P3 paralysis?

01/09/2004

The Canadian Council on Public-Private Partnerships says Canada has a problem - a large one. A quarter-century of under-investing and deferred maintenance of Canada's public infrastructure (roads, hospitals, schools, transit, water treatment etc.), coupled with the steady growth in Canada's economy and population, has created a huge gap between Canada's existing infrastructure and needed infrastructure. This gap is estimated to be between C$50 billion [$38 billion] and C$125 billion and growing.

Despite being over 10 years old the Canadian P3 market is still in its infancy and has exhibited fits and starts throughout its history. Are these growing pains or the convulsions of a terminally ill patient? Some fear it could be over before it really gets going. "The next 12 to 18 months is make or break for Canadian P3," says a Canadian banker. The market is driven by an infrastructure deficit on one hand and an endemic suspicion of private provision of public services on the other. Canada is at a point of time that draws close comparison with the UK in the early 90s, when strong Labour resistance stifled the PPP pipeline, effectively creating a moratorium.

As well as the Canadian Council, the public-private cause is helped by a number of P3 taskforces at province-level that mirror the work of Partnerships UK in the UK. However, opposing the work of these taskforces are a number of obstacles to any one project - these can be broadly split into primary and secondary obstacles.

The primary obstacles to P3 projects are almost without exception political, and exert greatest influence in the pre-contract period. Indicative of the need for infrastructure investment but the general suspicion and hostility with which P3 is regarded by the unions - particularly the most powerful union, Canadian Union of Public Employees (CUPE) - and Leftist politicians within the provinces themselves, a number of P3 projects have been worked up to preferred bidder stage only to be pulled at the eleventh hour, or a DBFO scaled back to limit the private sector to construction.

The C$1.5 billion Richmond-Airport-Vancouver rapid transport project (RAVP) is a case in point. RAVP moved up from the initial feasibility studies in April 2002, through to a short-listing of 10 consortia, to two consortia at best and final offer (BAFO) stage in March 2004, only for the concession awarder, Translink, to pull the project in May. In July, after looking at diluted alternatives without private funding, and without being impressed, the Translink board reapproved the project - hardly inspiring investor confidence.

The two consortia at the BAFO stage are SNC-Lavalin and Serco Group, and the Bombardier group comprising AMEC, Bouygues Travaux Publics, and Bilfinger Berger. Financing is anticipated to be split C$300 million from the airport authority, C$300 million from the British Columbia government, C$300 million from Translink, C$450 million from Ottawa, and C$150 million from the private partner.

Another P3 that hit the skids, this time in Alberta, is the Calgary Law Courts project. The project progressed as a 30-year concession DBFO but the transfer to the private sector has been scaled back to a design and build award.

This is typical of the Canadian P3 experience to date. Although as a whole Canada has a reasonable deal flow, it is sporadic and the terms to the private sector are liable to change seemingly on a monthly basis. The dithering over risk transfer began as early as the 407 highway project and runs to the present day. The 407 was originally slated to be project financed, but was funded by the public purse then sold in the private sector. And although sponsors and government have since ended up in court, 407 is still widely heralded as a success.

False dawn or real promise?

The bare facts say the immediate future looks rosy: the RAVP shunts onward, the C$300 million Abbotsford hospital project contract is close to signing, an RFP has been issued for the C$300 million Edmonton ring road, an RFP has been issued for the C$600 million Sea-to-Sky project, a preferred bidder has been named for both the William Osler and Royal Ottowa Hosiptals and their financing nears the market. Yet the battle-scarred Canadian project bankers have a jaundiced view of such optimism, and have learnt from bitter experience that many hurdles can bedevil a project right up until project contract signatures.

"The market is entering an interesting period, with a handful of large projects in the pipeline," says Paul Dunstan, managing director, infrastructure capital, ABN Amro. "What the market needs is a champion transaction - one that can quiet P3 detractors and provide a template and impetus for further projects." He adds: "P3 is experiencing the biggest push it has seen in a Canadian context and if it slides backwards there is a strong possibility that the industry will be finished for a very long time - there is a limit to the number of times industry players will ramp up and be let down."

But it is possible for P3 to flourish in one region and be shunned or abandoned altogether in another. "I would go along with the sentiment that the next 12 to 18 months is make or break," cedes Peter Hepburn, senior director, energy and infrastructure finance, CIT. "But it must be remembered that Canada is politically and economically decentralized - there is no single, coordinated approach to P3. In BC, for example, under the guidance of Partnerships BC, projects are promulgated efficiently and in a predictable way."

As it stands, British Columbia has the bulk of the deal flow, with Abbotsford hospital the potential champion project, and Ontario is probably second-most committed, with William Osler and Royal Ottawa hospital bubbling, through among others.

The province of Quebec is showing signs of promise, but any deals are about 24 months away - ambitiously, a C$2.2 billion Montreal Superhospital is slated for P3.

And while Alberta's change of government to the Right, followed by visits to learn more about the UK and Australia, appeared to spell good news for P3 it has largely shied away from private finance.

"Alberta, along with the rest of Canada, is undergoing a learning phase, trying to understand different models and risk transfer," says Conor Kelly, managing director, special finance unit, DEPFA. "Alberta has never delivered, and after pulling the [private] finance on the Calgary Courts project, the Edmonton ring road will be crucial for the credibility of the government of Alberta and the future of P3."

Alberta is a relatively rich Province, so P3 needs to show value for money and sponsors need innovation to make headway.

"For much of the past 10 years Ontario and Alberta have had Right-sided governments that were willing to consider P3, but didn't because of their stronger financial position," says Darryl Murphy, director, infrastructure finance, Royal Bank of Canada. "Whereas the less well-off provinces during this period were largely governed by Left-leaning governments, where arguably the need for P3 was great but the political will wasn't there."

The fiscal imperative for Canadian P3 is stronger than in the US where partnerships are effectively in competition with tax-exempt municipal bonds. But the provinces can still borrow at near sovereign-level and school and hospital boards can also tap the private market at a notch below provincial credit. Many of the provinces are therefore reluctant to accept P3 as merely an accounting fix, but are looking for value for money over the long term and an appropriate level of risk transfer.

Detractors are keen to jump on this uncertainty and badge P3s as privatisation to grab public support, whilst the pro groups support P3 equally polemically. Indeed, where the pre-contract period has normally been the preserve of commercial confidentiality, bankers are beginning to welcome transparency in the name of public interest.

For example, redacted agreement documents between the Province of Ontario and the preferred bidder, Healthcare Infrastructure of Canada, for the William Osler Hospital project were made available to the public after protests from the Ontario Health Coalition and the public. Hepburn at CIT, which is working as lead arranger on the deal says: "The level of scrutiny, from the public interest point of view, helped to strengthen the integrity of the model."

The model for the C$430 million William Osler project borrows heavily from the UK model but with changes to suit the Ontario market. The financing should go to market by the last quarter of 2004 and in all likelihood use a miniperm loan with a bond take out. The transaction time on the deal was protracted by 6 to 8 months because of a change Ontario government.

"Transaction times generally tend to be more protracted than in the UK," adds Hepburn. "There is no codification, so there is a large amount of variability from transaction to transaction, increasing the time for decision making and turnaround times."

Protectionist policies, apathy and outsiders

Away from the progenitors of P3 projects, Canada suffers from a number of secondary obstacles, such as the lack of a codified corpus of procurement law and standardised forms. Some potential difficulties are as a direct result of fiscal policies: there is no appetite for long-dated bank debt due to a shallow syndication market; and many P3 projects are conservatively structured to achieve a high rating and access the Canadian capital markets, perhaps capping risk transfer before its optimum level.

These issues may be partially overcome within the next six months if, as expected, monolines are awarded licences to operate by the Office of the Superintendent of Financial Institutions (OSFI).

Canada also has less creditor-friendly insolvency laws, which have more in common with the US system than the UK. "The Canadian insolvency regime, for instance, does not provide for a mechanism similar to an administrative receiver in the UK," says Craig Jamieson, Standard & Poors. "Secured lenders in Canada, therefore, are subject to the risk of stay or moratorium and the associated loss of control over assets during such a period."

Apart from these structural encumbrances there is also a sense of apathy regarding P3 emanating from the incumbent banks - BMO financial group, CIBC, National Bank of Canada, RBC, Scotiabank, TD Bank.

One domestic bank source says, "P3 is not high on the Canadian banks' list of priorities - it's not a core business. Better margins can be had elsewhere and deal flow has been sporadic. If new entrants want to come in with a syndication model, so be it - we will be the ones mopping up the holding debt."

A number of PPP players are carefully scrutinising the P3 market: CIT bought its way in - taking over Newcourt Credit in 1999, ABN Amro has Toronto and Vancover offices, and DEPFA is covering the market from a recently established New York office. It is likely that if they establish a foothold, the UK-style 30-year debt package will work in parallel with the traditional miniperm model.

Canada's infrastructure gap and nascent P3 market is a big draw for international contractors, but this could be offset by its potted history. "Canada is not awash with large contractors," says Darryl Murphy, RBC. "If you were a European firm putting together a business plan, you'd say Canada looks interesting, but they've got to start delivering."

So what is needed beyond political will to get Canadian P3 moving? The expertise of large construction firms is especially needed on the more ambitious projects such as the RAVP and Sea-to-Sky projects. And as for the banking sector, "If the Canadian banks are resting on their laurels, we are more than welcome to take lending positions in their own back yard," says an international banker.