

The Public-Private-Partnership “Fetish”:
Moving Beyond the Rhetoric
A paper prepared for the
2004 Canadian Political Science Association Annual Meeting
June 2-5
Winnipeg, Manitoba
Draft Please Consult Author Before Citing

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Abstract

Public-Private-Partnerships (P3s) encompass a broad range of commercial and financial activity involving state engagement of for-profit firms to either provide or partially finance publicly prescribed services through long-term contracts. Following Marx's analysis of commodities, P3s can also be understood as a fetish – objects, the value of which is created not by their usefulness, but because of the purely imaginary social relations that they imply. In this case the transformation of instruments for meeting public obligations into some form or another of private property. It must be acknowledged that states have long employed P3 arrangements to provide instruments needed to meet their obligations. However, the scope of activities that governments are willing to consider open to P3s has grown to unprecedented levels. So eager are states to do deals and so prominent are such deals in their financial rhetoric, that P3s have can now also be consider a fetish in the second sense of the word: Something or some activity that people have an irrational desire to have or to do. Most Canadian political-economy studies of P3s have focused on this rhetoric, attempting to understand the trend by relating this fetish to the political ideological agenda of neoliberalism. While valuable, this concentration has caused an equally critical question to be neglected. This question is why investors would want to take part in P3s? The paper argues that to understand the P3 fetish we have to consider the dilemma facing pension fund managers during the late 1990s. An imbalance in supply and demand for high quality bonds and dividend paying stocks emerged due to declining public debts, management practices at large corporations, and an increasingly aging population. P3s provided a solution to this dilemma. The evaporation of this economic context and a growing public awareness of the costs of these deals likely means that P3s will lose their status as a fetish in both senses of the word.

1. Introduction

In volume 1 of Capital, Marx struggled to come to grips with the change that takes place in things when they are acted upon by human labour. Once labour is applied to the products of nature, so as to make them useful for humans, they become commodities. However, it is not the usefulness by which the values of commodities are measured but by the social relations that are imbedded in their character. Marx described the mental process of transforming our understanding of things into relations among humans -- that underlies this method of measuring the value of commodities -- as the “commodity fetish” (1977: 163-177). This is because we are required to step outside of the material world of usefulness and enter the social constructed world of human imagination in order to make these judgments as to the value of commodities.

Public Private Partnerships (P3s) can also be understood as a fetish – objects, the value of which is created not by their usefulness, but because of the purely imaginary social relations that they imply. P3s encompass a broad range of commercial and financial activity involving state engagement of for-profit firms to provide, or partially finance, publicly prescribed services through long-term contracts. Essentially P3s are instruments for meeting the obligations of the state (things that there has been a strong social consensus that the state ought to do) that are transformed so as to involve private property ownership as a key element in the operation of the instrument. As a result of this transformation P3s carry a social meaning that, although it is imaginary, gives them a different value from the usual mechanisms by which public obligations are met.

Some might question whether P3s are actually anything new. At a certain level these critics are correct. The Western liberal capitalist democratic states (henceforward

WLCD states) have substantial experience with engaging private firms to aid in the meeting of their obligations. Some of these arrangements can and should be considered to be P3s. However, the scope of activities and the critical importance of endeavors that governments are willing to consider open to P3s has grown to a level not seen since the great transportation infrastructure-building era that produced transcontinental railways and trans-oceanic canals (in the case of Canada, see Waite 1971). Given the difference in scale and scope of the state's obligations when compared to this previous golden age of P3s, the present situation is unprecedented. So eager are state actors to do deals and so prominent are such deals in their financial rhetoric, that P3s can also be said to meet the more common definition of a fetish: Things people are eager to do or objects they desire for no apparently rational reason. Linder (2000:19) perhaps more gently hits on this point when he describes "partnerships" as a "de rigueur reform."

Most studies that seek to understand the emergence of P3s as a "de rigueur reform," both in Canada and abroad, have focused on the rhetoric of state actors. These studies relate the rise of P3s to the political ideological agenda of neoliberalism. These authors either see P3s as an attempt to translate neoliberal ideology into practice or as a response by neoliberalism's opponents to the challenges that this ideology poses to the state (see for example Bradford 2003; Ruane 2002; Shaw 2002; Linder 2000). Without directly referencing neoliberalism, the P3 trend is also sometimes understood as a mechanism for coping with the financial crises many governments have created for themselves by establishing both continuously falling taxes and balanced budgets as the primary benchmarks by which the public ought to judge their performance. In this regard, one of the bluntest explanations for the emergence of the P3 fetish in any

jurisdiction comes from that most respectable of organizations, the Ontario Hospital Association:

“The Public-Private Partnership model is being adopted as an option for the primary reason of securing additional funding capacity to meet service needs, without negatively affecting the government’s balance sheet. Although upfront payments are avoided ... it merely transfers the obligation to annual operating costs” (2003: 55).

In other words, the allegation being made is that the interest shown in P3s by the previous Progressive Conservative government of Ontario was driven by a desire to make public accounts appear better than they actual were. In much the same way that Enron disguised its massive debts by describing its borrowing as long-term contracts to purchase supplies and lease equipment, so the Province of Ontario has tried to “hide debt” by entering into long-term leases with private investors for new hospitals.¹

While valuable, this concentration on the rhetoric and motivations of the state has been at the expense of research on the other fundamental part of the P3 equation, why would capitalist investors want to finance, operate or own assets that derive their value from P3s in whole or in part? The answer to this question might seem obvious -- they want to make money. However, it becomes a far more interesting question if we accept that P3s are a fetish in the sense that Marx used the word (an object that has a worth determined by the social relationships that it embodies not its usefulness). Any investor in a scheme that produces a product or service for the state that is priced according to the social relations that characterize the product or service, not its usefulness, runs a risk that the bargain might come undone if the difference between cost and value is subsequently

recognized to be significant and to the disadvantage of the public. Opponents both within the political process and civil society will often attempt to bring such recognition to the public. This risk is taken very seriously by investors in P3s and by the financial advisors that help structure such deals (Macquarie North America 2001: 63). Some investors even go as far as to claim that they will not participate in projects unless they offer the state sponsor a reasonable bargain (Lewis 2004).² However it must be recognized that what constitutes a reasonable bargain will vary depending on where one is standing.

In the case of Canada, the question becomes doubly interesting when the large role that pension funds play as investors in the P3 market is recognized. These funds tend to be ‘risk adverse’ rather than “speculative” investors. The Quebec Pension Plan (La Caisse de dépôt et placement du Québec) Canada Pension Plan, Ontario Teachers Pension Plan, Ontario Municipal Employees Retirement System, as well as the Teamsters and British Columbia construction trades pension plans are just a few of the big name funds active in the Canadian P3 market. Meanwhile, many other pension plans -- as well as pooled and mutual funds that serve the needs of individuals saving for retirement -- participate indirectly through investments in limited partnerships established to pursue P3s (Chenery 2001; Gerard 1999; Hogben 2003; Greenwood 2003; Lewis 2004; Loinc 2002; Macquarie Bank 2004).

The argument advanced in this paper is that the rise of P3s is the result of a dilemma facing the capitalist executives who control and advise the vehicles that allow Canadians to save for retirement. Although a rather crude simplification, these individuals and institutions will be referred to here as pension managers and pension funds.

As a group, the beneficiaries that pension managers serve are aging. According to investment theory this requires managers to shift a greater proportion of the assets that they manage into more secure income yielding investments, such as investment grade bonds and companies with a reliable ability to pay dividends.³ However, as will be shown below, during the late 1990s and early years of the new millennium these become harder to find. Meanwhile, what income yielding investments that did become available paid relatively low interest rates. These problems have been magnified to a certain degree by laws that prohibit pension funds from investing more than 30 per cent of assets outside of Canada.⁴ It will be argued that pension managers became involved in financing P3s as part of a solution to their dilemma. Not only did P3s give pension money a needed home, but furthermore, the additional risks supposedly undertaken justified demands for higher yields than those being offered to investors in ordinary public debts. Finally, the same low interest rates made it possible to participate in P3s and structure them so as to at least reasonably approach the usefulness that could be achieved had the project been undertaken traditionally, thereby reducing some of the political risk in these projects. Consequently, P3s solve both of the problems facing pension managers, the availability of income investments and their low yields. As long as interest rates stay low, other income yielding investments are hard to find in Canada and state actors (as well as the publics that they serve) remain relatively “ignorant” of the true costs of the deals they are doing, the P3 fetish will live on.

The next section of the paper provides a brief introduction to P3s. Section three takes a deeper look at the dilemma facing pension managers and explores the conditions under which P3s make a good investment for pension funds and those in which they do

not. This section makes the argument that the time was ripe for P3s as Canada approached the millennium. Section four forms a conclusion by looking at conditions today and by offering some speculation about the future. It is suggested that the conditions necessary for pension funds to invest in P3 are eroding.

2. A Brief Introduction to the Philosophy of P3s

In the introductory section it was stated that P3s are alternative arrangements for creating the instruments that states require to meet their obligations (things that there has been a strong social consensus that the state ought to do). These arrangements have been transformed so as to involve private property ownership. As a result P3s carry a social meaning that, although it is imaginary, gives them a different value from the usual instruments developed to meet state obligations. This section serves to unpack this statement by looking at the ways in which the mechanisms necessary for meeting the obligations of the state can be transformed so as to involve private property ownership in alternative social relationships to those usually in place. This will be accomplished by exploring how WLCD states have traditionally involved private property ownership in the meeting of their obligations and the ways in which P3s differ.

Before proceeding it is important to describe in everyday terms the sort of relationships that exist in a P3. At one end of the scale of complexity are so called Design, Fund, Build Operate (DFBO) arrangements. A private firm is engaged to deliver a service and all needed infrastructure for either a regular lease payment, or the right to collect revenue from the service, or even some alternative payment (for example the right to use land freed up as a result of redevelopment), or some combination of the above.

Most of the hospitals built using a P3 process in the UK are of this type (Canadian Council for Public-Private Partnerships 2003: 29). In the case of urban transit, which is rarely viable on a market basis, the state often pays a subsidy to offset construction and/or operating costs (Macquarie North America 2001: 33-43). These contracts tend to be too big and complex for any one firm to undertake so consortiums form to bid on them, creating special purpose corporations that will carry out the project if their bid is selected. Given the scale of such undertakings, DFBOs also tend to involve very long-term contracts, usually the useful life of the facilities involved. The competing consortia offer rival plans on how they would help the state fulfill its obligations, rather than simply tender to build something pre-designed by the state (Calder 2004; Macquarie North America 2001:4-5). Pension funds sometimes finance these special purpose corporations by taking a share of their ownership or by lending them money through a bond issue.

At the other end of the scale of P3s are quasi-governmental organizations that have been freed by the state to issue their own bonds and credit notes. These become P3s when the terms of the bonds and how revenue from them can be used are so detailed as to make the bondholders virtual co-owners of the organization.⁵ In between these two extremes are a wide variety of other possible arrangements. So why are these arrangements so different from the traditional means by which the state has engaged private property owners to help it meet its obligations?

Hood (1983) argues that states have four sets of tools for collecting resources and for deploying these resources to achieve their goals. In ascending order of cost and effort required to employ them, these four categories of tools are: nodality, authority, treasure and organization. States both collect information and disseminate it to society relatively

effortlessly because they sit at the intersection of a variety of networks. By deciding what information to collect and what to pass on, the state can fundamentally change how we think about society as a people and what we choose to do. The state also grants tokens of authority to different actors and organizations, empowering them to collect resources for it and to act on its behalf. States use their treasure both to buy goods and services and to create financial inducements that encourage both individuals and organizations to act in ways that will further public objectives. Finally the state is an organization with personnel, infrastructure and property at its disposal that can be employed to collect necessary resources, or to undertake tasks.

Private property ownership (the right to determine the disposition of both productive property and the surplus value that it creates) has primarily been involved in the work of the WLCD state in connection with the use of the tools of authority and treasure. It is worth beginning with the state's use of treasure as this might be the most familiar of the two tools. The state, like any other organization, needs to procure resources that others are better able to produce so it uses its treasure to enter into contracts for their provision. Similarly, there are some tasks that the state needs fulfilled so it can meet its obligations to society that others are better able to do so it contracts the work out. In some cases the state also offers inducements so that private property owners will dispose of their property in a manner that advances public goals that the state cannot achieve alone or prefers not to undertake. Canada's income tax laws represent a catalogue of such inducements. In each of these three cases the state has essentially created property. Whether it is granting a contract that gives the holder the right to sell resources to the state, to carry out work on the state's behalf, or benefit from some

inducement, these rights can be bought, sold and otherwise assigned (unless such transfer is explicitly excluded in terms of the contract or laws).

Tokens of authority are a little more complex. If we go back in time we can find many instances of states granting ownership rights in terms of tokens of authority used to raise resources for the state. A good example of such an arrangement was the practice of “tax farming” that was common in pre-revolutionary Europe (Kiser and Kane 2001). In the post-second world war era, however, the most obvious example of this creation of property through the granting of authority to raise resources for the state is the role that “primary dealers” play in the auctioning -- and subsequent reselling -- of government bonds in many major countries (Breuer 1999; Bank of Canada 1998; Dupont and Sack 1999).⁶ States have also created private-property rights in the tokens of authority used to carry out their work. For example, in many provinces of Canada the countless variety of licenses and certificates needed as part of everyday life can be obtained at franchised “license bureaus.” These bureaus are operated by private entrepreneurs who have purchased or rented tokens of authority from the state.

These above examples, showing how the WLCD states have involved private-property ownership in the arrangements that are made to carry out their obligations, lack some or all of the defining characteristics of P3s. To understand why this is the case, we must first carefully consider what the word partnership means. While it can be used in a loose sense to mean any two entities that have a relationship, in its more literal sense, it means a relationship based on common goals, in which both entities share benefits and contribute resources over the long-term for both mutual advantage and out of a sense of commitment. This is the sense in which supporters of P3s use the word to describe these

arrangements. Those who are opponents or more ambivalent about P3s use this sense of the word to describe how P3s would operate if they did in fact represent undertakings of benefit to the public (Roseneau 2000: 219). In a P3 the common goal is a publicly agreed outcome (e.g. improvements to infrastructure or the building of a new health centre) and the degree to which each partner is obliged to contribute and receive rewards is based in the size, severity and types of risks each partner agrees to assume so as to make the project work (Taylor et al 2001: 40). In other words, risk (at least in theory) is the measuring stick by which the social relationships embodying P3s are valued, rather than the usefulness of the instruments that are being created to meet the state's obligations to society.

A further element of partnerships is trust (Taylor et al. 2001: 41). A central element of trust is a belief that your partners will not try to undermine you. This is why P3 contracts often contain language that grants the arrangement that the private partners are investing in what amounts to either a functional or spatial monopoly (Engineering News Record 2002).⁷ In a sense, such monopoly grants are understandable. If the service or infrastructure could be provided profitably on a competitive basis, there would be little need for such comprehensive public involvement in its provision.

With this in mind, it is clear as to why tendering and contracting-out exercises do not constitute P3s as the relationship is generally not meant to be long-term but rather, is subject to frequent re-bidding. Further, in such exercises the private party plays little role in defining the project but rather agrees to undertake work assigned by the state for a fee. Similarly, the granting of property rights via the issuances of tokens of authority, discussed above, also do not qualify as P3s. This is because those issued such tokens

generally must compete against other token holders so as to generate a profit from their investment in the token and/or because the token holders generally do not help define the projects that they are participating in.

It is the private partner's willingness to accept risk by staking capital to acquire an ownership share in the project that is said to justify the additional rewards that the private partner gains when a project for meeting public obligations is transformed into a P3, not the usefulness of the project. However, useful value cannot be ignored either. As noted above, if the costs of the project and its useful value to the state are too out of proportion, the project will probably be repudiated and fail. This political risk is just one of the many different types of risks that the public can share with the private partner(s) in a project. According to Akkawi (2001), adequately quantifying these risks and then developing a P3 model that transfers those risks that the public partner does not wish to bear to the private partner at a reasonable price is at the heart of any good P3 contract. In his article, he specifically describes the following risks:

Project Risk

The capital costs of the project might turn out to be greater than estimated or the project might take longer to create than anticipated.

Operating Risk

The operating costs of the project might turn out to be greater than estimated.

Technical Risk

The project might not work as well as expected or might suffer some sort of failure, either of which would impose the need for spending on other projects.

Financing Risk

The costs of acquiring the money needed to create and/or operate the project might be higher than estimated.

Regulatory Risk

Changes in regulations that necessitate future modifications, such as new safety standards, might impose costs on the project over its lifetime.

Public Policy Risk

Changes in public policy might reduce the need for the project. Imagine building a highway to relieve congestion, then subsequently raising gasoline taxes to encourage transit use.

Political/Legal Risk

The government may determine that the project is not in the public interest and either force modification or cancel it. Alternatively, legal objections brought either by public, market or civil actors, might handicap the project.

Force Majeure

The project might be damaged or destroyed by events beyond human control. Although Akkawi does not mention this, we should also include the risks arising from acts of war in this category.

To this list can also be added “demand risk” the anticipated customers or users for the project might never emerge, either for reasons beyond the control of any of the partners or the malfeasance of some or all of them. This is especially important as the P3 model is often seen as especially useful when the project can be expected to pay all or some of its way by generating its own revenue, such as with a toll-highway or transit line. However, demand is also one of the most difficult risks to allocate (Taylor et al. 2001: 83), or even assess.

Consider the following: The Greater Vancouver Transit Authority (GVTA) recently considered building a new transit line to Vancouver International Airport and the adjoining suburb of Richmond using a DBFO P3 model. The private operator would partially finance and completely own and operate the line. Ridership would clearly be the key to determining if the project would have the funds needed to pay back the private capital costs and allow an operating profit. However, ridership also depends on actions undertaken both by the state and private partners. For example if the trains fail to run on time (the private partner’s obligation) ridership might decline. However, if the busses

connecting to the line fail to run on time (the GVTA's obligation) ridership might also fall. These sorts of failings might seem easy enough to avoid if service standards for both the trains and busses are specified in the contract. However, what if the problem is subtler, such as ridership declining due to a lack of cleanliness? The same project also provides a good example of the difficulty presented in simply attempting to assess raw demand, even if the project works relatively flawlessly. The ridership forecasts prepared for this proposed project had a margin of error of plus or minus 15 percent for normal commuter traffic and plus or minus 20 percent for airport users (Jacobsen 2003: 11).

The methodologies employed in the calculation of risks and the monetary value associated with any transfer of risk are always complex, subjective, and often less than transparent (they might even be proprietary secrets). Given the weakness of the methods used to assess and value risk, there is a fair probability that super-profits will occur (Macquarie North America 2001: 44-45). If super-profits emerge, political opponents will allege that sharp dealing or improprieties occurred. This could indeed be the case, but such critics generally miss an even deeper problem with the use of risk-transfers. This basic flaw is that when monetarized, the risks outlined above form an equation that tends to self-balance over the long-run. In other words, a state can transfer a specific risk, associated with a specific project, to a specific partner or set of partners. From the point of view of these partners, these are genuine risks and they, therefore, demand a reward for assuming them. However, the state will have to assume an equivalently valued risk of a different sort, either in the specific contract in question or in some future one. Even though the state is paying a risk premium to private investors in each contract, in the long-run it will end up holding risks of exactly the same monetary value as it began

with, but will be out of pocket for the transaction costs and the premiums. The only way this equation will not self-balance is if one assumes the state can line up an infinite string of suckers to act as counter parties.

In that the monetarized value of risks ought to form a self-balancing equation, no real savings is possible to the state over the long run via risk transfer. In other words, it adds no usefulness to the mechanisms developed to meet state obligations. As a result, the act of risk taking via allocating direct private ownership in specific projects – the social relationship that marks out the P3 from other mechanisms employed for meeting state obligations -- is as fully and subjectively constructed as any of the other social relationships that embody the character of commodities. The act of restructuring mechanisms for the meeting of state obligations to society so as to involve private ownership cannot alter the useful value of such mechanisms.

Having said that, perhaps one comment in favour of the risk transfers that are supposedly at the heart of P3s is in order. While this model cannot change the usefulness of the infrastructure and services created to fulfill state obligations, the model might be able to prevent poorly conceived infrastructure and services from being created if employed properly. In that the proper development of a contract requires the state to explicitly calculate and monetarize the various risks, in order to trade them with private partners, it is possible that the P3 model can help avoid the creation of “white elephants” and “black holes”. Consider whether the now nearly abandoned Mirabel airport outside of Montreal would have built if required to undergo the sort of analysis needed to employ the P3 model? Meanwhile, in May 2004 the GVTA killed the Airport rapid transit project after analyzing the penultimate bids of the two finalists contending for the

contract. Both these bids were so far over budget as to leave previously undecided councilors convinced that the project was hopeless (Skelton 2004). Would the consortia have been so cautious in estimating the financials if they were simply bidding to build the system, rather than committing to successfully operate it as well for several decades to come?

It is this (hopefully) careful specificity of risks that also gives the P3 value from the standpoint of investors. There are two ways to manage risk as an investor. One way is to invest in an endeavor with as wide a breadth as possible, such as an index comprising Canadian federal, provincial, municipal and investment quality corporate bonds of different maturities. Each aspect of the Canadian economy presents risks that will emerge and recede at different times. In aggregate they are too numerous to accurately assess. However, barring catastrophe (so called systemic risk) they also ought to cross-cancel to a considerable extent over the life of the investment, leaving a solid rate of return. The other way to manage risk is to invest in as narrowly focused an endeavor as one can find so as to be able to assess all the risks involved as accurately as is possible. P3s present just such an opportunity for pension managers to attempt to assess and understand the risks that they are assuming. This opportunity is further enhanced by the practice of creating special purpose companies for the specific task of partnering with the public sector for each project. These companies, limited by the terms of their incorporation to one specific project, are more likely to consistently pay out the dividends and/or interest payments that investors anticipate. This is because the managers of such corporations are prohibited from gambling away these funds on efforts to grow their firms. Such investments are often called “income yielding”. It is to the

question of why pension fund managers are so interested in income yielding investments that we must now turn.

Section 3. The Hunt for Income and the Emergence of P3s

That Canada's workforce is aging is no secret. Over the 1990s the workforce in large portions of the economy has edged closer to retirement age. While the consequences of this for labour force planning are commonly recognized. What has been less apparent to the public is the implications that this has for pension funds and the choices facing the managers of these funds. These implications become even more serious when it is recognized that the sectors of the economy likely to be most severely and earliest hit by the baby-boomers' retirement wave -- for example, health, education, and managerial ranks throughout the private sector -- are also those where employees have the highest participation rates in both employer sponsored and personal pension plans (MacKenzie and Dryburgh 2003: 7-8; Maser and Dufour 2002: 40).

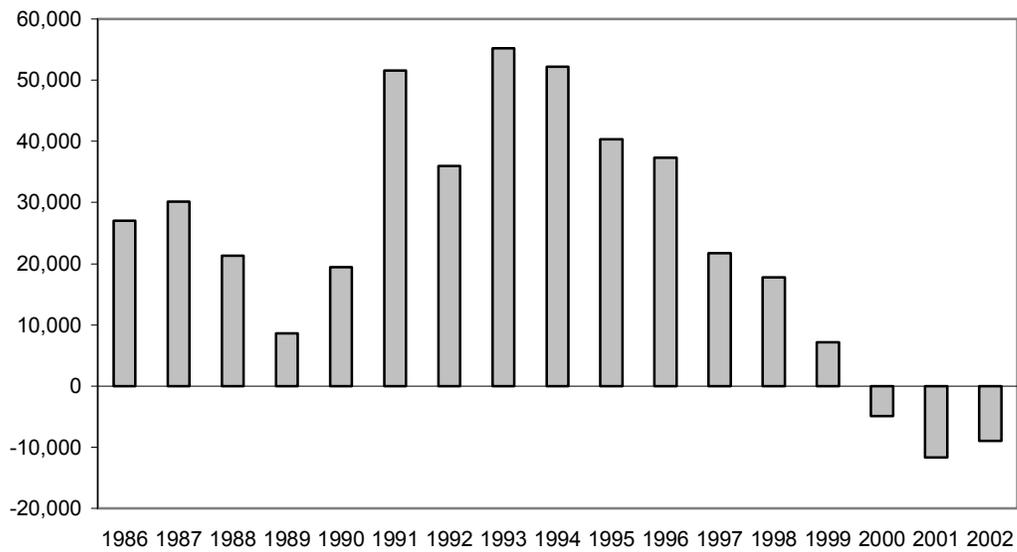
In order to understand the implications of this for pension fund managers, we have to consider the two general ways in which investors earn returns. These are capital gains and income. When an investor buys a security (be it a stock or a bond) and sells it for more than they paid for it, the difference in price is called a capital gain. When the investor receives interest on their investment or a dividend it is called income. While it is difficult to predict when a stock or bond might rise (or fall) in value, income payments are generally more predictable as the terms of a bond set a payment schedule. Though changeable, dividends are almost as reliable. Markets interpret changing dividend levels as conveying either good or bad news about the health of the company (Grullon et al.

2002: 388). Therefore, managers tend to set dividends that their firms can sustain in spite of most contingencies.⁸ Credit quality comes into play with income investments as market actors will generally demand higher rewards for holding the securities of organizations that they perceive to be less likely to honour their payment schedules. Consequently, investors who are likely to need their money soon -- and on a predictable schedule -- are generally advised to balance their portfolio in favour of income yielding investments issued by organizations with better credit quality. Those investors who do not need their money for a long time are advised to balance their portfolio in favour of investments that will produce capital gains and to not shy away from bonds or stocks issued by organizations with lower credit quality. Although the timing of rewards might be unpredictable, over the long-term, doing these two things is said to produce greater returns as a result of the risk premium markets demand that issuers pay to the holders of such assets (Ross et al. 1999: 369-392).

Given the workforce changes noted above, among other reasons, it should not come as any surprise that some observers believe we are at the start of an era that will see a widespread rebalancing of the portfolios held by employer sponsored pension funds away from investments that predominantly produce capital gains towards those that predominantly produce income. So far the scale of rebalancing has not been substantial (McInerney 2004: 6). However, even a slight shift in the targeted asset allocations by pension managers can have big implications for markets. For example, Canada's employer sponsored pension plans held assets valued at \$817.6 Billion in the year 2000 (Anderson 2003: 67). Therefore, if one were to use 2000 figures, demand for income yielding investments would grow by approximately \$8.18 Billion for every 1 percent

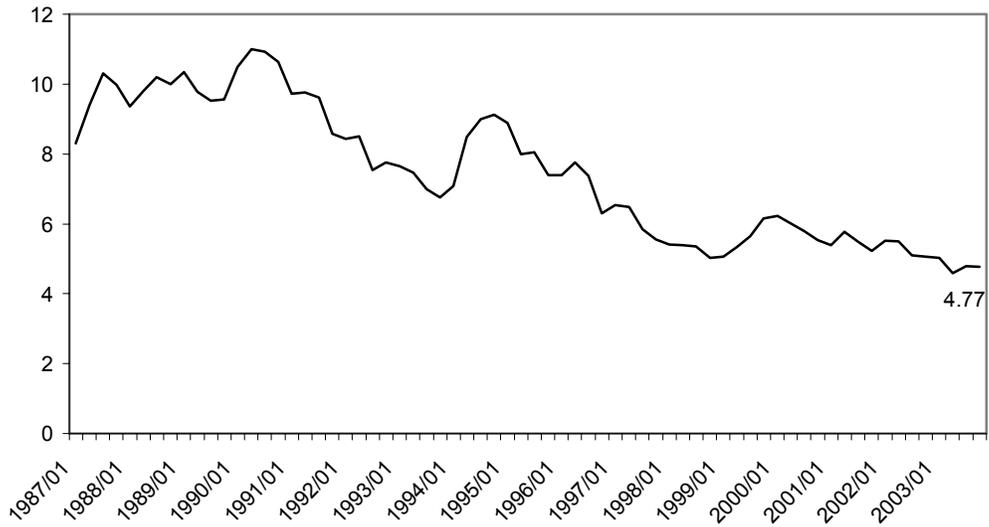
shift in overall asset allocation among these plans. The problem is that supply of investment grade income yielding investments has been drying up. Starting in 2000 Canadian governments became net redeemers of bonds, not issuers, as deficits were eliminated and total public debts were paid down. Meanwhile the yield on these bonds dropped substantially (see figures 1 and 2 below).

Figure 1 Net New Bond Issues All Levels of Government (\$ Millions)



(Source: Statistics Canada Cansim Data Base)

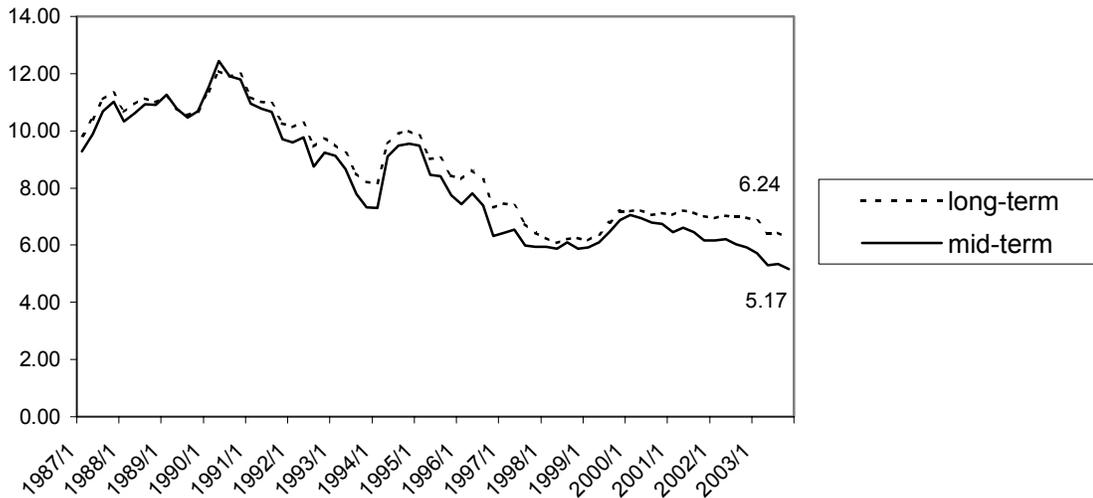
**Figure 2 Percent Yield 10 Year Government of Canada Benchmark Bond
(Quarterly Average 1987-2003)**



(Source: Statistics Canada Cansim Data Base and Bank of Canada)

Corporations, facing less competition for investors have been able to issue bonds on easier terms. Similarly, dividend income was becoming harder to come by as well. Corporations, for a variety of reasons chose to reward shareholders primarily through capital gains rather than dividends (See figures 3 and 4).

**Figure 3 Percent Yield Corporate Bonds Scotia Capital Inc.
Average Weight All Corporations (Quarterly Averages 1987-2003)**



(Source: Statistics Canada Cansim Data Base and Bank of Canada)

**Figure 4 Dividends Percent Yield Toronto Stock Exchange 300
(Monthly Average Calculation)**



(Source: Statistics Canada Cansim Data Base)

Making the whole situation worse was the disappearance of Canadian companies to invest in. In the late 1990s many foreign (predominantly US) firms took advantage of a weak Canadian dollar to buy out rivals, or used the opportunity to buy-out shareholders in their Canadian subsidiaries. Either way, the net result was the same, fewer investment

grade Canadian companies. Limited to first 20 then 25 and finally 30 percent foreign content, pension managers found themselves picking from a constantly shrinking pool of smaller and riskier firms (Janigan 2000).

As a result, pension managers looking for income yielding investments, had to accept relatively low returns and be willing to invest in organizations and issues with lower credit quality in order to get it. As with power, markets abhor a vacuum. With so many investors looking for income yielding investments and being presented with so few and such poorly rewarding options, it was only natural for financial entrepreneurs to create new investment vehicles to meet their needs. The president of the Ontario Municipal Employees Retirement System (quoted by Drury 2002) explained his pension fund's interest in P3 infrastructure deals this way: "We need to pay pensions, retaining a portfolio of both traditional bond and equity returns as we do so. We use to finance such investments [as public infrastructure] with government bonds. But as the government no longer issues them we've learned to adapt."

The very same trends that made the last years of the 1990s and early years of this millennium a difficult time for pension managers searching for new income yielding investments also made it an ideal time for the P3s. While riskier than traditional public bonds, they appeared less risky than income yielding investments tied to the performance of corporations. This is because, as noted above, for the most part P3s are granted either a functional or spatial monopoly. Second, the low and declining interest rates of the era, combined with narrowing spreads between risk free public and more risky corporate bonds, made it possible for the investors seeking to develop P3s to competitively finance

the creation, redevelopment and/or management of infrastructure and services for states. Finally this same interest rate trend also made P3s far more attractive investments.

It is generally accepted that any for-profit organization seeking to replace the public sector as a provider of infrastructure or services faces two major barriers in delivering a product offering comparable usefulness at the same cost (use value) to the state. The first barrier is the need to make a profit on the transaction. The second barrier is the higher cost of capital that private organizations face in comparison to state organizations. As a result, the for-profit organization must develop strategies and techniques to perform the tasks involved in the contract with a far greater level of cost-effectiveness. This represents a significant challenge (Keenan 1999).

In fact, it is this author's contention that the whole fiction of public savings due to "risk-transfer" (which as noted above is theoretically impossible for the state to benefit from over the long-term) has been latched onto by the P3 industry in order to justify the inevitably higher costs associated with the model when operating on an "all other things being equal basis."⁹ Nevertheless, even getting costs down to the point where a slightly higher price can be justified by a claim that it is an appropriate reward given the "risk-transfer" involved is no small feat. What might escape notice, however, is that the scale of the challenge is not static.

Imagine that a province wishes to employ the DBFO P3 strategy to create a new hospital. According to the terms of this hypothetical tender, private partner will be expected to provide a building and all the non-medical support services. In fact provinces are at various stages of acquiring hospitals on this sort of basis in Alberta, British Columbia, Ontario and Quebec (Calder 2004). To simplify matters, let's assume

that the companies with specialties in each area covered by the tender come together to create a special purpose corporation to make a bid. Let's also assume that the only funding that this corporation needs has been provided through a bond issue that is sold in its entirety to a pension fund (which they might later resell part or all of to other investors). Above and beyond the cost of providing the hospital and services the consortium will have to work the need to repay the bond-holders and to make a profit into their bid. In order to offer the public sector reasonable use value they will have to find a way to reduce operating costs by something close to the total of these two factors. Now let's look at how the scale of their task changes depending on the economic conditions.

We can construct a relatively simple model that shows the cost savings that the operators of our fictional special purpose corporation have to approximate by looking at the spread between the yields on public and private bonds of similar duration, and the profit margin investors would demand. In that the example being employed here is a hospital, the yield on the Scotia Capital long-term provincial bond index will be used as an indicator of the cost of capital to the state.¹⁰ The yield on the Scotia Capital long-term corporate bond index will provide our indicator of the cost of private capital.¹¹ At a recent chamber of commerce forum held to discuss the construction of a highway tunnel under Vancouver's harbour, a leading expert on P3s stated that investors generally want to see a 15 percent return on investment (quoted in Barraclough 2002). While recognizing that this comment was specific to "dumb" infrastructure such as a tunnel and that a different rate might be appropriate for a staffed facility such as a hospital, this once again seems a reasonable number for illustrative purposes. As noted, this model is hypothetical, however, it does reflect real trends in interest rates and business

requirements. Although different numbers might be used they ought to produce a reasonably similar trend line.

Two factors generally impact on the cost of money provided through bond markets to corporations, the interest rate being paid on relatively risk free government bonds and the difference in credit quality between government and corporate borrowers that investors are willing to tolerate without demanding an increased risk premium. Therefore, in an era when provincial balance sheets are sound and businesses are facing a time of crisis the spread will grow. When business conditions are sound and government balance sheets are weighed down the gap will shrink. Finally the lower the absolute cost of corporate borrowing, the lower will be the burden of the 15 percent return as this is not static but grows and falls proportionately with the interest rate it is levied on. If money costs you 1 percent you in turn must earn 1.15 percent on it to earn a 15 percent profit. However, if money costs you 2 percent, you in turn must earn 1.30 percent on it to earn a 15 percent profit.

As can be seen in Table 1, the late 1990s were something of a golden age for those wanting to finance a P3. The gap between corporate and provincial credit costs was low, meanwhile declining interest rates added the further bonus of lessening the weight of the 15 percent return investors sought on their investments.

Table 1 Cost of Public vs. Private Money

| Year | % Yield Scotia Capital Long-Term Prov. Index Annual Average | % Yield Scotia Capital Long-Term Corp. Index Annual Average | Plus 15% | Total % Spread (Cost over Prov. Funding) |
|------|---|---|----------|--|
| 1982 | 15.58 | 15.97 | 18.37 | 2.79 |
| 1983 | 12.62 | 12.73 | 14.64 | 2.02 |
| 1984 | 13.36 | 13.50 | 15.53 | 2.17 |
| 1985 | 11.69 | 11.79 | 13.56 | 1.87 |
| 1986 | 10.31 | 10.37 | 11.93 | 1.62 |
| 1987 | 10.61 | 10.70 | 12.31 | 1.70 |
| 1988 | 10.86 | 10.94 | 12.58 | 1.72 |
| 1989 | 10.49 | 10.80 | 12.42 | 1.93 |
| 1990 | 11.53 | 11.85 | 13.63 | 2.10 |
| 1991 | 10.60 | 10.85 | 12.48 | 1.88 |
| 1992 | 9.48 | 9.90 | 11.39 | 1.91 |
| 1993 | 8.56 | 8.87 | 10.20 | 1.64 |
| 1994 | 9.23 | 9.41 | 10.82 | 1.59 |
| 1995 | 8.92 | 9.08 | 10.44 | 1.52 |
| 1996 | 8.00 | 8.15 | 9.37 | 1.37 |
| 1997 | 6.81 | 6.99 | 8.04 | 1.23 |
| 1998 | 5.91 | 6.20 | 7.13 | 1.22 |
| 1999 | 6.18 | 6.64 | 7.64 | 1.46 |
| 2000 | 6.51 | 7.15 | 8.22 | 1.71 |
| 2001 | 6.36 | 7.10 | 8.17 | 1.81 |
| 2002 | 6.14 | 6.99 | 8.04 | 1.90 |
| 2003 | 5.71 | 6.50 | 7.48 | 1.77 |

(Source: Statistics Canada Cansim Data Base and Bank of Canada)

This situation has partially reversed since 2000 as provincial indebtedness declines and investor concern over Canadian corporate credit-worthiness – whether justified or not – mount (Angastiniotis et al. 2004: 10-12; Vazza et al. 2002: 5). In other words, even though rates have remained relatively low, the cost of private relative to public capital has increased. To put this in perspective, imagine that our hypothetical consortium established a special purpose corporation to bid on a DBFO P3 hospital project in 1999. Now imagine that this project went reasonably well so the province tendered for an identical second hospital in 2002. In order to deliver reasonable value to the state, based on the figures in Table 1., the consortium would have to attempt to

squeeze an additional 30 percent in annual savings out of the special purpose company created to deliver the second project. Still even accepting some widening of the gap has occurred, as long as absolute interest rates remain relatively low, the second part of the equation, the multiplicative weight of the need to return 15 percent on investment is kept in check.

The absolute level of interest rates themselves provides a further explanation for the enthusiasm pension managers have shown P3s in the last few years. With no inflation in sight, the higher than normal bond yields (justified by the “risk-transfer” involved) or the almost-guaranteed dividends involved in providing monopoly services offered by P3s, protected investors against any further decline in interest rates. However, by the same token, a rising interest rate trend would make such locked in returns less attractive, and in the case of dividend yielding shares in P3s require the managers to squeeze out further cost-efficiencies to raise the dividend to match rising interest rates.

In sum, P3s offered pension funds and states an apparent win-win. For a little more cost, the state could stretch out payments and keep up the veneer of its claim to be providing the public with falling deficits and lower taxes. Meanwhile, assuming modest cost savings could be found by the special purpose corporations assembled to deliver P3s, the pension funds could earn a bit better return than a traditional government bond and possibly dividends if they took an equity stake in projects as well. Finally, as long as the cost difference was within reason, this could be sold to the public as a reasonable bargain given the risk transfers involved. As long as interest rates remain low and offerings of income yielding investments remain sparse, pension fund managers have every reason to continue to participate in P3s on these terms.

Section 4. Is Interest in P3s in Decline: A Conclusion or an Epilogue?

At the end of the 1990s pension fund managers needed a new form of income yielding investment and the economic conditions were such that they could offer to fund P3s on attractive terms. The cost of private capital relative to public capital and the overall low level of interest rates meant that they could participate in consortiums created to deliver infrastructure at prices close to the cost that would prevail if public capital had been used. Whatever extra cost was involved could be ascribed to the risks transferred to the private partners in the project. However, there is a good possibility that this golden era of Canadian P3s is now over. A number of prominent deals have had to be taken off the table when it has proven difficult for the consortiums bidding on projects to approach the cost of carrying out these projects within estimated budgets or with a cost reasonably similar to that of traditional public procurement. In some cases bidders are actually walking away. This has occurred in spite of prominent political support for such deals by neoliberal governments.

A look at the major attempts to use the P3 process in British Columbia helps demonstrate this. In 2001 the BC Liberal's came to power with Gordon Campbell as Premier. The government implemented a stereotypical neoliberal program similar to that adopted previously in provinces such as Ontario and Alberta. The government soon began to express "zealous enthusiasm" in using the P3 model wherever feasible for the provision of infrastructure and services (Tafler 2002: 16). Nevertheless, two of the government's most prominently proposed DBFO tenders have already collapsed. After entering negotiations with a finalist to build an extension to Vancouver's convention centre for the 2010 Olympics, the government admitted the P3 model would be too costly

and adopted a traditional public sector approach (Constantineau 2003). Meanwhile, as noted previously, the GVTA's proposed Airport rapid transit project was killed when neither of the two finalists in the bidding process seemed likely to be able to complete the project on budget (Skelton 2004). A third prominent DBFO project is also in trouble. This is the attempt to use the P3 model to procure a new hospital for the Vancouver suburb of Abbotsford. At present tendering is still on going, but one of the two finalists withdrew from the competition (Leslie 2004) which ought to say something about the project's feasibility. As well as these DBFO failures, some mention must also be made of the government's attempt to use a P3 model to lease the province's only toll highway to a private operator. When it became known that the project would only be viable if tolls were increased by 30 percent, political pressure killed the idea (McInnes 2003). Projects that have gone ahead have tended to be those that involve privatization masquerading as P3s, such as the sale of BC Rail and those that do little more than replace direct public borrowing with borrowing by quasi-governmental agencies, such as freeing universities to issue their own debt instruments to fund ancillary service and non-educational infrastructure (for example new student residences and parking garages).

It is indeed possible that the above noted projects all failed because they were ill conceived, as most had credible critics before they began (see for example Project Finance 2003). However, most large public investments have critics. In order to explain such a string of failures we need to look for other reasons. Therefore, it seems even more likely that the hypothetical example presented in the previous section is reflective of a serious real-world problem facing those who wish to bid on P3 projects today. Given the economic conditions in place it is harder than it used to be to structure a P3 that provides

the return investors are seeking and the useful value that the state is looking for. Pension managers looking for investment grade income vehicles are not going to fund projects if they do not offer a reasonable use value to the state. This is because projects that are seen as wasteful or unfair by tax payers will only lead to the sort of instability they are seeking to avoid by engaging in P3 deals (Lewis 2004).

Therefore, the question becomes how likely is it that the current hostile climate for P3s will endure? Three factors in particular are worth noting. First the American government is running up massive deficits. This will eventually impact on interest rates in Canada in that US Treasury Bonds serve as a sort of global benchmark (Economist 2003). Meanwhile, in that rising interest rates are meant to slow the economy, the risk premium on corporate debt over government issues will also go up, though P3s might be somewhat protected from this due to the fact that they deliver essential services (Athanasakos and Carayannopoulos 2001).

Second, the P3 is not the only alternative financial product that has been invented to meet the needs of investors seeking greater opportunities to earn income. For example, at \$85 Billion the market for income trusts is five times larger than that for P3s (Calder 2004; Scofield and Church 2004: B6). In an income trust arrangement a company separates its operations from its finances. The financial arm, or trust, operates like a mutual fund. It takes in investors' money and loans it to the operations arm. The loan is then repaid out of its earnings and these are distributed to investors in the trust. In that this transforms profits into a cost of doing business, it also eliminates most corporate taxes owed by the firm. Taxes are then paid only by the investor receiving the distributed income from the trust. In that many investors (such as pension funds) are tax-

exempt this bit of financial engineering increases returns substantially. The problem is that in order to qualify for this tax break, the trust has to be an “unlimited” company, meaning investors are 100 percent responsible for any losses, not just to the limit of their investment. Second, Ottawa has tried to discourage pension funds from being involved in this market. Due to pressure from pension managers, both barriers are being swept away as this paper is being written (Hayward 2002; Scoffield and Church 2004). This will open wide swathes of the Canadian economy to pension funds seeking income investments, creating further competition for the cash needed to fund P3s and further raising their cost.

The final factor to consider is “newness.” Earlier P3s were in part easier to arrange on favourable terms due to public ignorance as to the issues and costs involved and an underestimation on the part of private managers as to the difficulties involved in partnering with the public. In Ontario the 407 Toll Highway and the Toronto Hospital (now University Health Network), both previously seen as successes (Fell 2002), have since fallen into difficulty (Standard & Poor’s 2004a and 2004b). Meanwhile the most ambitious P3 ever contemplated in Canada, the breaking up of Ontario Hydro has been a nightmare for the public, government and investors alike (see for example Vieira and Benzie 2003). Opposition parties, non-partisan watchdogs such as auditors, and civil society groups learned from these mistakes and are asking not only tough questions but the correct ones. This is making it all the more difficult to develop public support for P3s unless both the state and its private partners agree to greater levels of public disclosure, something that private organizations might not feel comfortable with (Poschmann 2003: 2).¹²

As a result, it is hard to see the sort of environment that helped create the golden age of Canadian P3s returning any time soon. It cannot be doubted that P3s are here to stay. However, given the previously noted change in economic environment, the increasing availability of other income investment vehicles and the increasing public awareness of the benefits and potential costs of this model, it is likely that this is an epilogue for P3s as a fetish. This is the case whether one uses the term in the sense of an irrational characterization of value, or as a de rigueur reform.

Section 5. Literature

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¹ It should be emphasized that the discussion here only touches on the literature that seeks to explain how P3s became a "fetish" or "de rigueur reform". There is another literature that seeks to explain P3s as a neutral financial technology that serves specific public sector needs and ought to be employed when and where appropriate. The final report of the British Institute for Public Policy Research's "Commission on Public Private Partnerships," is one of the better of these studies. However, even the IPPR report admits that, in the past, the Blair led Labour government has sometimes appeared to be using P3s as a means to massage its balance sheet (Taylor et al. 2001: 80).

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- ² When a government becomes displeased with a P3, there are many things it can do to force its private partner to re-negotiate, even if the partner comes under the protection of treaties such as NAFTA. For example, the simple existence of such displeasure creates risk for investors. Therefore, if the financial markets become aware of it, the securities issued to finance the project will be discounted, causing at least temporary losses to their holders. If the government goes out of its way to demonstrate its displeasure, such as by publicly threatening legal action, the losses will be worse. Just such a threat by Ontario against the owners of the 407 highway led Standard & Poor's (2004a) to place the firm on "credit watch with negative implications".
- ³ The credit quality of organizations issuing debt and the individual debt issues themselves are generally divided into two categories, "investment grade" and "non-investment grade". As the names imply, the former ought to be suitable as long-term investments and present little risk of default. The latter category does not. Many pension funds either tightly limit their exposure to non-investment grade debt or refuse to hold it altogether. Different ratings agencies have different ratings schemes for differentiating credit quality. Standard & Poor's (2002) issues credit ratings for long term debt on a scale from AAA to C. A credit rating below BBB is non-investment grade + or – symbols after the ranking indicate comparison to other issuers and issues within the given rank. A D rating means the organization is in default.
- ⁴ In the late 1990s, pension managers lobbied the federal government intensively to have the figure raised from 20 percent (Carrick 1997).
- ⁵ For example, when Toronto Hospital issued \$280 Million in bonds in 1998 the offering memorandum tied use of the money to a specific renovation project and gave bondholders the right of approval over any changes in the structure of the hospital, mergers or major asset disposals outside of this project (Toronto Hospital 1998: 28-29). In that the hospital is Ontario's largest health facility, this amounts to a defacto right of veto over any future restructuring and health reform efforts in the greater Toronto area until the bonds are paid off.
- ⁶ In Canada only primary dealers may bid directly for federal government bonds at auctions. Primary dealers are firms appointed by the Bank of Canada based on their demonstrated ability to effectively take part in these auctions and to make a secondary market in the bonds. In the United States the auctions are open, however, firms designated as primary dealers make the lions share of the bids and dominate trading in the secondary market (Bank of Canada 1998; Dupont and Sack 1999).
- ⁷ An example of this was the aborted attempt to convert Toronto's Pearson airport into a P3 in 1993. The contract, if allowed to stand, would have obliged the

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- Canadian government to compensate the private partners if the government allowed any further development at airports within 75 KM that drew passengers away from Pearson (Weston 1993).
- ⁸ Sometimes a firm will find itself with unanticipated cash on hand and use it to make an unanticipated dividend payment to shareholders. However, the management of such a firm also generally reminds shareholders that this is unusual and might not even call it a dividend at all, but rather, a “special distribution.” In the Spring of 2004 financial speculation turned to whether Microsoft might be preparing to make such a payout (Savitz 2004).
- ⁹ By an “all other things being equal basis” is meant that the infrastructure or service involved is of the same quality as the purely public infrastructure or services it replaces. Otherwise, the P3 is just a veil for cutbacks. Similarly, if the savings are delivered by cutting the wages and benefits of workers, rather than say investments in technology that improve the productivity of said workers, then the P3 is once again just collecting a fee for doing the government’s dirty work, rather than delivering use value to the state and public.
- ¹⁰ The yield spread between federal and corporate bonds would be commensurately wider, making the task facing our hypothetical consortium that much tougher.
- ¹¹ This index was designed to serve as a benchmark for the Canadian investment grade corporate bond market.
- ¹² To illustrate the point made here. The report from Macquarie North America (2001) cited extensively in this paper amounts to little more than a summary of the literature on P3s, some relatively general advice (such as ways risk was managed in other contracts), examples of best practices and the recommendation that the P3 format might be suitable for the proposed Vancouver Airport rapid transit line. Nevertheless it was stamped “Confidential”.