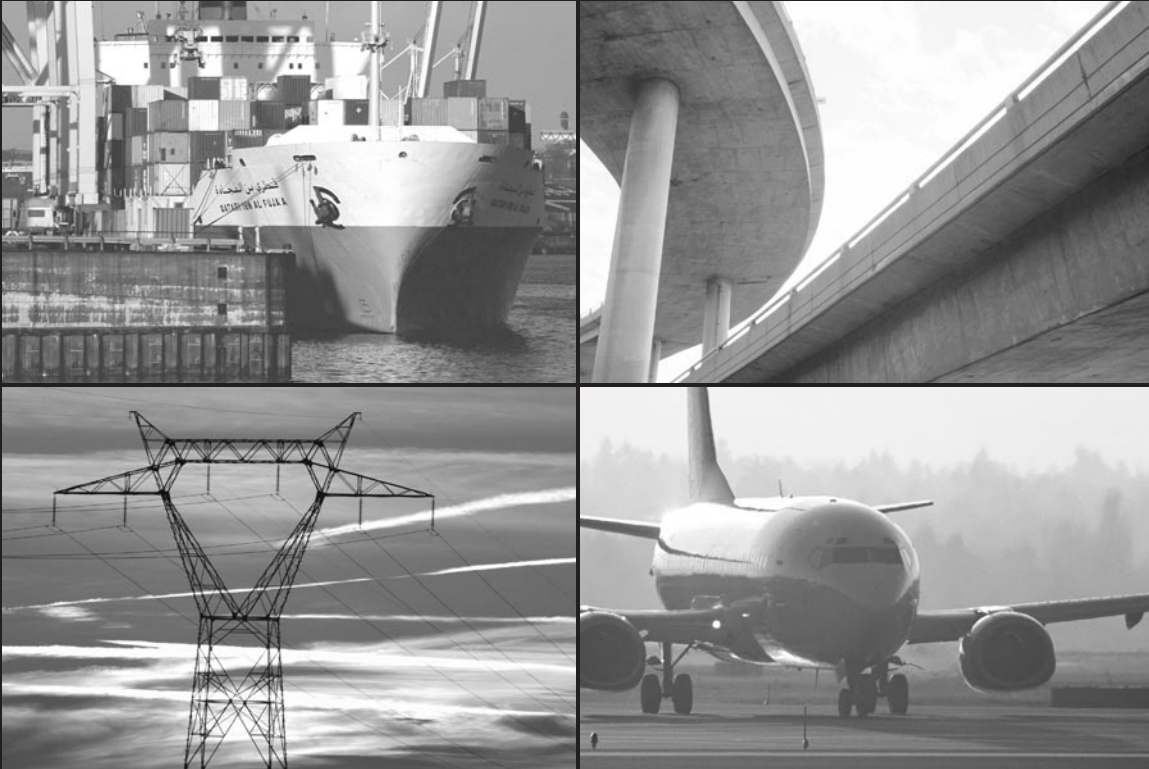


# CROSSROADS

Cracks In The Foundation

Issue No. 1 – April 2004





## Introduction

Goodmans and KPMG, two leading firms that provide infrastructure renewal and procurement services in Canada, have joined forces to provide you with *Crossroads* – a regular publication designed to provide practical articles on current trends and developments in these areas.

Our mission: to provide you with up-to-date information essential to your understanding of the opportunities and pitfalls to ensure you can be well positioned to determine the most effective strategies for your participation in infrastructure projects.

In this first issue, we discuss:

- the need for and recent history of infrastructure renewal in Canada, and
- the options available to achieve infrastructure renewal.

## Infrastructure Renewal In Canada

Canada faces enormous infrastructure challenges. According to statistics published by the Canadian Federation of Municipalities, the municipal infrastructure deficit stands at \$57 billion. Estimates of the infrastructure deficit for all levels of government run as high as \$125 to \$130 billion. Given our growing and ageing population, this deficit is sure to increase significantly in the near term. This deficit represents the cracks in the foundation of our country: the bridges, roads, water treatment plants, hospitals and schools so badly needed in many communities.

Governments at all levels are seeking progressive approaches to address the infrastructure deficit. There have been a number of recent innovative public infrastructure projects in Canada, most commonly in the highway and bridge sector, but with notable projects in other sectors as well. For example, both Ontario and British Columbia have pursued hospital projects, at the William Osler Health Centre and the Royal Ottawa Health Care Group in Ontario and at the Vancouver Coastal Health Authority and the Fraser Health Authority in British Columbia. Ontario has also pursued projects in a range of sectors, including courthouses and correctional facilities and Alberta has sought to develop a courthouse and is seeking to develop school facilities in reliance on a public-private partnership. As well, British Columbia is currently proceeding with the Britannia Mine water treatment plant.

Highways and bridges continue to dominate innovative infrastructure development in Canada. In British Columbia, procurement processes relating to the Fraser River Crossing bridge project and the Richmond-Airport-Vancouver transit project are underway, and others such as the Sea-to-Sky Highway improvement project and the development of the Sierra Yoyo Desan Road are in progress or pending. In Alberta, a procurement process relating to a segment of the ring road around the City of Edmonton known as Anthony Henday Drive is also underway. Ontario's Highway 407 remains a landmark transaction in the field. The Province of Quebec has hired advisors for the development of the A25, and there is some hope that Quebec's plans will extend to the A30. In Atlantic Canada, a procurement process relating to the Trans-Canada Highway, which constitutes an extension to the Fredericton-Moncton Highway, is also underway. The collective value of these projects is enormous by Canadian standards.

Provincial and municipal governments continue to lament the shortfall in public infrastructure investment in Canada and are seeking to address that shortfall through creative infrastructure development. The value for money that properly managed innovative infrastructure development can bring, augurs well for its continued use.

## Canada Versus the World

Canada's innovative public infrastructure development is modest by global standards. Europe, Asia and Latin America dwarf Canada both in terms of the number of public infrastructure development and operation projects and in terms of total project value. Europe is aided, no doubt, by the heavy use of the Private Finance Initiative (PFI) in the United Kingdom, which has gained adherents in much of the English-speaking world, including Australia, South Africa, and Ireland, each of which has tailored the United Kingdom approach to their own jurisdictions. Asia's numbers are large, in part, because of the high population and the corresponding need for infrastructure development, and also, because of the pressure on less wealthy countries to develop infrastructure in reliance, to some degree, on private finance. Latin America is in a similar situation.

## Canada's Special Challenges

**Canada faces a number of special challenges in pursuing innovative public infrastructure development:** the constitutional separation of powers between the federal and provincial governments; the sub-optimal dynamics of federal-provincial-municipal fiscal relations; the concentration of public infrastructure development responsibility at the provincial level; and the low population densities across much of the country.

By contrast, a country such as the United Kingdom enjoys a number of advantages: it is a (more or less) unitary state, relations between central and local governments are less encumbered by the roles of intermediate public institutions, public infrastructure development is concentrated at the central government level (including through its capital funding of transfer partners), and it has double the population and a far smaller land mass. These advantages allow for a steady transaction volume and a similarity of deal structures and procurement processes that are more difficult to achieve in a country like Canada.

One key implication of this is that innovative approaches to infrastructure development in Canada needs to rely more on effective marketing and specialized expertise than on ready-at-hand, off-the-shelf solutions.

**Canada is at risk of not successfully balancing deal flow and supplier capacity,** given its relatively small size and the fragmentation of its market. The expectation of consistent deal flow provides an incentive to the supplier community to make the necessary investment of time and resources to develop the competencies required to participate in innovative infrastructure development deals. While Canada has a history of reasonably steady deal flow in the highway and bridge sector, there has been more limited deal flow in other sectors, such as healthcare. However, there is the potential for increased deal flow in other sectors as well. This may result, at some point, in constrained supplier capacity in both traditionally active sectors as well as in less active sectors. This is not to suggest that deal flow should be limited; rather, deals should be brought to market in an orderly fashion.

**Canada needs to enhance its international competitiveness in the field,** and deal flow in the domestic market can facilitate this. While the lion's share of the work under any infrastructure development project almost invariably falls to domestic suppliers, the work that is most likely to be imported is the value-added work, such as project management and specialized technical expertise. While it would not be appropriate to shield Canadian suppliers from international competition, increased deal flow in the domestic market is more likely to

promote development of the Canadian supplier market than is increased deal flow outside the country. Given the global opportunities in public infrastructure development, development of the relevant Canadian supplier market may very well be a laudable goal.

## The Options Available

Innovative infrastructure development requires innovative approaches to project delivery. We have called these alternative project delivery methods “APDs”.

APDs may be divided into 3 broad categories:

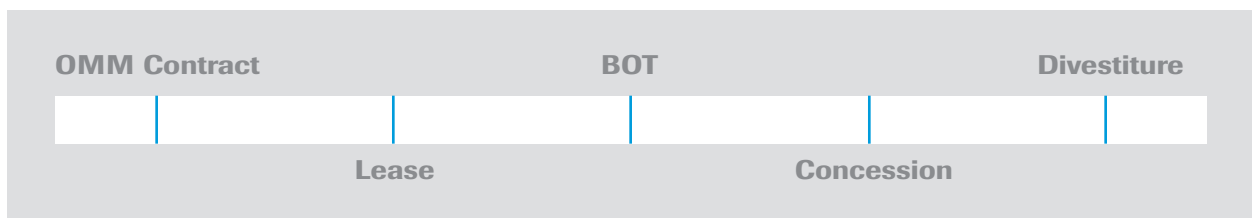
- outsourcing,
- public/private partnerships, and
- privatization.

Outsourcing is the contracting by a public agency for the performance or completion of government functions by a private sector organization. The government agency provides payment for services and/or facilities through government funds for the execution of a function that may have previously been performed by the agency itself.<sup>1</sup>

Public/private partnerships (P3s) are a means of utilizing private sector resources with a blend of outsourcing and privatization. P3s can involve the design, construction, financing, operation and maintenance of public infrastructure or facilities, or the operation of services, to meet public needs. Generally, the agreement under which the P3 operates is closely governed by a contractual relationship between the public and private sectors with the objective of utilizing the best skills and capabilities of each sector. The objective of a P3 is to provide a more efficient and cost effective means of providing the same or better level of service.<sup>2</sup>

Privatization involves the sale of a Government owned asset to the private sector, or private operation of a function that may have previously been performed by the public sector.<sup>3</sup>

There is a wide range of possible contractual models that can be utilized to implement APDs. It is useful to think of these models as points on a continuum of ever-increasing private sector involvement and risk assumption, as illustrated below:



The following is a brief summary of certain of these contractual models:

- **Operation, Maintenance and Management Contracts (“OMM”)**: In this model, the public entity owns the facility and retains the responsibility for capital improvement but delegates the responsibility for day to day operation, maintenance and/or management to an outside contractor. The contractor is paid by the public entity, which controls the revenues received from end-users.

<sup>1</sup> National Council for Public-Private Partnerships, “For the Good of the People: Using Public-Private Partnerships to Meet America’s Essential Needs, a White Paper On Partnerships,” at p.4.

<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

- **Lease:** In this model, the public sector leases the facility to the private sector for a defined term, together with the obligation to operate, maintain and manage the facility. The principal difference between a lease and an OMM contract is the allocation of revenue risk to the private sector. Under a lease, the private sector operator must charge and collect revenues from end-users. Ownership of the facility, together with responsibility for rehabilitation and upgrades remains with the public sector.
- **Build-Operate-Transfer (“BOT”):** Under this approach, the private partner builds a facility to the specifications agreed to by the public agency, operates the facility for a specified time period under a contract or concession agreement with the agency, and then transfers the facility to the public agency at the end of the specified period of time. Usually, the private partner provides all or part of the financing, so the contract is structured to be of sufficient length to enable the private partner to realize a reasonable return on its investment. Variations on this approach which either add or reduce private sector involvement and risk assumption, include among others:
  - > **Design-Build (“DB”):** Design-Build is a project delivery system whereby the owner, whether a public or private person or entity, hires a single entity or team for the design and construction of the project. The majority of the project risks are passed on to the design-builder who obligates itself to provide a completed project to the owner. The design-builder’s obligations usually include land assembly, design, construction and supervision of construction, and commissioning of a fully operative facility.
  - > **Build-Own-Operate (“BOO”):** A contractor constructs and operates a facility for performing public services without transferring ownership of the facility to the public sector. Legal title to the facility remains with the private sector entity.
  - > **Design-Build-Operate (“DBO”):** In a DBO project, a single contract is awarded for the design, construction and operation of a public facility, with title to the facility remaining with the public sector.
  - > **Build-Develop-Operate (“BDO”):** Under these arrangements, the private partner leases or buys an existing facility from a public agency, invests its own capital to renovate, modernize or expand the facility and then operates it under a contract with the government.
  - > **Design-Build-Operate-Finance (“DBOF”):** Under this project delivery method, there is an obligation on the part of the consortium that is designing, building and operating the project to also finance the capital and operating requirements of the project, ideally without reliance on funding by the owner. The design-build-operate-finance team carries out the four distinct functions and usually fronts all expenses and construction costs.
  - > **Buy-Build-Operate (“BBO”):** This approach is a form of asset sale that includes the rehabilitation or expansion of an existing facility. The government sells the asset to the private sector entity, which then makes the improvements necessary to operate the facility in a more cost effective manner.<sup>4</sup>
- **Concession:** In addition to all of the features of the lease model described above, under the concession model, the private sector is responsible for all on-going capital investment in the facility or service. A lease or concession agreement may be used in contract models that include the operation of the facility as one of the private sector's responsibilities, and either the public sector retains legal title to the facility or, in the case of a concession

<sup>4</sup> Definitions are found in United States General Accounting Office, “Public-Private Partnerships: Terms Related to Building and Facility Partnerships”, April 1999.

agreement, the public sector, through legislation, grants to the private sector the right to raise and collect revenues from the operation of the facility or service. Concession terms of 20 to 30 years are not unusual and may, in fact, be considerably longer.

- **Divestiture:** A divestiture is a sale by the public sector of the infrastructure or service to the private sector. Divestiture may also be accomplished through concession agreements with lengthy terms, such as 50 to 90 years or longer, with reversion rights in favour of the public sector.

APDs may in practice be a combination of one or more of the contract models set out above. A summary of the significant features of each of these delivery models is set out in the following chart:

Delivery Model	Facility/Service Ownership	Operation & Maintenance	Capital Investment	Revenue Risk	Duration
OMM Contracts	Public	Private	Public	Public	3-5 years
Lease	Public	Private	Public	Private	5-30 years
BOT	Private then Public	Private	Private	Private/Public	20-30 years
Concession	Public	Private	Private	Private	20-30 years or longer
Divestiture	Private	Private	Private	Private	Indefinite

In subsequent issues of *Crossroads*, we will be providing advice on which APD is most suitable for each particular type of infrastructure project. Please stay tuned.

## Goodmans LLP

Based in Toronto, with offices in Vancouver and Hong Kong, Goodmans is recognized internationally as one of Canada's premier transaction law firms. *Lexpert* called us a "corporate powerhouse", and the *National Post*, "a testament to smarts over size". We rank among the very best lawyers in Canada in our fields of practice, not only in our own estimation but also in the opinion of recognized independent guides to the world's leading lawyers including, *Lexpert*, *Chambers and Partners*, *Euromoney* and *Law Business Research*.

With over 190 lawyers and offices in Toronto, Vancouver and Hong Kong, Goodmans provides a complete spectrum of legal advice and representation to domestic and foreign business clients ranging from entrepreneurial businesses to multinational corporations across a wide range of industries. Goodmans' **Procurement and Infrastructure Renewal Group** has been at the forefront of the most important public infrastructure development projects in Canada, such as Highway 407, the Fredericton-Munton Highway Project in New Brunswick and most recently, the Toronto Waterfront Revitalization Initiative.

## KPMG LLP

KPMG LLP is the Canadian member firm of KPMG International, a Swiss cooperative. KPMG is the global network of professional services firms whose aim is to turn understanding of information, industries, and business trends into value. With more than 100,000 people worldwide, KPMG member firms provide audit and risk advisory, tax, and financial advisory services from more than 750 cities in 150 countries. Currently KPMG LLP has over 4,000 people in 35 offices across Canada.

KPMG's **Public-Private Advisory Group** is one of the leading advisors in Canada for public infrastructure development projects involving both the public and the private sectors. Founded in the 1970's, it has been involved on both the owner and the bidder side of transactions across Canada, the United States, Latin America, Europe, and Asia, typically for projects in the \$100 million to \$1 billion range. KPMG has centres of excellence in public-private advisory work in Toronto, London (England), and Melbourne.

In one of their most recent landmark deals, members of KPMG's Canadian, UK and Irish firms advised Ireland's National Roads Authority in the implementation of its N4/N6 Kilcock-Kinnegad highway project, the first public-private partnership in the Irish road sector and Project Finance International's 2003 Infrastructure Deal of the Year.

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