The Problem with Public-Private Partnerships

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Economic crisis exposes the high costs and risks of P3s Author(s): Toby Sanger Corina Crawley April 1, 2009

If there is one thing that the current financial and economic crisis has shown, it is that the neoconservative economic model of deregulation, privatization, tax cuts, free trade and unequal growth is bankrupt. And yet, incredibly, Canadian governments and corporations are using the economic crisis to push more of the same policies: tax cuts, the sale of public assets, and, especially, more privatization through public-private partnerships (P3s).

The shifting rationales of P3s has always been highly dubious.

P3s had been used by politicians as a form of off-book accounting to make it appear as if public spending and deficits were lower than they actually were — but then public auditors forced governments to include these obligations on their books.

P3 proponents then claimed that their projects could be less expensive, more innovative, speedier, and more accountable than public service delivery — but a string of failures, delays, little transparency, and secretive deals proved these claims wrong.

Most recently, P3 advocates have acknowledged that they cost more, but they try to justify these deals by claiming that P3s transfer massive amounts of "risk" from the public sector to the private sector. By using highly questionable "value for money" accounting, they claim that the higher costs of P3s, particularly on the financing side, are offset by transferring colossal amounts of risk to the private sector.

While independent experts have criticized these deceptive rationales and faulty accounting for years, the details can be complicated. The misleading accounting practices remain, but the financial crisis has exposed the false economics of P3s in a number of different ways:

• The economic and financial crisis was caused by the same policies behind the push for public-private partnerships.
• Private financing is more costly and risky than public financing.
• The private sector is worse at managing risk than the public sector.
• Risks can never be completely transferred through P3s.
• Additional and complicated P3 requirements lengthen the process and add to delays.

This economic and financial crisis has a number of deep roots, but what propelled both the later stages of the boom and the consequent crisis was a systemic cover-up of losses, mispricing, and mismanagement of risk in the private sector.

Sub-prime mortgages were only a small part of this. On top of these and other debts, the financial industry built a web of speculation and highly leveraged securitized assets that were sold to unsuspecting buyers as solid investments. This helped to provide easy credit for a number of years, but it was only a matter of time before the financial house of cards came tumbling down.

Despite trillions of dollars provided by the taxpayers in public bailouts (and much more in accommodative actions by central banks), financial institutions around the world, including many of those behind P3 projects, continue to teeter on the brink of insolvency. It was only effective public nationalization of major banks and financial institutions in a number of countries that managed to save the world's financial system from collapsing around the world.

In a thoroughly perverse twist, these free market economic policies led to the largest public bailouts in history and what Nobel-Prize winning economist Joseph Stiglitz has described as a "new form of public-private partnership, one in which the public shoulders all the risk, and the private sector gets all the profit."

Public-private partnerships have fundamentally been about giving private investors and financiers high returns with low risks, at the long-term expense of taxpayers and the public. The financial backers of P3s were able to borrow capital at lower rates of interest, thanks in large part to unregulated and often fraudulent activities in financial markets. This narrowed the interest rate spread between private and public sector borrowing rates, allowing P3s to appear more financially attractive than otherwise. They were still a bad deal for taxpayers, but low private sector costs of borrowing meant that faulty accounting didn't have to cover up as much.

These low borrowing rates for the private sector were not based on economic fundamentals or realistic calculations of risk in the private sector. Private financial institutions engaged in systemic cover-ups, miscalculations, and passing on of undisclosed risks to unsuspecting investors. The unregulated financial markets allowed financial speculation to flourish, siphoning funds away from productive investments in the real economy. As a result, the paper economy grew, but real economy stagnated. Then the whole house of cards came crashing down.

As a result, private financing costs for P3s have increased and will continue to stay relatively high, while costs of public borrowing have tumbled. This will continue to make P3s both more costly and more risky for the public.

The spread (difference between public and private sector interest rates) for short-term borrowing rates in Canada is now about 100 basis points higher than it was during the five years of easy credit. According to a recent industry report, the spreads for P3 financing have doubled, on average, compared to last year. On a typical project, this increased spread of 100 basis points would increase the cost of financing by about 10% to 15%, or by upwards of $20 million for $100 million over 30 years.

There is no foundation to the claim that the private sector is better at managing risk than the public sector. Virtually all P3s in Canada have been justified on the basis that they transfer large amounts of risk to the private sector. But a growing list shows that P3s are both more risky and more costly for the public:

• B.C. Bridges. The financing behind Partnerships B.C.'s flagship Golden Ears Bridge project came close to collapse when its financial backers almost went into default. The German government came to the rescue with a $77 billion bailout of the German-based parent of the Irish Depfa Bank. The other financial partner of this project, Dexia, also received a $9.6 billion injection from taxpayers.

• Alberta Schools. A key player behind Alberta's P3 schools project has also come close to collapse. Last year, Babcock and Brown Ltd. lost 97% of its stock value while its P3 arm, Babcock and Brown Partnerships Ltd, recently laid off 25% of its staff.

In every single project approved so far as a P3 in Ontario, the costs would have been lower through traditional procurement if they had not inflated by these calculations of the value of "risk." The calculations of risk could just as well have been pulled out of thin air – and they are not small amounts. For a number of projects, the estimates of risks transferred inflated the base project costs by over 50%. The total amount of risk supposedly transferred through projects in Ontario has now reached over $1 billion, all based on sketchy calculations. The total cost savings of traditional procurement compared to P3s for Ontario's projects has now reached well over $500 million if these dubious calculations of risk are excluded.

Some examples of excessive costs include:

• Ontario hospitals: Ontario's Auditor-General recently revealed that the province's flagship P3 hospital, Brampton Civic, cost the public $200 million more than if it had been publicly financed and built directly by the province.

• East Coast Toll Roads: An estimated more than $300 million in tolls were produced on the Cobequid Pass for a deal in which private financiers put up $66 million. The Nova Scotia government is paying an effective interest rate of 10% for 30 years, twice its rate of borrowing. High fines for using adjacent roads force truckers to use the toll road.

• Universities: A P3 project at the Université de Québec à Montréal failed, doubling the cost to the public from $200 million to $400 million.

• West Coast Highways: B.C.'s Sea-to-Sky Highway will cost taxpayers $220 million more than if it had been financed and operated publicly.

Risks can never be completely transferred through P3s, because governments will always be ultimately accountable for delivering public services and infrastructure.

This responsibility is not changed by expensive and lengthy P3 agreements. If problems arise, it is the public that always has to pick up the bill at the end of the day.

If P3 operators run into problems or don't achieve expected returns, they can just walk away, leaving the public sector to pick up the tab.

• Recreation: The City of Ottawa was forced to bail out two of three of its flagship P3 recreation arena projects in 2007. Both of the parent companies were still very profitable, but wanted even higher returns.

• Water and wastewater: Hamilton's water and wastewater services had to be taken in-house after a string of owners, including an Enron subsidiary, created a financial mess of the P3, including a raw sewage spill that had to be cleaned up at public expense.

P3 programs in Canada are largely modeled on the U.K.'s "Private Finance Initiative" (PFI), which has its own spectacular failures.

Metronet, the private company that won a £30 billion, 30-year P3 deal to upgrade and maintain London's Tube network, failed and had to be taken over by the City of London's transport authority last year. The Metronet failure has already cost U.K. taxpayers an extra £2 billion (nearly $4 billion Canadian) and left Londoners with 500 subway stations in various states of disrepair for a P3 deal that was forced on their city by the central government under its PFI initiative. And this is just the beginning: costs for the City of London are already expected to grow by an additional £1 billion. Even the normally conservative Economist magazine now admits that these P3 deals now look like "complicated costly mistakes."

Other projects in the U.K., Australia,and New Zealand are in crisis or have been under call for greater oversight.

Governments are under increased pressure to speed up infrastructure investments as an important means of stimulating the economy.

The same factors that make P3s complicated and risky also mean that they usually involve significant delays and high legal and financial costs. This means they are particularly inappropriate for the type of accelerated infrastructure investments that are now required for the economy.

As the U.K. Treasury has advised: “A PFI transaction is one of the most complex commercial and financial arrangements that a procurer is likely to face. It involves negotiations with a range of commercial practitioners and financial institutions, all of whom are likely to have their own legal and financial advisors. Consequently, procurement timetables and transaction costs can be significantly in excess of those normally incurred with other procurement options."

In Vancouver, for instance, the publicly operated and financed Millennium Line rapid transit project started operation three years after the process got under way. In comparison, the P3-financed Canada Line transit project is not expected to be in service until 2009, eight years after B.C. Transit got its process started. Similarly, the Evergreen Line transit line has also been delayed until 2014, at least 10 years after approval.

The recent announcement by the British Columbia government that it has raised the threshold for projects to be considered as a public-private partnership to $50 million in order to accelerate capital investment is a clear acknowledgement that the P3 requirement delays investment, particularly for smaller projects.

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Recent failures, bailouts, and excessive costs show that the risk analyses and value-for-money accounting used to justify P3s are clearly flawed and cover up the true costs and risks for the public. Governments in Canada will be forced to rescue or bail out a growing number of P3 projects in the coming years, particularly with harsh and turbulent economic conditions expecting to persist for a several years.

At the same time, private investors will put increasing pressure on governments to increase the number of P3s, since they provide them with long-run, secure, and relatively high returns. But taxpayers who subsidize these high returns should be very concerned.

The current financial and economic crisis didn't just occur because of a number of isolated failures in the financial industry. The unregulated financial markets allowed financial speculation to flourish, siphoning away funds from productive investments in the real economy. As a result, the paper economy grew, but the real economy stagnated with negative or zero rates of productivity growth during recent years.

Public-private partnerships are not just a highly questionable deal for the taxpayers; they also have a negative impact on the economy. The investment banks and funds that are now heavily promoting P3s would do more good for the economy if they returned to what should be their primary role: financing investments to boost productivity and growth in the languishing private sector economy. Smaller Canadian contractors are squeezed out of access to infrastructure contracts while international firms take public funds sunk into P3 projects out of the country.

Public services and infrastructure are best financed and delivered by the public sector. Private industry has a key part to play in its traditional role of designing and constructing public infrastructure under contract. But expanding these deals to include private financing and operations makes them much more complicated, expensive, and risky. Canadians need more public investment to rebuild our economy – but they can't afford more expensive, unaccountable, and risky public-private partnerships.

As Greg Malone puts it: “P3s ahould be called P12s — Public-Private Partnerships to Plunder the Public Purse to Pursue Policies of Peril to People and the Planet for all Posterity.”

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