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From P3s to AFPs

NEW BRANDING BUT SAME BAD DEAL

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Executive Summary

The Ontario government claims its move to fund Ontario hospital infrastructure needs through a new “alternative financing and procurement” model will be more transparent than public-private partnerships (P3) financing. The government says the 14 announced projects will save the province \$341 million. This report works with the government’s assessments and finds the \$341 million savings estimate to be hugely optimistic. In fact, the province could find itself on the hook for at least \$585 million in *extra costs* — not savings — by going this route.

Introduction

During its first term in office, Ontario's Liberal government introduced the “alternative financing and procurement” (AFP) model for public infrastructure.

The government claims that this model provides greater transparency than P3 financing and will yield savings for the public purse.

An examination of Infrastructure Ontario’s “value for money” assessments of hospital projects suggest that AFPs are lacking both in transparency and in protection of the public purse.

Infrastructure Ontario has conducted a value for money assessment of all AFP projects. These estimates compare the costs associated with the AFP project to a public sector comparator. Both Infrastructure Ontario and the provincial government rely on these assessments to demonstrate that AFP is a better way to fund public infrastructure than traditional financing. A look at the methodology behind these assessments raises serious questions.

To begin with, the information made available in these assessments is insufficient — it fails the true transparency test. The limited information that is publicly available raises serious questions about the validity of the value for money assessments' results.

The province's value for money results hinge on two questionable assumptions:

- The first questionable assumption is that a substantial amount of public money can be saved by transferring risk from the government to private sector AFP service providers. It assumes that risks associated with large, complex construction projects such as supplier disruptions, bad weather or changes in specifications can be borne more cheaply by the private, stand-alone entities responsible for AFP projects than by the government.
- The second questionable assumption is that financing costs for these projects are far below what the available evidence indicates that they would be.

Using the data from Infrastructure Ontario assessments and its method of estimating a public sector comparator starting from the winning AFP bid, we constructed alternative estimates of value for money for Ontario's hospital projects and came to vastly different conclusions than the government.

Our estimates include alternative assumptions on risk transfer, financing, transactions costs, taxes and insurance premiums. These alternative assumptions are more conservative than the available evidence suggests that they should be.

Yet, using these conservative assumptions, we found the AFP hospital projects could result in a cumulative increased cost to the public purse of \$585 million, compared to Infrastructure Ontario's optimistic estimate that the province will save \$341 million.

We cannot conclusively say these projects will actually cost the government \$585 million more using an AFP method of financing for one simple reason: because Infrastructure Ontario doesn't provide us with enough information.

What we can say is this: the AFP saving for Ontario hospitals could be — *at most* — \$341 million. But the AFP disadvantage could cost the Ontario government *at least* \$585 million.

This represents a significant chasm between Infrastructure Ontario's estimates, which show a 16 per cent saving from using AFP, and ours, which show a potential 27 per cent increase in costs.

How Ontario arrived at AFPs

In the lead up to the 2003 election, Premier Dalton McGuinty promised to bring the Royal Ottawa Hospital and William Osler Health Centre in Brampton into the public system. Shortly after the government was elected, it announced that the projects in Brampton and Ottawa would proceed. The contracts were modified, but only to provide for public ownership.

Subsequently, the Ontario government announced a program of alternative financing and procurement (AFPs) for hospitals and other public infrastructure. Its position is that AFPs are not P3s because they will remain publicly owned and controlled. However, AFPs still look very much like P3s because they will be privately financed, and some will be bundled with lengthy complex service agreements. Many of the problems associated with P3s arise from private financing and operations.

The rationale provided by the government for choosing this method of financing is that it has established controls that it believed would deliver value for money and would transfer risk to the private sector. The government claims that AFPs are marked by transparency and openness.¹ These efforts were responses to the well-documented evidence that the costs of public-private partnerships (P3s) tend to be higher, while the quality of the service is reported to be poor.^{2 3 4 5 6}

In addition to the direct impacts on finance, delivery, and quality of individual projects, there are broader political and policy implications for this method of financing. Most importantly, it creates a new and powerful stakeholder group — the private consortia — whose clear long-term interest is the expansion of health care privatization.

This government has put some limits on private intrusion into the public health care, such as the limitation on consortia providing clinical or soft support services in hospitals.⁷ But these are limits a future government could easily reverse, using the AFP structure created by this government to pursue a more aggressive privatization strategy.

In support of its claims, the government makes public value for money assessments. These assessments involve:

- An estimate of “base” costs, an estimate of the “risk premium” charged by the private sector, the differences in transactions costs, the risks retained by the government, and adjustments to establish “competitive neutrality” between public and private sectors.

- These estimates are adjusted for the timing of payments to provide comparable estimates that are either present valued or future valued depending on the type of project.
- They are then used to calculate the value for money of using traditional public procurement as compared to AFP.

Concerns with value for money assessments: Accountability and transparency

The government claims the process for awarding AFP hospital contracts is transparent and provides for public accountability. However, the value for money assessments fall far short on a number of fronts:

- The initial value for money assessment that determines whether the government will proceed with AFP financing is not made public.⁸ There is no opportunity for public scrutiny of the basis of the decision to enter into a P3 for a particular facility.
- The amount of information that is disclosed about the methodology and assumptions used to determine value for money estimates is insufficient. The costs associated with financing, and the assumptions made by Infrastructure Ontario are not provided in sufficient detail.
- Finally, it is apparent from caution statements in the transmittal letters for the value for money assessments that these assumptions are not even audited by the accounting firms that are conducting the value for money assessments. The following caution in the audit letter in the St. Joseph's Healthcare value for money assessment is replicated in slightly different forms in all of them:

We did not audit or attempt to independently verify the accuracy or completeness of the information or assumptions underlying the PSC, which were provided by IO, and/or the successful proponent's final offer, nor have we audited or reviewed the successful proponent's financial model.⁹

Concerns with value for money assessments: What costs are included and excluded

In the government's value for money assessments, the public sector comparator cost is estimated indirectly, by subtracting

private sector costs that would not be incurred in a public model from the bid price of the successful bidder. Underestimates of those cost differentials will therefore result in an overstatement of the public sector comparator cost and therefore bias the comparison.

In these assessments, Infrastructure Ontario claims that for competitive neutrality, certain costs and insurance premiums associated with private sector financing are added back into the public sector comparator. Infrastructure Ontario's position is that taxes are costs that ultimately result in revenues to the public sector, and therefore should be excluded from comparisons between the two forms of financing.

However, assigning general revenues from different levels of government back to a specific project cost does not capture differences in the cost of that particular project.

Similarly, the economic advantages associated with the government's ability to self-insure — because of its capacity to spread risk and its resources as the Crown — should not be ignored when the two methods of financing are being compared.

While the value for money assessments acknowledge higher financing costs, they do not disclose the actual financing costs, which include both the higher borrowing costs and the rates of return on private sector capital invested in the project.

These financing costs are not reported separately; but are reported jointly with the risk premium charged by the consortia. These combined risk and financing costs average 14 per cent of the costs of the hospital projects announced by Infrastructure Ontario. This compares to the 30 per cent premium associated with risk transfers identified by the Association of Certified Accountants in Britain.¹⁰

The evidence on financing costs for P3s is generally only made public as the result of legal proceedings. The available evidence indicates that the rates of return or financing costs for P3s or AFPs are twice that of traditional public sector financing.¹¹

It appears that the combined costs of financing and risk transfer reported in these value for money assessments are far below what would be expected from the available evidence.

The Ontario government has released two background papers that provide an overview of the kinds of risks that are quantified in the value for money calculations, and provide estimates of the shares of these risks that are retained by government under a "traditional" model of financing, under a "build finance" model or a "design, build, finance, and maintain" model.^{12 13}

TABLE 1 Risk Retained by Province at Average Impact

	<i>Build/Finance</i>			<i>Design, Build, Finance, and Maintain</i>		
	AFP	Traditional	Transfer/Reduction	AFP	Traditional	Transfer/Reduction
Policy Strategic	9.0%	15.8%	6.8%	5.6%	20.4%	14.8%
Total Project	16.7%	43.6%	26.9%	16.2%	76.5%	60.3%

SOURCE Infrastructure Ontario

These papers are not transparent enough in their methodology or their rationale to account for the differences in risk retained by government under traditional or AFP models. For example, it is unclear why risks such as those associated with incomplete tender documents are assumed to be lower in the AFP model when there is no reason why traditional government financing could not include complete tender documents.

These papers claim that for a build finance project, traditional government financing results in 43.6 per cent of the risk being retained by the government, while 16.7 per cent is retained by government with AFP.¹⁴

For design, build, finance, and maintain projects, 76.5 per cent of the risk is retained by government with traditional financing as compared to 16.2 per cent with AFP financing.

Table 1 shows these estimates of risks retained by government in these papers.

According to these papers, 25 per cent of public sector risk reduction from AFPs is associated with policy or planning risks. This includes such risks as changes in government funding policies or changes in law, policy or protocols.

These events can be legitimately characterized as risks to the proponents of the AFP projects. However, the government's ability to maintain its power to govern and make decisions in the public interest would be more appropriately characterized as a positive outcome rather than downside risk, both for the public and the public sector.

Concerns with value for money assessments: Differences between risk premium and risk transfer

Infrastructure Ontario calculates the risks retained by the public sector under AFP and traditional public financing.

The value of these risks is based on the probability of the risk occurring and its financial impact on the project.

The assumption in the value for money estimates is that the price that the consortia charge for the risk transfer falls far below the monetary value of that risk transfer to govern-

ment.¹⁵ This implies that Infrastructure Ontario is making one of two assumptions:

- That the consortia are subsidizing the costs of these projects by charging the government less for bearing project risks than expert estimates of the costs of bearing those risks. This assumption would be inconsistent with how economists expect the private sector to behave, and with the fiduciary responsibility of the consortia to their shareholders.
- The government fails to build terms intended to mitigate risk into contracts using public sector financing, but somehow can build these terms into AFP contracts. There is nothing that would prevent the government from using the tools of design/build contracts, turnkey contracts, fixed price contracts with penalties and product warranties in public sector financing. Since it doesn't seem possible that the government would have that set of skills for one set of negotiations and not for another; this assumption is not very plausible.

What would the value for money assessments look like with different assumptions?

In its value for money assessments, Infrastructure Ontario estimates a public sector comparator by starting with the winning AFP bid and making adjustments to arrive at the public sector cost. That same approach is used in this paper, but with more realistic assumptions about public/private cost differentials.

To illustrate the process, we start with the following example. This example has the categories of costs reported by Infrastructure Ontario for each value for money assessment. The winning AFP bid was \$100. The public sector comparator cost estimate is \$92. The \$8 difference accounts for both the risk premium charged by the private sector and the differences in financing costs.

In this example, the value of risk retained by the public sector under AFP was \$11 and it was \$39 dollars under the public sector comparator. Finally, the transactions costs under the

public comparator were \$10 and under the AFP model they were \$14.

Adding together the cost of the winning bid, the transactions cost and the retained risks, the total cost of the AFP project was $\$100 + \$11 + \$14 = \125 . Adding together the base cost estimate of \$92, the retained risk of \$39, and the transactions costs of \$10; the total costs of the traditionally financed project was \$141. For this example, using the Infrastructure Ontario approach produces value for money of \$16.

Starting from the winning bid, but with more realistic assumptions, we repeat the calculations to re-estimate the public sector comparator. We don't have enough information from Infrastructure Ontario to know how they arrived at the price charged for the risk transfer, or how much it is. Economic theory tells us that the cost of the risk transfer to the private sector will be included in the bid price.

If the risk retained under public sector bid was \$39 and the risk retained under AFP was \$11, then we can assume the risk transferred from the public sector to the private sector is \$28. This \$28 will be part of the cost base, and will be subtracted from the AFP cost to arrive at \$72.

Then we look at the transactions costs. Governments are not the only party with higher transactions costs in AFP contracts; the private sector bidders do too. If we assume that the private bidder's transaction costs are the same as the government's at \$14, the public sector comparator cost is \$72 minus \$14 or \$58. To make it comparable, we have to add back the government's transactions costs in the public sector comparator of \$10, bringing the cost to \$68.

That results in an AFP disadvantage of almost \$28 before we even take into account borrowing cost differentials.

Financing costs are not reported separately in the value for money assessments, despite the fact that Infrastructure Ontario indicates these costs are included as a separate line in the bids.¹⁶ In order to estimate differences in financing costs between the public and AFP, we used the shares of financing base costs example in Infrastructure Ontario's methodological guide.¹⁷

This showed financing costs as 20 per cent of base costs in the public sector model, and 21.52 per cent in AFP model. This assumption provides a lower AFP financing cost than the evidence would lead us to expect, but we are trying to keep within the Infrastructure Ontario framework.

The financing cost for the AFP example is \$21.52. The financing costs for the public sector comparator would be 13.60. The

difference of \$7.92 would reduce the public sector comparator base cost to \$60.08.

Now we have to add back the government's retained risk in each case. For the AFP, the exercise is pretty straightforward. The retained risk is \$11, so the AFP total risk adjusted cost is \$125. For the public sector comparator, the total risk is \$39. But we know that 25% of the measured risk consists of the risk of a change in public policy, which we've argued shouldn't be counted as a potential liability to government. Therefore, the risk adjusted total cost for the public sector comparator is \$60.08 plus \$29.25 (75% of \$39) or \$89.33.

Instead of the positive value for money of \$16, the AFP process costs \$35.67 more than public financing. For some projects, this difference would be larger because we don't add back in the taxes and insurance paid by the private sector.

We are not saying that in this example the project will actually cost the government \$35.67 more using an AFP method of financing rather than costing it \$16 less. We can't answer that question because Infrastructure Ontario doesn't provide us with enough information to do so. What we can say is that the AFP saving using the government's method is *at most* \$16 and the AFP disadvantage using a corrected methodology is *at least* \$35.67.

We repeated the calculations used in this example for each of Ontario's 14 hospital projects that had available value for money assessments. We used Infrastructure Ontario's estimates for the project costs of each model, risks retained under each model, and transactions costs. We used Infrastructure Ontario's base costs to estimate the difference in financing costs. Then we went through the same steps in the calculations that we did in the example above.

The results of these calculations are in Table 2. Each AFP project shows negative rather than positive value for money.

These are present value costs for build, finance and maintain projects, and the cost at completion for build finance models. Rather than saving the province \$341 million as Infrastructure Ontario calculations show, these projects cost the province an additional \$585 million for a net difference of \$926 million. More detail on how we arrived at these estimates is available in Tables 3 and 4 at the end of this paper.

Policy Response Required

Evidence is building on the failure of Ontario's AFP experiment to address the well-documented problems associated

TABLE 2 Value for Money of Ontario AFP Hospital Projects (\$\$ millions)

Project	AFP Bid	OAB “Value for Money”	Infrastructure ON “Value for Money”	Difference
Hamilton Health Sciences HGH	45.0	-13.2	7.2	20.4
Hopital Montfort	188.8	-40.4	19.0	59.4
North Bay Regional Health Centre	551.7	-156.3	56.7	213.0
Ottawa Hospital	46.7	-16.6	56.7	73.3
Queensway Carleton	66.3	-18.6	7.9	26.5
Quinte Health Care Belleville	72.2	-19.5	10.7	30.2
Rouge Valley Health System	63.9	-17.6	8.6	26.2
Runnymede Healthcare Centre	62.5	-21.6	11.3	32.9
Sarnia Bluewater Health	214.1	-53.5	10.8	64.3
Sault Area Hospital	407.8	-126.5	16.2	142.7
St Joseph’s Health Care, London	32.2	-9.7	101.7	111.4
Sudbury Regional Hospital	131.9	-36.4	3.1	39.5
Sunnybrook Health Sciences	142.0	-29.4	16.7	46.1
Trillium Health Centre	104.1	-25.6	14.1	39.7
Totals	2129.2	-585.0	340.7	925.7

SOURCE Infrastructure Ontario Value for Money Assessments and author’s calculations

with P3s. In fact, AFPs are starting to look very much like P3s by any other name.

The government should therefore take the following actions:

- Establish an immediate and indefinite moratorium on Infrastructure Ontario’s AFP projects in the hospital sector.
- Do not approve or announce any additional AFP projects for which contracts have not been signed.
- For projects where contracts have already been signed, deepen the commitment to full transparency by providing total disclosure of all financial aspects of these agreements.
- For projects where AFP contracts have not been signed, the financing method should be shifted to traditional government financing.
- Ask the Provincial Auditor for an immediate review of the value-for-money assessment of AFP projects. This is essential to provide the government, and the public, with a complete and accurate assessment.
- The review should include auditing and independent verification of the accuracy and completeness, as well as the underlying assumptions, of the public sector comparator,

and the successful proponent’s final offer and their financial model.

- The review should assess the risk transfer to the private sector. This review should include an assessment of whether AFP shifts only the timing of project cost increases and delays, and the value for money of the risk transfer.

Notes

- 1 Ministry of Public Infrastructure Renewal. (May 9, 2007). Ontario Using Alternative Financing and Procurement Approach to Protect Public Interest.
- 2 Pollock, A. M., Shaoul, J., & Vickers, N. (2002). Private finance and “value for money” in NHS hospitals: a policy in search of a rationale? *British Medical Journal*, 324, 1205–1209.
- 3 Pollock, A. M., Player, S., & Godden, S. (2001). How private finance is moving primary care into corporate ownership. *British Medical Journal*, 322, 960–963.
- 4 Gaffney, D., Pollock, A. M., Price, D., & Shaoul, J. (1999). A four-part series called The Private Finance Initiative: NHS capital expenditure and the private finance initiative — expansion or contraction? *British Medical Journal*, 319, 48–51.
- 5 Auerbach, L., Donner, A., Peters, D., Townson, M., & Yalnizyan, A. (2003). *Funding Hospital Infrastructure: Why P3s Don’t Work, and What Will*. Ottawa: Canadian Centre for Policy Alternatives.
- 6 *Report of the Auditor General*. (1998). New Brunswick: Author.

- 7** Sapsford, Ron. (December 15, 2006). Memorandum to All Ontario Hospitals, Services Excluded from Hospital Alternative Financing and Procurement Projects, December, 15, 2006.
- 8** Infrastructure Ontario. (2007). Assessing Value for Money: A Guide to Infrastructure Ontario's Methodology. Queen's Printer for Ontario. p. 4.
- 9** Infrastructure Ontario. (2007). Value for Money Assessment: St. Joseph's Health Care, London Redevelopment Project.
- 10** Association of Chartered Certified Accountants. (2004). "Evaluating the Operation of PFI in Roads and Hospitals", Research Report No. 84, p. 10.
- 11** For a discussion of the available evidence see Mackenzie, Hugh. (2007). Doing the Math, Why P3s for Alberta schools don't add up. CUPE Alberta. p. 15.
- 12** Altus Helyar Cost Consulting. (November 2007). Infrastructure Ontario Design, Build, Finance and Maintain Risk Analysis Services.
- 13** Altus Helyar Cost Consulting. (March 2007). Infrastructure Ontario Build Finance Risk Analysis and Risk Matrix at March 2007.
- 14** Altus Helyar Cost Consulting. (March 2007). Infrastructure Ontario Build Finance Risk Analysis and Risk Matrix at March 2007. p. 18.
- 16** This is dependant on the PSC and the preferred bid having the same base cost structure. It is evident that IO makes this assumption as stated in *The Guide to Infrastructure Ontario's Methodology*: "It is IO policy to update the PSC with the base costs (after stripping out the private sector party premium) contained in the preferred bid", p. 7.
- 17** Infrastructure Ontario. (2007). Assessing Value for Money: A Guide to Infrastructure Ontario's Methodology. Queen's Printer for Ontario. p. 7.
- 18** Infrastructure Ontario. (2007). Assessing Value for Money: A Guide to Infrastructure Ontario's Methodology. Queen's Printer for Ontario. p. 6.

TABLE 3 AFP Costs

(\$\$ millions)	Base Cost	Risk retained	Transactions	Total cost
Hamilton Health Sciences HGH	45.0	6.8	2.1	53.9
Hopital Montfort	188.8	24.5	6.6	219.9
North Bay Regional Health Centre	551.7	22.2	18	591.9
Ottawa Hospital	46.7	7.8	2.8	57.3
Queensway Carleton	66.3	10.6	3.8	80.7
Quinte Health Care Belleville	72.2	9.9	3.5	85.6
Rouge Valley Health System	63.9	10.1	3	77.0
Runnymede Healthcare Centre	62.5	9.9	3.3	75.7
Sarnia Bluewater Health	214.1	15.5	6	235.6
Sault Area Hospital	407.8	38.8	11.5	458.1
St Joseph's Health Care, London	32.2	2.7	1.6	36.5
Sudbury Regional Hospital	131.9	11.2	10.3	153.4
Sunnybrook Health Sciences	142.0	6.7	5.4	154.1
Trillium Health Centre	104.1	5.0	4.2	113.3

TABLE 4 OAB Public Sector Comparator

(\$\$ millions)	AFP Base Cost	Risk Transfer	Increased transactions costs	Financing costs	Other financing	Public sector base cost	Public sector risk retained	Transactions	Total cost
Hamilton Health Sciences HGH	45.0	11.6	3.5	3.7	0.0	26.2	13.8	0.7	40.7
Hopital Montfort	188.8	34.5	10.2	11.8	0.0	132.3	44.3	3.0	179.5
North Bay Regional Health Centre	551.7	207.7	30.4	56.0	0.0	257.6	172.4	5.6	435.6
Ottawa Hospital	46.7	11.6	4.1	4.3	2.1	24.6	14.6	1.5	40.7
Queensway Carleton	66.3	15.4	5.3	5.2	0.1	40.3	19.5	2.3	62.1
Quinte Health Care Belleville	72.2	14.9	5.8	5.2	0.0	46.3	18.6	1.2	66.1
Rouge Valley Health System	63.9	16.1	4.5	5.1	0.0	38.2	19.7	1.5	59.4
Runnymede Healthcare Centre	62.5	15.0	5.4	5.5	2.4	34.2	18.7	1.2	54.1
Sarnia Bluewater Health	214.1	34.8	10.1	14.7	12.1	142.4	37.7	1.9	182.1
Sault Area Hospital	407.8	181.9	18.3	46.2	0.0	161.4	165.5	4.7	331.6
St Joseph's Health Care, London	32.2	6.6	2.6	2.6	1.2	19.2	7.0	0.6	26.8
Sudbury Regional Hospital	131.9	30.5	12.8	10.7	0.0	77.9	31.3	7.8	117.0
Sunnybrook Health Sciences	142.0	29.3	8.1	9.6	0.0	95.0	27.0	2.7	124.7
Trillium Health Centre	104.1	23.9	6.3	8.0	2.0	63.9	21.7	2.1	87.7

SOURCE Infrastructure Ontario Value for Money Assessments and author's calculations.