mcmillan vantage
policy group

World Exchange Plaza, Suite 2000, 45 O'Connor Street
Ottawa, ON Canada K1P 1A4 / 1 888 603 7720

Canada's Infrastructure Bank: An Opportunity to Step Up and Rebuild Canada's Post-Pandemic Economy

Tim Murphy and Drew Fagan

Infrastructure projects are a prominent part of the 'stimulus' toolbox governments use in times of economic stress. This time will be no different. The reasons are obvious.

Construction represents seven per cent of Canada's economy; money in construction workers' pockets quickly cycles back into the economy to create consumer demand. Public infrastructure is also an investment in the future, building assets that enhance public services and enable private sector growth over the long term.

Canada's Minister of Infrastructure Catherine McKenna has identified the acceleration of infrastructure projects as a key goal of her Department. At the same time, she has changed the leadership at the Canada Infrastructure Bank (CIB), creating the opportunity for it to be part of the solution during the pandemic crisis and as the economy reboots.

The CIB has clear challenges facing it as it considers how to help. First, it was designed primarily to generate the most complicated and difficult large-scale projects, those involving revenue risk. Making these projects shovel-ready can take years, not months or weeks. Secondly, the CIB has done little of note as a centre of excellence for infrastructure development. Thirdly, and more broadly, it is not yet a credible organization in the eyes of government or the private sector.

There is, nonetheless, a role for the CIB in these challenging times that can link it, and its $35 billion in capital, with the pressing needs of an economy facing unprecedented challenges. This involves the CIB acting as a policy and capital backstop to existing partnerships between the public and private sectors across a range of projects - that would - provide essential public assets and services to Canadians.

The federal government has invested hundreds of millions of dollars in public-private partnerships (P3s) across the country pursuant to a risk transfer model that did not take into account the delays and cost overruns everyone expects to result from the Covid pandemic. Direct federal projects (such as the Gordie Howe Bridge) and cost-shared projects in essential areas (such as transit projects in Ottawa, Edmonton, Toronto and elsewhere and electricity generation in Newfoundland and British Columbia, for example) will almost inevitably experience significant delays and cost overruns.

The scope of the P3 problem is potentially massive and the incremental costs to construction companies, many of which are currently involved in multiple projects, could lead to serious solvency concerns.

In Ontario alone, there are 24 P3 projects currently in construction. Productivity declines on these projects are estimated to be as much as 40 per cent due to absenteeism (fears of illness; travel restrictions; unavailability of child care), workplace operational restrictions (social distancing, including in elevators etc.) and supply chain disruptions. We note that the Canadian Construction Association recently estimated that the incremental costs for projects could be as high as five per cent of total construction costs.

Even if we assume a much more conservative two per cent, the costs are enormous. If we take the 24 Ontario P3 projects and assume an average project construction cost of $750-million, this would result in incremental costs of $360-million. And this does not count the costs of delay, which on projects where a pandemic is not a force majeure (such as in Ontario's standard form project agreement), the costs climb quickly. The daily liquidated damages payable on the Ontario projects alone is close to $2-million. With three months' delay due to Covid-19, this is an additional $180-million. Covid costs could, therefore, be as high as half a billion dollars for these 24 projects alone.

Governments of all stripes need a sensible approach to these unanticipated problems. Of course, most of the P3 contracts covering these projects do not provide any relief to the private sector for this kind of problem. In some cases, delay relief is granted but without any support for the extra costs that will arise from delays, changes to construction methodologies, supply chain disruptions or increases in the cost of materials, all of which are expected to be significant.

Governments can shrug their collective shoulders and say the contract is the contract, but this is likely to be a pyrrhic victory.

Project companies, and more importantly, the construction companies that form them and provide the design and construction services, will have to fully absorb the additional costs and the extremely costly liquidated damages that will need to be paid to lenders. This will almost inevitably end in project failure and, possibly, the failure of the very construction companies that we will need to deliver the infrastructure stimulus when the lockdown ends.

This prediction is not fear mongering. A few construction companies in the P3 space have already failed or are close to insolvency; examples include Bondfield Construction and the international firm, Carillion. Other Canadian construction companies were already quietly exiting the P3 market due to risk allocation challenges even before the Covid-19 pandemic.

The opposite government reaction seems equally problematic: to have the relevant contract counterparties (federal government agencies, provinces, municipalities and broader public sector agencies such as transit providers) absorb the full cost risk. Many of these agencies and governments are running out of money too. And these are the very entities which can best produce "shovel-ready" projects. It also seems contrary to the Minister's goal to force what few scarce dollars are available into just keeping what we already have. That is not stimulus but merely saving the furniture.

What's needed is a financial bridge; a way to get these existing projects completed that doesn't waste government resources and doesn't put construction jobs and companies at risk.

This is where the CIB can be help by doing two important things. First, it can be a source of capital to help to "fix the gap." Secondly, it can devise a solution that can be used by all of the project participants that gets everyone focused on completing the project and less on litigating who is paying and what the contract says.

From a policy point of view, the CIB as a capital bridge makes sense. It would be backstopping the investments the federal government has already made in these projects by providing a path to substantial completion and successful operation. It would be providing liquidity supports to other levels of government in recognition of Ottawa's better fiscal position and its leadership role in driving economic stimulus. It would also be ensuring that saving existing projects do not cannibalize needed investments by these agencies and provinces in new shovel-ready projects.

In addition, this new role can help give the CIB something it lacks – market credibility and a leading role in the public-private infrastructure space. By devising an "off the shelf" Covid-delay package, it will be providing a needed service right now. It will help the CIB achieve one of its central goals, becoming a centre of infrastructure excellence, by building a solution that understands the changes in work patterns on construction projects and the needed alterations to market risk allocation and provides a balanced risk allocation and does so in conjunction with market participants and government agencies.

The framework for CIB support can be reasonably straightforward. It would focus on projects that meet a significant threshold of federal investment. The projects must have achieved financial close and be facing a reasonable prospect of real project delays. The capital backstop can be in the form of a long term zero percent loan or even a grant as appropriate, recognizing the long-term financial limitations on many governments and public agencies. The size of the loan or grant can be formulaic based on the duration of the pandemic delay multiplied by the construction costs times a factor set based on the project type. Using a formula has the benefit of speeding up the process of getting the projects back on track and avoids long and costly litigation delays.

In return, the private sector will have to put a little water in its wine too. Government acknowledgment of the pandemic as an unanticipated risk and support for certain delay and overrun costs should require a waiver of claims and an acceptance of a new level of cost-certainty. The private sector will also need to develop mitigation plans for both costs and project delays that passes both an objective test of what is reasonable in the circumstances and otherwise meets the criteria outlined in the project agreement, such as limitations on overhead and profit claims claimable by the private sector. Equity may have to take a haircut on its expected returns as, in some cases, should the debt capital providers. In some cases, specific project agreement provisions may need adjustment, but with the CIB developing on overall framework and providing a liquidity backstop, this flexibility should be left to the local contracting agencies.

There is one major objection to this path that needs to be directly confronted; that the solution for each project should be left to the contracting parties to sort out. Here, the argument is that the parties negotiated a large and comprehensive contract and the private sector agreed to accept the contract risks, even those that arise on an exceptional basis. While true for each project, this argument completely ignores the systemic problems this "solution" creates. The "tough luck" approach by the public sector can generate either or both of two consequences, both of which are at odds to the aims of the CIB and the federal government.

Firstly, a strict reliance on the contract could lead to project failures as delays and costs accumulate beyond the risk transfer that equity, lenders or construction contractors can or are willing to absorb. As there are dozens of current projects in the marketplace, a rising tide of project failures will have serious adverse consequences. Construction workers no longer working. Long project delays on key public infrastructure (see the project experience on Bondfield projects as an example). Potential construction company failures leading to a further drain in the public confidence at a crucial time in the economic life of the country.

Secondly, such a series of failures could undermine the public's trust in the notion of a partnership between the public and private sectors. These project failures will land back on the public sector with a loud thud. To date, P3s in Canada have derived their public support from the fact that they have not, especially recently, been a controversial method for delivering public assets. A series of public failures will bring that quickly to an end – undermining confidence in the model at a time when the CIB has yet to build an independent credibility of its own.

This challenge applies across the country in the P3 sector. However, the problem doesn't end there. These same companies operate in the non-P3, traditional infrastructure space. The role we propose for the CIB, as a source of capital to help to "fix the gap," is no less relevant for the non-P3 market, albeit without the same debt financing challenges.

The CIB's raison d'etre was to generate revenue-risk projects (and to act as a centre of excellence for national infrastructure development). It's unlikely that revenue-risk projects will be realistic soon, given present challenges. But the CIB's funding envelope could be put to good use in the manner already described.

CIB-generated loans to organizations, including provincial and municipal governments facing additional debt challenges already, will not always be sufficient as a "financial bridge." CIB-generated grants also will be required.

Furthermore, CIB leadership during the present crisis would embed it in the Canadian infrastructure landscape in a way that has eluded it until now.

The Minister of Infrastructure has clearly outlined certain priorities for her portfolio – getting the vast resources available in her department into the market - quickly and effectively. The idea proposed here is one way for the CIB to help to do this right now.

Tim Murphy is a Managing Director of McMillan Vantage, infrastructure and project finance lawyer at McMillan LLP and the author of <u>Public-Private Partnerships in Canada: Law, Policy and Value for Money</u> - Canada's only textbook about P3s.

Drew Fagan is a Senior Advisor at McMillan Vantage, a Professor at the Munk School of Global Affairs and Public Policy, University of Toronto and was formerly Ontario's Deputy Minister of Infrastructure.