Hugh Mackenzie
Principal

Memo to: Ontario Health Coalition

Re: Assessment of material disclosed by the Government of Ontario Regarding the North Bay Regional Health Centre project

Date: 6 June 2007

Summary

I have reviewed the documents relating to the North Bay P3 hospital project as disclosed by Infrastructure Ontario. My findings are described in detail below. In summary:

1) The disclosure on the North Bay P3 hospital project is inadequate and falls far short of the disclosure ordered by the Court in the Brampton P3 project.
2) Virtually all of the key financial information has been deleted.
3) The Value for Money comparison of the projected costs if the hospital was to be built under a traditional publicly financed model to the costs under the privatized P3 is so limited as to be meaningless. According to the independent consultant, they did not assess the basis for the cost projections in either the public model or the private bid.
4) The extremely limited information provided in the Value for Money summary shows that the financing and transaction costs under the privatized P3 model are significantly higher (by $159.7 million or 38%).
5) The entire financial case for the government's decision to privatize rests on a controversial cost adjustment called "risk transfer". However, no information is disclosed to allow public scrutiny or evaluation of the risk transfer, and there are significant flaws in this approach.
6) This is a gargantuan contract, with a disclosed total cost of $1.05 billion and a duration of 30 years. It is in the public interest that this agreement be subject to complete public disclosure and rigorous scrutiny of the assumptions that have been used to justify the significantly higher costs ($159.7 million) of the private financing model.
7) The limited information in this disclosure flies in the face of repeated promises by the government for "public interest", "transparency" and

"appropriate public control". Moreover, the mounting evidence in Ontario and abroad is that the high costs of P3 privatization will have a damaging impact on health care budgets that will likely result in cuts to hospital and community health care services. There is nothing in the disclosed documents that provides any reassurance that this will not be the case in the North Bay P3 hospital project.

Analysis of North Bay Regional Health Centre documents

1) Disclosure

After months of public pressure, the Provincial Government has finally responded to demands from health care advocates and the community in North Bay to release financial details of the recently-concluded Alternative Financing and Procurement (P3) deal for the new North Bay Regional Health Centre.

In addition to 695-page document described as the Project Agreement, the government has released a publication of Infrastructure Ontario, Value for Money Assessment, North Bay Regional Health Centre, which purports to demonstrate that the private project delivers value for money relative to a public sector comparator. However, key information, including the Direct Lender's Agreement and virtually all the financial information is excluded from the disclosure.

Indeed, the extent of the government's disclosure in North Bay is trivial compared with what was voluntarily disclosed for the Osler Health Centre in Brampton, not to mention the full details the government was forced to disclose in the Osler case following a court challenge.

On the critical financial issues, the disclosure is virtually non-existent. In the 695 pages of the Project Agreement, as released, only one number – an annual project payment, before (unspecified) adjustments – appears. The only other numbers in the document are page and paragraph numbers.

The words "intentionally deleted" – the legal equivalent to blacking out the relevant sections - appear five times in the document. The word "redacted" – also the legal equivalent to blacking out the relevant sections – appears in the document a total of 359 times.

"Redacted" appears everywhere in the document where one might expect to see a number, most notably in Schedule 30 to the Agreement, which is entitled "Financial Model" for the project.

The omission of the financial model is significant, because it highlights the contrast between the extent of disclosure in the Brampton and Ottawa P3 hospitals and the North Bay Regional Health Centre project. In both Brampton and Ottawa, the government voluntarily released a two-page detailed summary of the financial model for the project. While the summary did not meet the test of

full disclosure, it did enable critics of the project to understand the underlying economics of the projects. Furthermore, in the course of discovery proceedings in a court challenge of the Brampton project, the Government was ordered by the Courts to disclose essentially all of the relevant financial details.

In making its ruling, the Court rejected all of the arguments currently advanced by the Government for its refusal to disclose relevant details in North Bay.

While the parts of the Agreement released by the Government provide some insights into the scope of the project, they are completely unhelpful in understanding the economics of the deal.

The encouragingly-titled "Value for Money Assessment" is not much more helpful. The scope of the assessment itself is so limited as to be meaningless. As the auditors state in their covering letter:

> "We did not audit or attempt to independently verify the accuracy or completeness of the information or assumptions underlying the PSC [public sector comparator], which were provided by IO [Infrastructure Ontario], and/or the successful proponent's final offer, nor have we audited or reviewed the successful proponent's financial model."
>
> PriceWaterhouseCoopers letter of transmittal, 16 March 2007 [specification of acronyms added]

The analysis was concluded after the final deal had been sealed. Plenary Health was selected as the preferred proponent on January 19, 2007 and the agreement closed in March 2007.

In other words, what is called a value for money assessment is nothing more than a comparison of numbers provided by the parties to the deal after the contract had been awarded. The Assessment does not provide an independent assessment of either the methodology used to determine the public sector comparator or the financial model of the proponent. Under the circumstances, it would be nothing short of shocking if the Assessment were to have found anything other than value for money, given the information-sources used and the stage at which the assessment was conducted.

2) Financial Assessment

Even given these limitations, however, the VFM Assessment hints at some useful information.

According to the report, Infrastructure Ontario estimates the present value cost of the public sector comparator at $404.6 million compared with a present value cost for the private project as presented by the proponent of $551.7 million. In addition, transaction costs charged to the project amount to $18 million for the

private project as opposed to only $5.4 million for the public project. The difference -- $159.7 million or 38% -- shows a cost advantage for the public project.

How do we get from a $160 million disadvantage to a $56 million advantage for the private project?

According to the VFM Assessment, Infrastructure Ontario estimates that, net, the project transfers risks valued at about $210 million to the project proponent. That is how a $160 million disadvantage becomes a $56 million advantage. Thus, the entire case for the P3 privatization rests on a $210 million “risk transfer”.

We know why the basic project costs would be much lower for the public sector than for the private sector. The Brampton and Ottawa hospital models demonstrate that borrowing costs in these arrangements run roughly 200 basis points (2%) above government borrowing rates – what it would cost the government to do the project itself – and that once a return on the proponent’s “equity” investment is taken into account, blended borrowing costs would be approximately 8% compared with government borrowing rates of about 4.5%.

We also know that the complexity of the financing of P3 projects drives up the legal and accounting costs to put the deals together, compared with traditional public sector financing. Project proponent costs for P3 financing appear to run to about 4% of the amount to be financed, compared with about 0.05% for public borrowing. And because in the hospital sector these deals tend to be 3-party deals (project proponent, Government of Ontario and local hospital board) we would expect to see that 4% multiplied by 3 to arrive at total deal costs.

On the face of it, then, the AFP/P3 deals don’t make any economic sense.

3) Risk transfer

In the beginning of Ontario’s foray into the world of P3s, these mechanisms were justified on the basis of the claim that the government did not have access to the capital needed to complete the projects required, that the government could not acquire the needed capital at reasonable cost, and that infrastructure capital was only available to government through public private partnerships.

When that justification was exposed as illegitimate, a different argument was required. That’s where risk transfer comes in.

In the Infrastructure Ontario rationalization of its P3 projects, the demonstrably higher private-sector borrowing costs are offset by an assumed value of the risk transferred from the public sector to the private operator. The risk transfer, and the value attached to it, are key to making the P3 appear to be financially justifiable. Yet the government has provided no detail to back up the enormous and critical value assigned to risk transfer in the North Bay project.

Even a detailed breakdown would be useful. We could look at individual risks to determine whether or not it would make sense to build risk sharing into the public sector model. For example, it is quite common in public sector construction projects to negotiate fixed-price "turnkey" terms in which the contractor bears the risk of construction cost overruns. Absent a breakdown of the calculated risk transfers, that is not possible.

More important, the government's current approach to risk analysis its use in project assessment do not withstand even the most superficial scrutiny. Values are assigned to various risk without any empirical data to support those values. You would think for example, in generating an estimated value for the risk of construction cost overruns that the government would use historical data on the extent of cost overruns in similar projects in Ontario and elsewhere. As testimony in the Ontario Legislature's Standing Committee on Public Accounts indicates, however, no such data were used. Instead, the risk data were based on purely theoretical models.[1]

Even if the values attached to the various risks were calculated correctly, the way they are used is questionable.

First, the analysis assumes that the value of the risks in question is the same for the government, which is transferring the risk, as it is for the project proponent, to whom the risk is being transferred. The most basic kind of risk analysis would demonstrate that that cannot be true. In general, one would expect the value attached to any given risk by the government to be less than the value that would be attached to it by an individual project proponent.

Why? Because the government is responsible for the administration of literally hundreds of projects, it is able to pool the risk associated with any one project over those hundreds of projects. The larger the number of projects over which a given risk can be spread, the lower the value of the risk and the lower the cost of insuring against that risk. For the P3 operator, the situation is reversed. Because P3 projects are generally owned by stand-alone entities – usually limited partnerships – established for the sole purpose of building and operating the project, all of the risk associated with that project must be absorbed within the financial model of that single project. The smaller the number of projects, the higher the value of any given risk and the higher the cost of insuring against that risk, with the highest cost associated with stand-alone projects.

The economics of risk management for public projects are analogous to the economics of risk management in the operation of a dental or drug insurance plan. Just as insurance rates are lower, the larger the group covered, the cost of

[1] Standing Committee on Public Accounts, Legislature of Ontario, May 2007, responses to questions by Howard Hampton, MPP Rainy River and Peter Tabuns, MPP Broadview Greenwood.

risk management in public projects is lower, the larger the number of projects among which the risks are shared.

The risk transfer model assumes that the risk value built into the project proponent's price is the same as the value of that risk to the government. In fact, the value to the government will be substantially less.[2] Yet the VFM Assessment's conclusion with respect to the merits of the public sector comparator vs. the P3 project is critically dependent on the assumption that the values are the same.

This is exactly the conclusion reached by the British Association of Chartered Certified Accountants in a study of road and hospital P3s in Great Britain, published in 2004.[3] This study delves extensively into the use of risk transfer as a justification for P3 schemes. Reviewing other studies of hospital financing in Britain, the study observes (note: "PFI or Private Finance Initiative is the British term for P3 or "Alternative Financing" mechanisms):

> Several studies have examined the business cases supporting the use of private finance for new hospital builds, and questioned the ability of the methodology to measure VFM in an unbiased way, the degree to which the business cases demonstrate VFM and the higher cost of PFI over conventional procurement (Gaffney and Pollock 1999; Price et al. 1999; Pollock et al. 2000; Froud and Shaoul 2001; Shaoul 2005). Their evidence shows that the VFM case rests upon risk transfer. The credit ratings agency, Standard and Poor's, in its report for the capital markets (Standard and Poor's 2003), states that the PFI companies carry little effective risk. Other work shows that the high costs of PFI projects lead to affordability problems, an issue that the emphasis on VFM downplays, and lead to hospital downsizing in order to bridge the affordability gap (Hodges and Mellett 1999; Gaffney and Pollock 1999; 1999b; Gaffney et al. 1999a; 1999b; 1999c; Pollock et al. 1999).
>
> p. 7

And summarizing its own conclusions with respect to risk transfer, the study concludes:

> The net result of all this is that although risk transfer is the central element in justifying VFM and thus PFI, our analysis shows that ***risk does not appear to have been transferred to the party best able to manage it.*** Furthermore, rather than transferring risk to the private sector, PFI has, first,

[2] In general, measured risk varies with the square root of the number of cases over which the risk is spread. So, for example, the value of a given risk spread over 36 projects will be one-sixth of the value of that same risk absorbed by a single, stand-alone project.

[3] Pam Edwards, Jean Shaoul, Anne Stafford and Lorna Arblaster, "Evaluating the operation of PFI in roads and hospitals", Research Report No. 84, Association of Chartered Cerfitied Accountants, Certified Accountants Educational Trust, 2004.

> created additional risks to the public agency and the public sector as a whole that must increase costs to the taxpayer and/or reduce service provision, a travesty of risk transfer. [emphasis added]
>
> p. 222

It is worth noting in passing that the risk assessment and transfer methodology used in Britain is essentially the same as it is in Ontario, down to the detail of referring to the process through which risks are identified and measured as “risk workshops”.

Second, it is assumed implicitly that there is no alternative to a P3 available to the government to transfer project risk. That is also not true. As noted above, it is quite common for capital projects to be built on a fixed-price guaranteed basis, with the risk of cost over-runs borne by the contractor. Governments are in a position to choose whether to transfer construction cost risk to a contractor – at a price – or to self-insure against cost overruns by retaining responsibility for cost management.

Third, it is doubtful, in the specific situations in which P3s are contemplated, that risk is ever really fully transferred from the government to the project proponent. Why? Because the consequences of default on the agreement are not evenly balanced between the government and the project proponent. In the case of the project proponent, the consequences of default are limited by the fact that the project is legally a stand-alone entity. A proponent’s liability on default is generally limited to any equity invested in the project that has not been drawn out in the form of profit. There is no recourse to the financial resources of the entities financing or providing services to the P3. For the government, there is no walk-away option. If the proponent defaults, the government’s payments under the P3 agreement stop, but it still has to provide the hospital services. It still has to run the hospital. In the end, the risk falls back on the government, leaving open the question of why the government would pay someone to absorb a risk that, in the event of default, it will have to absorb in any case.

As shaky as its economic justification may be, however, the risk transfer model does serve its political purpose well. It sounds plausible. It feeds into popular pre-conceptions about governments’ ability to mange. And it presents a perfectly impenetrable black box to potential critics.

Assessment

As the McGuinty government constructed its rationale for its about-face on P3s, from opposition in principle to the Brampton and Ottawa hospital projects to exclusive reliance on P3s for its current program, it stressed the fact that it would learn from the mistakes made in the Harris-Eves government’s P3 program. But, despite repeated promises by the Minister of Public Infrastructure Renewal to modify the projects to ensure “public interest”, “transparency”, and “appropriate

public control", the government has pursued a policy of public relations and secrecy over substantive change and accountability.

To deal with the negative political optics of P3 privatization, the government dropped the term "public private partnership" and is proceeding with the same financing model under a different name – the antiseptic-sounding "Alternative Financing and Procurement".

To limit the potential damage from critics, it has reduced public control and stifled legitimate public scrutiny by curtailing its disclosure of financial information. The McGuinty Government has refused to disclose even the degree of detail that was voluntarily released concerning the Brampton and Ottawa hospital projects it opposed while in opposition, much the degree of detail it was compelled by the Courts to release concerning the Brampton project.

And to move the debate away from the discredited argument about access to capital and financing costs, the government has embraced "risk transfer" as the new rationale for its continued policy of P3 privatization. Risk transfer has three key advantages for the government. It is plausible. It exploits a reputational weakness of public administration. And it is a perfectly impenetrable black box, generating justifying numbers that cannot be reproduced by outsiders.

None of these changes has fundamentally altered the P3 concept. And none of these changes has altered the fundamental economic conclusion: that P3s are unjustifiably costly and will likely lead to cuts in health care services.

Conclusion

As a developer and operator of public infrastructure projects, the public sector has three key advantages: the government can borrow money at substantially lower interest rates than any private entity; the government is in a position to pool risk over a large number of projects, thus reducing the risk-related costs associated with any single project; and the government is clearly best placed to protect the public interest.

In Orwellian fashion, Ontario's P3 hospital financing scheme claims an advantage for private development in each of these three areas of clear public sector advantage. Access to capital clearly costs more, yet it is continually cited as a P3 advantage. Risk is clearly more cost-effectively managed in the public sector than in the private sector, yet risk transfer has emerged as the pivotal factor in the justification of P3 projects. And notwithstanding the self-serving declaration in the North Bay Project Agreement that "the public interest is paramount", it goes without saying that, for the private P3 operators, the financial interest of their shareholders is paramount.