Pulling the Plug on Privatization

The Slow, Painful Death of P3s in Ottawa

A CUPE 503 Briefing Paper

Introduction

Imagine, if you will, an intensive care unit in a large city hospital. A gravely ill man lies comatose in bed, surrounded by weeping family members. Electrodes connect his ailing body to a heart monitor which emits faint, intermittent beeping sounds. The line on the screen suddenly goes flat and the sounds from the monitor cease for a few seconds to the horror of his loved ones - only to start up again, weakly and hesitantly. As his condition deteriorates, each of his bodily functions fails, leaving him a pale reflection of the man they once knew. Clearly, he isn't long for this world – in spite of the best efforts of medical staff to save him. Sensing this, the doctor suggests taking him off life support – pulling the plug – so he can die a peaceful, natural death.

Judging from the experience of many local governments in privatizing public services, slow, lingering death is not restricted to hospitals – as municipality after municipality finds itself forced to cope with dead or dying public-private partnerships (P3s). And nowhere is this more apparent than in Ottawa where a spate of failed P3s has caused many citizens to demand that the City pull the plug on privatization and go back to providing services the way they used to be done – the way that worked – in-house.

The Push to Privatize

While a number of municipalities now rue the day they ever heard about P3s, the truth is that not so long ago many of them saw these arrangements as an answer to prayer, finding themselves caught between growing citizen demands for new and better services and shrinking federal and provincial transfer payments. Which is why so many of them decided to take the easy way out – and privatize services. Unfortunately, as many were soon to discover, privatization doesn't solve problems. It creates new ones – bad ones.

Short Term Gain for Long Term Pain

That so many fell into this trap is not surprising, given that privatization often initially looks like a pretty good deal. A good example is the use of P3s to build new infrastructure. At first, many of these projects are quite a hit. New facilities go up – which makes citizens happy. And politicians are happy too since they now have big accomplishments to point to at election time. Best of all, the debt acquired in building them appears on the balance sheet of the private sector partner – not the municipality. This allows local politicians to take credit for the facilities, while still claiming to be reducing the city's debt and keeping taxes down. Finally, the fact that the municipality only has to make relatively modest annual lease payments instead of the large one-time charge it would face otherwise gives people the impression they are getting a good deal.

The optics are equally good when you privatize existing services. For work previously performed by in-house employees, who enjoy good salaries and benefits, is now done by low-wage, non-union private sector workers who have few benefits. And getting rid of the vehicles, equipment and facilities previously needed to do the work in-house lets you shed yet more costs – and even gives you a little extra cash back from their sale.

Sounds good, doesn't it? Unfortunately, that's not how most P3s work – as all too many municipalities have discovered.

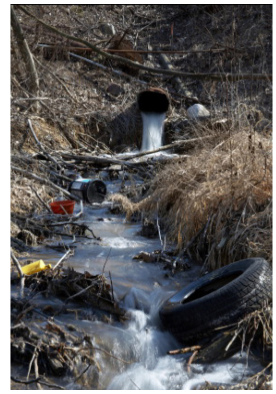
For the truth is that using a P3 to build new infrastructure usually costs a municipality a lot more in the long run than if it had built the facility itself. The reason it initially looks so good is that the cost is spread over a number of years. It's only when you add up the total cost over the entire life of the contract that you realize just how much more it will cost you. So what we're talking about is not a free lunch, but short-term gain for long-term pain.

So why are P3s more expensive? Well, financing costs are one reason, given that governments can borrow money more cheaply than companies. So the cost of capital is bound to be higher for a P3. Then there's the company's profit to add in – usually a hefty one. And the private sector partner is going to try and pass on as many of its costs as possible to the municipality. So taxpayers can expect to eat some of those as well. And companies will almost certainly load in some factor to cover any risk they might incur over the life of the project. Many will also look for a way to recover the cost of competing for the business in the first place. Finally, there are the transactions costs involved in letting out a contract and supervising the work to make sure it's satisfactory.

The question of risk is a particularly important matter since one of the biggest benefits touted by proponents of P3s is their supposed potential for transferring risk from the public to the private sector. Forget it. It doesn't happen. Just ask any municipality that's had to bail out a project that went wrong. And there's even some additional risk in a P3, which comes from the fact that the goals of the private and public partners are often quite different. This was pointed out in the latest report by the City of Ottawa's Auditor, who in his discussion of the municipality's P3s, felt moved to remind Councilors that "the City needs to be particularly conscious of risk in that the profit motive of partners, while an acceptable element of these partnerships, does imply differences in objectives for the project compared to the City's goals." Simply put, the City needs to realize that P3s often involve additional risk flowing from the fact that companies are primarily concerned with their bottom line, not the welfare of the community. Excellent advice – which any municipality would be wise to heed!

Sadly, the record of P3s in taking over existing in-house functions isn't much better – with examples of failure occurring in almost every area: health care, education, recreation, snow removal, garbage collection, and water and sewage treatment.

Probably the most striking example of just what can go wrong is Hamilton-Wentworth's efforts to privatize its water and wastewater systems. This was a nightmare by anyone's standards. For by the time it was over, the contract had been held by four different



companies – one even connected with Enron. Costs were out of sight. And problems with the facility resulted in one of the worst sewage spills in Lake Ontario's history – with the municipality getting stuck with the bill for cleaning up hundreds of homes and businesses. After ten years of misery, the municipality threw in the towel and took operations back in-house – with taxpayers footing the bill.

Still, there was a silver lining – eventually. In 2006, one year after taking operations back in-house, the municipality reported that performance at the treatment facilities had gone up – and come in $1.2 million under budget. The city also saved a further $195,000 in performance bonuses that would have been paid to a private operator who met the same standards. So much for privatization!

The Ottawa Experience

With so many examples of what can go wrong, you would have thought that municipal politicians in Ottawa would have tried to avoid making the same mistakes. But they didn't. Instead, the City pursued privatization with a passion.

Taking the Fun out of Recreation

Recreation was one area where P3s were used a lot, spurred on by then Mayor Bob Chiarelli, who saw them as a good way to get new infrastructure the City might not otherwise be able to afford, a point he emphasized in an all-candidates question and answer session held during the most recent election. He stated:

> *"I support P3's when they make sense. Our residents need services like recreational facilities and we can't build them fast enough with just taxpayer dollars. My practical approach to P3's has led to the building of the Sensplex in Kanata (the first new arena built in Kanata in the last 40 years), the expansion of the Ray Friel Centre, the Thunderdome in Orleans, a new Long-Term Care facility on Porter Island, etc. These services would have waited for years until the City could afford to pay for them. … My non-ideological approach means that these important facilities can be available now, at a price we can afford."*

Apparently, many voters disagreed if we are to judge by the election results. But Ottawa taxpayers were not out of the woods yet - as shown by revelations that two of these 'successes' were in serious trouble and would have to be bailed out or taken in-house. Faced with this reality, some wondered why Ottawa had decided to use P3s when other communities had a string of failures which included:

- The 1996 **City of Victoria P3** used to build and operate a multiplex facility. A first attempt was cancelled when the company broke its promise not to increase costs. The second one has not done much better. In addition to missing the opening date, the cost to the city will be double the original estimate, after accounting for interest payments over the life of the deal, and ice time will be 25% more expensive than at arenas owned and operated by the municipality.
- The **City of Guelph P3** in which the municipality invested $10.5 million and guaranteed a $9 million loan for the construction of a new arena mall complex. When the private sector partner got into trouble, the City had to cover its debt. In 2001, the City began covering the company's $750,000 mortgage payments and all of the federal and corporate taxes associated with the project.
- The **Cranbrook P3** deal to build a 4250-seat arena. After construction got off to a late start, the real fun began. Ownership changed several times – with the City having to absorb cost overruns. And it saw its borrowing power drop due to the cost of the long-term lease it had agreed to. By the time the project failed, the City had the highest debt level in the province and residents were faced with a 7% tax increase resulting from the project.

So why did the City persevere in the face of so many failures in other jurisdictions? Part of the answer, it seems, can be found in remarks made by the Mayor at a groundbreaking ceremony for the Sensplex P3 where he praised privatization, saying it would "allow Ottawa residents to incur little or no debt while enjoying the benefit of outstanding facilities". And he went on to cite the rink as "a prime example of new infrastructure sooner and for less cost to everyone."

High praise indeed! Unfortunately, that's not what happened – which became clear when Sensplex officials appeared before City Council, seeking money to bail the project out. This was not a happy occasion, judging by the remarks of Councilor Alex Cullen:

> *"They have already drawn a million dollars out of the operating reserve. This after we guaranteed the construction of the facility through the municipal capital facilities agreement. We waived property taxes. We contribute toward their operating reserve. And we're a guaranteed client for 2,400 hours of ice time a year. And they can't make ends meet?"*

Apparently not, since the organization asked for and got a $1.4 million bailout over three years and another $225,000 for its operating reserve.

As it turned out, this P3 was in better shape than the Ray Friel Centre, which the City had to take over – along with its $12 million debt. Not a happy day for Ottawa taxpayers! Nor were local politicians pleased either – as shown by Council's call for a review of the financial health of each and every one of the City's P3s. Still, old habits die hard – which may explain why Council went on to approve yet another P3. This one involved the construction of a $900,000 beach pavilion, which also quickly became the subject of controversy - with critics charging that it gave the company a monopoly over the popular beach area where it was to be built.

Privatizing Garbage Disposal – A Trashy Idea

Garbage collection is a challenge for any municipality. And that certainly is true of Ottawa which privatized its garbage collection very early on. Unfortunately, this didn't solve the problem. It simply put off the day of reckoning, which arrived in the 1990s when one of its contractors announced that it would no longer be able to live up to its contractual undertakings. It was a mess. Garbage piled up in the streets. Irate citizens bombarded councilors with complaints. Sensing a crisis, the City took some of its garbage collection back in-house.

Happily, things went well. Many of the workers previously employed by the contractor went to work for the City, bringing their expertise and knowledge of collection routes with them. And the municipality quickly assembled the vehicles and equipment it needed. Trash collection was once again restored in all parts of the city and the number of complaints fell. Then a strange thing happened. The City discovered that having an in-house capability kept its remaining contractors on their toes and resulted in lower private sector bids when it came time to renegotiate contracts. Taxpayers were finally getting a well deserved break.

Loading the Dice – Against the City

Still, that wasn't the end of it – as seen by a number of critics who charged that in-house garbage collection was actually cheaper. This was confirmed in an April 2007 report to the City's Planning and Environment Committee which found that in-house collection was 20% cheaper than the lowest price contractor – with in-house collection costing $75.72 per tonne, considerably lower than the average of $86.60 per tonne for the contractors. The $2.2 million in savings from just one of Ottawa's five collection zones helped fund the City's green box pilot composting project – with $1.5 million left over. Which caused many to wonder why the City was using more expensive private contractors and why lower cost in-house bids were not winning more tenders.

The answer, it seems, lies in the City's flawed competitive process which gives an unfair advantage to companies by forcing in-house bids to include a number of "ghost charges" in all of their cost estimates. These imaginary or inappropriate charges – not required in private sector bids – inflate in-house costs and allow costlier private sector bids to win.

To better understand how this works, you first need to understand a bit about how the process works. In deciding whether to privatize, a municipality needs to compare three sets of costs: the direct cost of doing work in-house, the cost of an outside contractor, and the internal costs incurred in a contractual arrangement. In-house costs typically include personnel, equipment and materials. The cost of an outside contractor usually is the money a company is looking for to do the work. And internal costs involve those costs related to bidding, letting out a contract and supervising the contract work

– which are also called the transaction costs. Once you have those, you are ready to evaluate the options.

Unfortunately, that's not how it works at the City of Ottawa. For instead of considering just real costs and those shared costs that actually apply, it places an additional burden on in-house bids by requiring them to include a number of "ghost costs". Doing this makes less expensive in-house bids look bad and more expensive private sector bids look good.

This requirement flows from the City's decision to use a full cost accounting approach – which loads up in-house bids with fictitious and inappropriate charges - when evaluating bids instead of an avoidable cost approach, recommended by most economists and accounting experts, which includes just real costs and those costs which would be eliminated if you gave the work to a contractor.

The result is to load the dice against lower cost in-house bids – and taxpayers.

Ghost Charges Haunt Ottawa Taxpayers

A good way to grasp how these "ghost charges" are haunting Ottawa taxpayers by favoring higher cost solutions is by examining one recent in-house bid for some of the City's garbage collection business.

To begin with, the in-house bid added $15,000 per year or $90,000 over 6 years, supposedly for a "Letter of Credit". This particular line item referred to the bond a company might have to provide to allow for the possibility of it defaulting on its obligations. That's a reasonable requirement to make of a private sector company. But a City department is not going to go bankrupt – which means it should not have to include such a cost item in its bid. It's a fictitious cost. That's ghost charge number one.

Ghost charge number two involves the $13,250 (or almost $80,000 over six years) the City would supposedly have to pay each year for insurance. This is also a fictitious cost, given that the City of Ottawa, like most large municipalities, self-insures. It's cheaper that way. So the City would never buy such insurance from an outside company. It should be noted that many large garbage disposal companies also self-insure – which begs the question why it is that large companies are not similarly required to include in their bids an amount equal to the insurance costs facing their smaller private sector rivals.

The third ghost charge squeezed into this bid is a big one. It involves program support costs of $192,300 per year (or $1.15 million over six years). One problem here is that many of these overhead costs are not incremental – that is, they would not increase or decrease depending on who wins the bid. This is particularly true of the finance costs which included charges for the budget process and tax collection – costs that would stay the same, no matter who won the contract. It is important to note that these additional – quite imaginary - charges were only included in the in-house bid. None of the private sector bids faced a similar requirement.

Then there is the matter of direct fleet costs - which accounted for over $2 million of the total $4.162 million bid. While this almost certainly involves ‘ghost charges’, the lack of transparency in the competitive process makes it hard to know with any certainty what they are and how they are arrived at.

Of course, the use of ghost charges isn’t the only problem facing the City’s evaluation process. For example, in this particular tender, a number of overhead, enforcement and transaction costs, which tend to be much higher for private sector bids, were not included in any of the bids. This gave a significant advantage to the private sector bidders.

Adding all of these inappropriate or imaginary charges into in-house bids has serious consequences for the fairness of the competitive process by making less expensive in-house bids look more expensive than those submitted by private contractors. As a result, many more contracts go to more expensive outside contractors.

When this happens, private companies strike it rich with higher profits, but citizens, taxpayers and working families lose out, because they end up paying more for lower quality service, and with jobs that barely pay a living wage.

Sadly, that’s not all that’s wrong with the City of Ottawa’s supposedly fair bidding system. There’s also the question of just how fair the “Fairness Commissioners” are – those outside individuals the City of Ottawa hires to review in-house bids to make sure they are “fair”. A good example of some of the problems that can occur with such individuals can be seen in the case cited above. In this particular situation, the person selected for the position of Fairness Commissioner came from a firm called “P3 Advisors”, whose main line of business involves helping set up P3s – which may explain why so many phantom costs were ultimately included in this particular bid. So much for fairness!

And last – but unfortunately not least – there’s the larger question of just how open and transparent P3s and the contracting out process are – not just in Ottawa, but everywhere in Canada.

The answer, it would seem, is not very open at all. For the federal government’s much vaunted “accountability” legislation and provincial accountability regulations leave private contracts and P3 deals pretty much off the hook. Which is why ordinary citizens rarely get detailed information on such deals – and then only under the most extraordinary circumstances. And public auditors are often not much better off – with some complaining about limited access to files and information, with fuller information only being made available when things go seriously wrong.

This lack of openness and transparency is particularly troubling in the case of the “public sector comparators” governments use to compare public and private costs – the details of which are seldom, if ever, made public.

A good example of why this is a problem is shown by the four year court battle by the Ontario Health Coalition to get financial information about Ontario's first P3 hospital. What it discovered was a shocker – namely, that doing it this way had cost $300 million more than if the government had built it. That's $300 million which could have been used to improve citizens' lives.

So it's clear we need to know much more about these deals before they are made. The process should be open, transparent and fair – which it clearly isn't now.

Time to Pull the Plug

Based on the evidence, it's clearly time to rethink the use of P3s in Ottawa. For if the patient isn't dead yet, he's probably pretty close – with the signs of impending death there for all to see. A number of Ottawa P3s are already dead or on life support. Nor is it very encouraging for taxpayers to discover that the P3s the City has in the area of garbage collection are substantially more expensive than the in-house option.

Faced with this reality, it's little wonder that many citizens have concluded that it's time to pull the plug on privatization in Ottawa – so the City's ailing P3s can die a peaceful, natural death and the municipality can go back to doing things the way that worked – in-house. This becomes a particularly compelling argument when citizens realize that the only obvious alternative is to continue paying more than necessary for municipal services and go on bailing out ailing P3s. Not a pleasant prospect.

Of course, pulling the plug may be painful for a few – such as the companies that currently profit from P3s and a few right-wing politicians determined to use privatization as a way to shrink this country's public sector. But for the rest of us - the vast majority – it will be a blessed relief. For once completed, it will allow the City to provide its citizens with the high quality municipal services they require and deserve – at a price they can afford.

Pulling the plug is the right thing to do - and the smart thing too - for our communities and our citizens. And the sooner we do it, the sooner we can put the City of Ottawa back on a firm financial footing.