potential. For instance, cities with decaying central business districts are not attractive places in which to locate a business office or retail operation. Call them crazy, but many members of the general public do not like to shop and work in an environment where they are likely to confront the more troubled elements of society such as panhandlers, drug pushers and users, etc. Nor do they like the limited parking that also comes with high charges or long rides into town fighting traffic congestion. Unless these types of underlying problems are addressed, the construction of a modern office facility is unlikely to prove a successful venture. This is especially true where business locating in the downtown core is subject to higher levels of business or property taxation than business in surrounding communities.

PFIs and AFPs involve less ambitious schemes. They are often tied to the procurement of assets that governments and their agencies will use in actual service delivery.

The term "private finance initiative" originated in the UK 1992 autumn budget statement, in which the prospect of such transactions was advanced as a means of achieving closer partnerships between the public and private sector. In its 2005 budget speech, the UK government explained that the term had come to mean that "…the public sector defines what is required to meet public needs and ensures delivery of the outputs through the contract. …Consequently the private sector can be harnessed to deliver investment in better quality public services whilst frontline services are retained within the public sector."

Complicating matters is the fact that the abbreviation PFI is also used in relation to the OECD's Policy Framework for Investment, which is a comprehensive and systematic approach for improving investment conditions. Developed by a task force including representatives of 60 different governments, as well as business, labour and international organizations, it cover the following broad policy areas: General Investment conditions; Investment promotion and facilitation; trade; competition; tax; corporate governance; responsible business conduct; human resource development; infrastructure and financial sector development; and public governance. In dealing with these matters, it addressed some 82 questions to governments, which are intended to help them design and implement policy reform to create (according to the OECD) "a truly attractive, robust and competitive environment for domestic and foreign investment."

The goal of the OECD PFI is to promote a healthy environment for all investors, including multinational enterprises. It must be noted that although the OECD's PFI can have relevance in relation to government capital procurement, it covers a much wider range of matters. Nevertheless, the broad issues considered by the OECD often stray into discussions on the narrow question of the merits and demerits of capital infrastructure procurement using a PFI approach.

The term "alternative financing and procurement" appears to have originated in Ontario. The term is employed to describe (in the words of Infrastructure Ontario) "an innovative way for the government to deliver on its commitment to maintaining and expanding public infrastructure." The process involves using "private financing to strategically rebuild vital infrastructure, on time and on budget, while ensuring appropriate public control and ownership." Ontario AFP projects are guided by the five principles set out in the government's

Building a Better Tomorrow framework. These are:

- public interest is paramount;
- value for money must be demonstrable;
- appropriate public control and ownership must be preserved;
- accountability must be maintained; and
- all processes must be fair, transparent and efficient.

AFP does not necessarily affect public ownership of core public assets such as hospitals, schools or water and wastewater infrastructure. These public sector assets usually continue to be publicly owned. Nevertheless, contractual arrangements limit the latitude of the public sector to vary the overall operation of the facilities concerned. Such arrangements can also limit future government policy freedom.

Both AFP and PFI have come to describe not a single approach to capital asset procurement, but rather a cluster of approaches. This recognizes the fact that no single approach can successfully address all infrastructure needs, therefore it is necessary to consider a broader range of infrastructure financing and procurement models in relation to the specific project that is to be carried out. However, all of these approaches share the foundation that a greater degree of long term private sector involvement in government infrastructure procurement process affords advantages that more traditional methods of procurement lack.

Conceptually, the delivery of a capital facility may be broken down into five elements: design, construction (or build), finance, maintenance and operation. In the traditional design-bid-build approach, the government specifies what is to be built, often even dictating the materials and other components to be incorporated into the finished facility. Under the AFP approach, the approach is more output focused. The government specifies a functional requirement that is to be satisfied.

The most basic of the AFP procurements methods is the design-build contract. It is the only one of the methods that is also widely employed in the private sector. In design-build (DB) construction, a single entity provides both the design and construction on what is essentially a turn-key basis. The owner drafts the specification that the finished facility is to satisfy, and the contractor builds to that specification. The DB approach allows the government the highest level of flexibility, however, it offers the lowest prospect of risk transfer among the various AFP approaches.

In other forms of AFP projects, the government asks the contractor to arrange the up-front financing for the facility. The government then pays that amount back through annual charges. The taxpayer still pays the bill, but this approach allows a considerable degree of risk transfer – at least on paper.

One of the most popular methods is known as design-build-finance-maintain (DBFM). Under this approach, as well as undertaking to build the facility, the contractor will assemble a consortium which produces the design and undertakes to maintain the building for a lengthy period following its construction (generally 30 years). Maintenance is usually limited to "hard" maintenance, with the government remaining in control of the overall operation of the facility. The contractor also arranges the financing, which will have an equity and a debt component. In recent years, there has been mounting pressure to reduce the equity investment, as a means of keeping down the cost. Although, in the normal case the government will enter into a direct agreement with the lender under which it agrees to limit its rights to terminate the contract in the event of default, the investment made by the equity party (and its active oversight of the overall process) affords the government some degree of insulation against the risks associated with capital procurement. The government pays for construction, financing and maintenance costs on an amortized basis over the life of the contract.

Design-build-finance-operate (DBFO) projects are similar, but involve a higher degree of private sector participation. Such contracts have often been employed in relation to highways. In practice, it is difficult to differentiate DBFO contracts from privatization of the relevant asset. Payment in relation to a DBFO contract may be effected through a variety of mechanisms, such as tolls (i.e., user pay), shadow-tolls (government pays based upon measured volume of usage); payments based upon performance measures, such as availability, congestion management and safety; or some combination of the foregoing.

In addition to the foregoing methods, AFP projects may also take the form of build-finance; design-build-finance, and build-finance-maintain. Each of these methods will be selected by reference to the unique circumstances of the transaction.

The numerous forms of AFP transaction make clear that the AFP approach is a highly sophisticated, and therefore complex, one. Involvement in this kind of transaction requires the support of expert advisors. Such advice is essential due to the complexity and long term nature of these transactions, which give rise to numerous unique risks. That said, if the correct method of organization is selected, and the process is carefully managed, the AFP approach can lead to some significant savings.