Chapter 5
Fredericton-Moncton Highway

Contents

Fredericton-Moncton Highway

Background

5.1 There are a number of reasons why we feel it is important that we look at the Fredericton-Moncton Highway project. First, it represents a large commitment of public money. Additionally, it is the largest public-private partnership arrangement ever entered into by the Province, and the first toll road to be constructed in New Brunswick. There is also a high degree of public interest in this project, particularly related to the tolling issue. For all these reasons we feel reporting from our Office on this project should be of considerable interest to the Legislative Assembly.

5.2 The agreements for the Fredericton-Moncton Highway project are now signed. However, we do not feel that our work will simply be a historical review. There may well be some lessons learned that can be applied to future provincial public-private partnership arrangements. It is in those areas where our recommendations are targeted.

5.3 We also feel that our review provided us with valuable information on the government decision-making process in general and that our recommendations may provide some guidance for future government decision-making.

5.4 In this chapter we will be addressing the decision-making process that led up to the issuance of a Request for Proposals to three short-listed bidders on the project on 27 March 1997. By that date, all substantive decisions about structure, financing, tolling, risk transfer, and the role of the private sector partner in design, construction, operation, and maintenance of the highway and tolling system had been made and approved in principle by the government.

Fredericton-Moncton Highway Project description and chronology

5.5 In our 1998 Report, we included a description of the Fredericton-Moncton Highway project, along with an analysis of the accounting treatment of the transaction. The project represents a commitment on the part of the Province to make “sub-lease” payments totalling $1.514 billion over the first 30 years of the agreement. In addition, the Province is committed to fund operation, maintenance and rehabilitation (OMM) costs of the highway and tolling system over that period. (Highway OMM payments are fixed at $168 million plus adjustments for inflation over the first 20 years. Tolling system OMM payments are fixed at $35.2 million plus adjustments for inflation over the first 10 years.) The Province will receive an estimated $321 million in concession fees from the project over a 30 year period, mainly consisting of toll revenues in excess of what is required to fund toll-based debt repayments and interest.

5.6 On 4 April 1997, the Minister of Finance formally announced the Province's intention to create a public-private partnership to build the Fredericton-Moncton Highway. It was noted that it would be the biggest public works project in New Brunswick history. That announcement included confirmation that the business model had been developed by RBC Dominion Securities Inc. Appendix I shows a chronology of key milestones in the decision-making process for the Fredericton-Moncton Highway project. It covers the period up to the date of issuance of the Request for Proposals to the three short-listed bidders.

Scope

5.7 Our audit objective for our 1999 work on the Fredericton-Moncton Highway project was as follows:

> *To determine if the Province employed an adequate decision-making process in planning the existing structure for the Fredericton-Moncton Highway project.*

5.8 In doing our work we considered significant decisions made, relating to the highway, up to 27 March 1997, the date the Request for Proposals was issued to the three short-listed proponents. We first reviewed the government objectives set for the project. We then looked to see how these objectives were translated into specific terms in the Request for Proposals. Our approach was to establish whether the decision-makers had access to sufficient, accurate information, that alternatives were considered, and that the decisions made seem reasonable in light of available information.

5.9 Our work included discussions with representatives of the Department of Transportation and the Department of Finance. We also reviewed documents provided by those representatives, along with many other pertinent documents, including Hansard, the government's new public-private partnership guidelines, and other government information releases. Additionally, we prepared our own analyses as required.

5.10 Our work was intended to examine the provincial decision making related to government objectives for the Fredericton-Moncton Highway and the contents of the Request for Proposals. We did not attempt to determine whether government objectives had been or were likely to be met, as that was beyond the scope of our planned work for 1999.

Results in Brief

5.11 Selection of government objectives for the project was made at the ministerial level over a period of several years. For the most

part, we were unable to find any documentary support for the objectives chosen, where alternatives existed.

5.12 Three financial objectives were developed and provided to RBC Dominion Securities Inc. by the government and were intended to form the basis for their structural recommendations. Ten general project objectives were developed by departmental staff and hired consultants for inclusion in the Request for Qualifications (RFQ) and Request for Proposals (RFP). Taken together, we feel that these objectives should be considered the government objectives for the project.

5.13 The structure of the Fredericton-Moncton Highway project was closely based on the public-private partnership model recommended by RBC Dominion Securities Inc. Other structural options for the project were proposed and analyzed, but the option chosen appears to have been the only one that would allow for the achievement of all government objectives as defined.

5.14 The Province has the option of buying back the highway at the end of the lease term at fair market value. A fair market value payment will be required despite the fact that all lease-based and toll-based debt will be paid off by that time.

5.15 In June 1996 the government announced its intention to pursue a four-lane highway project between Fredericton and Moncton. The decision-making process from that point up to the issuance of the RFP appears to have been well co-ordinated. Responsibility was assigned to various individuals or groups for each decision that had to be made. In addition, the Province hired a process consultant (KPMG) who was involved in the decision-making process after the June 1996 announcement and provided a positive opinion after the process was completed.

5.16 The gross interest cost between the issue date for the lease-based debt of 19 February 1998 and the commencement of repayments will total approximately $214 million on the original $540 million debt.

5.17 The terms of the RFP provide for the transfer of significant additional risks to the private sector over the traditional Department of Transportation highway construction approach. Departmental representatives indicated that all decisions made were subject to extensive discussion between departmental representatives and hired consultants. However, we did not see documentation supporting the decision to transfer those risks on cost benefit or other bases.

5.18 The additional costs associated with having project debt issued by a third party were significant. There were benefits

accruing to the Province from this decision. However, we did not see analyses that established that the value of these benefits met or exceeded the additional costs incurred.

5.19 The decision to allow RFP bidders to place more than the minimum amount of toll-based debt will have negative cost consequences for the Province.

5.20 Proposed Fredericton-Moncton Highway toll rates are comparable with those in other jurisdictions in North America.

5.21 Board of Management approved the tolling protocol and certain other items pursuant to their approval of "Financial Parameters for the Fredericton to Moncton Project – Finance" on 27 February 1997. Otherwise, the contents of the RFP were not approved by the Board of Management or Executive Council. Those bodies relied on departmental staff and hired consultants to ensure the RFP contents were appropriate.

Detailed Findings

Groups or Individuals Involved in Decision-Making Process

5.22 Government financial objectives for the project were decided upon at the ministerial level with reference to consultants' reports. Other objectives, specific to the project, were developed by departmental staff with the assistance of hired consultants. Co-ordination of all decision-making starting with the formal project announcement in June 1996 was assigned to the Project Manager, a senior government official from within the Department of Transportation. From that point, all steps in the process appear to have been completed within established timeframes. The contents of the Request for Qualifications (RFQ) were based upon the RBC Dominion Securities Inc. interim report. The contents of the Request for Proposals (RFP) were developed by a number of small committees that included representatives of government and various private sector consultants who were hired by the Province to provide their expertise. Certain of these consultants also provided some input to the RFQ and were involved in the assessment of responses to that document.

5.23 Departments represented in the decision-making process up to the issuance of the RFP included the Department of Transportation, the Department of Finance, the Department of Natural Resources and Energy, the Department of the Environment, the Department of Justice, the Department of Economic Development and Tourism, the Department of Supply and Services, the Department of Agriculture, and the Department of Municipalities, Culture, and Housing.

5.24 The planning/decision-making phase of the project included fairly heavy reliance on consultants. Many of the consultants who were hired had significant previous experience working on public-private partnership arrangements in other jurisdictions in Canada and elsewhere.

Decision-Making Information

5.25 There were a number of reports upon which decision-making was based for the Fredericton-Moncton Highway project. The key report was prepared by RBC Dominion Securities Inc. It dealt with the feasibility of a public-private partnership arrangement for the Fredericton to Moncton highway and recommended the structure that was subsequently adopted for the project. Material from that report was used extensively by decision-makers. Other reports that provided important input included the provincial white paper *"Highways for the Next Century"*, the "*Feasibility Study for Toll Highways and Private Sector Involvement for Highway Development in New Brunswick"* prepared by ADI Limited, and the traffic study prepared by Wilbur Smith and Associates. All these documents are discussed in more detail in the project chronology presented in Appendix I.

5.26 Aside from reports, we were told that valuable information was obtained through dialogue with other jurisdictions that had employed public-private partnership models for similar projects. Those projects included the Ontario 407 highway, the Nova Scotia highway, and the Confederation bridge.

5.27 We noted one case where information used by decision-makers may have been misleading. The RBC Dominion Securities Inc. report includes the comment, *"...a public private partnership approach could be used to achieve: i) construction cost savings estimated by ADI Ltd of $60 million..."* The $60 million figure came from a report by ADI Limited. That company was requested in 1996 to provide an independent assessment of cost estimates for design and construction of the proposed Trans-Canada highway between Fredericton and Moncton. Terms of reference included the following statement.

> *"Review current plans for the highway and develop estimates of the cost of the work to be done (both design and construction separately). Separate estimates are required on the basis of traditional approach to designing and building through a number of tendered contracts, and on the basis of a single design-build project...Costs of designing and installing toll facilities have not been addressed in this estimate."*

5.28 ADI made the following comments in their October 1996 report.

> *"....When the Highway 407 project in Ontario was initiated, design-build costs were estimated at 90% of traditional methods. This has since proven accurate.... Anticipated savings on design-build projects are not as much a function of the type of project (traditional vs. design-build) as they are to the scale of the undertaking. Design-build economies are maximized through large scale ventures such as the Fredericton to Moncton Highway Project. However, this project is sufficiently large that cost savings could also be*

significant should the decision be made to break the work into several sections."

"A design-build proponent would expect to achieve economies on highway design and construction through the following measures:

- *Longer sections of highway under construction at the same time within the same contract will encourage more efficient balancing of cuts and fills, especially through use of large off-road earth moving equipment.*
- *Large contracts will permit establishment of specialized crews for specific and repetitive tasks, hence more efficiency. (i.e. Excavation, borrow, sub-base, etc.)*
- *Due to the size of design-build contracts, mobilization costs will be reduced.*
- *Under a design-build approach, the design review process will be streamlined."*

5.29 The report goes on to list areas where economies could be expected on bridge structures construction.

5.30 The RBC Dominion Securities Inc. report implied that the $60 million cost savings could be attributed to the public-private partnership structure. However, the original ADI report clearly indicates that the savings relate to economies of scale, not project structure. Therefore, we feel that the RBC Dominion Securities Inc. report may have misled decision-makers in the design-build area.

Departmental comments

5.31 *We believe that the RBC Dominion Securities report is quite clear and not misleading when it states "…a public private partnership approach could be used to achieve: i) construction cost savings estimated by ADI Ltd of $60 million…". It does not attribute the savings to the public private partnership but rather states that this is one possible way to achieve the savings identified by ADI Ltd. as possible in a Design-Build project. The source of the savings was understood by the decision makers.*

Fredericton-Moncton Highway Project Objectives

5.32 In our opinion, the selection of government objectives for the Fredericton-Moncton Highway project was one of the two key decisions made for the project. (The other was the decision to sign the final agreement with the Maritime Road Development Corporation.)

5.33 The basic government goal for the Fredericton-Moncton Highway project was to increase public safety by improving the highway system between Longs Creek and Moncton. More specific government objectives for the highway project were formulated at the ministerial level over a number of years of preliminary planning starting with the provincial *"White Paper"* in 1993. We feel that it would have been appropriate to limit these government objectives to such broad statements as "for lowest cost to the Province" and "as quickly as possible" rather than providing more specific objectives to provincial staff. Doing this would have enabled provincial staff to be more creative in completing the project, while still meeting the broader goals and objectives of government. Departmental representatives indicated that the financial goals selected by the government, and the resulting public-private partnership structure for the project, limited their ability to identify acceptable alternatives for many of the project objectives that they later formalized.

5.34 We found lists of objectives in two places. Three government financial objectives were provided to RBC Dominion Securities Inc. when they were contracted to provide structural recommendations for the project. In addition, a list of ten project objectives considered relevant to bidders was developed by departmental representatives with the assistance of hired consultants and presented in the Request for Qualifications (RFQ) document. This list was prepared after the RBC Dominion Securities Inc. interim report was issued and the structure of the project had been decided. It appeared again in the Request for Proposals (RFP) with slightly modified wording. Some of these objectives, such as the four-year completion goal, had already been referred to by government in their previous announcements. We consider the three government financial objectives combined with the ten project objectives to encompass the government objectives for the project.

5.35 The three government financial objectives provided to RBC Dominon Securities Inc. were:

- to avoid an increase in provincial debt;
- to achieve a reasonable cost of funds; and
- to achieve an optimal degree of risk transfer to the private sector.

5.36 Upon consideration of these financial objectives, RBC Dominion Securities Inc. recommended the project be structured as a public-private partnership with at least a minimum level of funding being provided by third party (i.e. toll and ancillary) revenues. This recommendation was accepted by decision-makers and project planning proceeded to the RFQ phase under the assumption that a public-private partnership structure would be adopted.

5.37 Departmental staff said that the government objectives for the project were sometimes competing. For example, they understood that transferring risks and requiring certain construction and environmental standards would lead to additional cost for the Province. These objectives had to be balanced when deciding what to include in the RFP.

5.38 Our work on government objectives for the project included developing a clear understanding of the meaning of each objective. We then attempted to determine if reasonable alternatives existed to those selected. Where reasonable alternatives did exist, we determined if analyses had been prepared that compared the alternatives and made decision-makers aware of the limitations their selection would make on structural options for the project as well as the benefits. We then assessed the objective selected for reasonableness given the information presented. Government objectives for the project are discussed individually below.

5.39 In doing our review of objectives, we noted a lack of documentation supporting the selection of specific objectives where reasonable alternatives existed. Lack of staff involvement may be the reason for this deficiency in the case of government financial objectives. The Departments of Transportation and Finance indicated that they only became involved in the decision-making process for this project after the official announcement that the project would proceed, in June of 1996. However, there is evidence that these issues were discussed at the political level prior to that date, including the various reports that were requested as previously discussed and Hansard documentation from the Legislative Assembly. Departmental representatives indicated that very tight timelines for planning the project led to the lack of documentation supporting project objectives selected for inclusion in the RFQ and RFP. They did note, however, that decisions related to project objectives were subject to intensive discussion and debate between departmental staff and hired consultants.

Government financial objectives

5.40 As previously noted, RBC Dominion Securities Inc. was given three government financial objectives in their work for the Province early in 1996. Two of them related directly to financing aspects of the proposed project. They were, “to avoid an increase in provincial debt”, and “to achieve a reasonable cost of funds.” They are discussed below. The third relates to risk transfer and is covered under *“Project Objective 4”* later in this chapter.

To avoid an increase in provincial debt

5.41 This objective can be interpreted as requiring the Province to enter into an operating lease arrangement and to have an arm’s length third party arrange for the financing of the project. The obvious alternative would be not to have such an objective, thereby permitting the Province to finance the project.

5.42 There were two arguments made supporting the need for this objective. The first was the possible effect of more provincial borrowing on the provincial debt rating, and therefore future borrowing rates. The second was the requirement of the Province to live within the financial boundaries established by the provincial balanced budget legislation.

5.43 The argument that additional borrowing by the Province may adversely affect the future borrowing rate supposes that the debt rating agencies would ignore debt issued by a third party, but supported by government payments. In fact, in their 1997 report, RBC Dominion Securities Inc. made the following statement in referring to the likely effect of project debt being issued by Project Co.

> *"… Credit rating agencies will count $580 million commitment (89% of capital costs) now …"*

5.44 Their opinion was confirmed in a November 1998 Standard and Poors report that discussed the 1 June 1998 affirmation of the Province of New Brunswick's credit rating.

> *"Tax-supported debt (net of cash holdings), which includes all provincial direct and guaranteed debt as well as municipal debt, but excludes the self-supporting obligations of NB Power…rose once again in fiscal 1998. This was entirely due to the issuance of lease-based debt (not directly by the province, but by the New Brunswick (F-M) Project Co., a not-for-profit company incorporated earlier this year) to help finance the construction of the Fredericton-Moncton Highway project. While this debt does not represent a direct obligation of the New Brunswick government, and therefore does not affect provincial direct debt…, Standard and Poors considers it appropriate to treat it as tax-supported debt because the province (through its Crown Corporation, New Brunswick Highway Corp.) is ultimately responsible for making the sublease payments to cover the debt service on the lease-based debt. These payments will be a charge on the province's consolidated fund, are statutory appropriations that are not required to be voted on annually by the Legislative Assembly of the province, and must be paid from the date that the highway is fully open to traffic for the full term of the lease-based debt."*

5.45 So, the only debt that the Province would have avoided in their credit rating evaluation would have been the toll-based debt of $174.5 million. That is because it will not be repaid through provincial tax revenues, but rather by highway user tolls. The Province was aware of the RBC Dominion Securities Inc. opinion on the likely treatment of the lease-based debt, and chose to adopt the public-private partnership structure anyway. Therefore, we do not feel that the possible effect on the provincial credit rating of additional debt should have been a significant factor in the adoption of this objective.

5.46 The other argument made for adopting this objective would be that balanced budget legislation would not be met if highway design and construction costs were treated as capital expenditures over a four year construction period. This issue was also covered in the RBC Dominion Securities Inc. report to the Province of New Brunswick dated 25 June 1997. The report states, *"To achieve the Province's fiscal objectives, it is important that the financing approach achieves operating lease treatment and does not result in consolidation of the project financing onto the accounts of the Province."*

5.47 On 19 December 1997, the Minister of Finance made the following comments in the Legislative Assembly:

> *"We could probably build it if we decided we would not touch one single kilometre or mile of road anywhere else in the province. Over the next four years, if we dedicated every single penny of capital construction to this project, we probably could do something. However, if we followed the normal fiscal framework, if we took into account the fact that we have balanced budget legislation that we have to respect, it would take us between 15 to 20 years to accomplish this. All we are saying to you is that it is not uncommon for a jurisdiction to move into this area of partnering with the private sector to accomplish projects that would otherwise take a lot longer for us to do. ... Why are we doing the project? Why is it a better deal? It is a better deal because we would not have the project if we didn't do it with the aid of the private sector partnering. We simply cannot afford to do it in the normal circumstances because of our financial situation."*

5.48 Also on 17 December 1997 in the Legislative Assembly the Minister of Transportation made the following statement. *"The decision was made by Cabinet that we would have a toll highway.....But the fact of the matter was with no toll highway, we would not have a highway..."*

5.49 In our opinion, these comments do not refer to a lack of available borrowing room for the Province. They would have needed only to borrow and service an additional $174.5 million in toll-based debt. Rather it refers to the need, alluded to by RBC Dominion Securities Inc., to have at least 11% of total funding for the project come from outside of government. This minimum level of toll revenue was necessary to ensure the project would qualify for operating lease treatment under current accounting rules.

5.50 In our opinion, the provincial balanced budget legislation led to decision-makers adopting the objective *"to avoid an increase in provincial debt."* However, we saw no evidence that consideration was given to making a one-time exception and ignoring the balanced budget legislation for the Fredericton-Moncton Highway project. Since the balanced budget legislation does not impose any penalties on the Province when it is not met, we feel that such an option should have been considered. Not setting this objective for the project would have freed the Province up to issue debt for the project directly. The implications of direct provincial debt issuance will be discussed later in this chapter.

To achieve a reasonable cost of funds

5.51 This objective is related to the value-for-money objective, but recognized that the borrowing cost for this project would be somewhat higher because debt would be issued by a third party rather than the Province. This higher borrowing cost was effectively payment for transfer of certain repayment risks to the private sector.

5.52 RBC Dominion Securities Inc. reflected this in comments in their 1997 report.

> *"....We estimated a cost of funds of 30 basis points above the Province's 30 years bullet bond rate for the lease-based debt and a cost of funds of 100 to 125 basis points over Canada bonds of similar duration for the toll-based portion. On a blended basis, the cost of funds then represents a 36 to 38.5 basis point premium to the Province's 30 year bullet bond rate."*

5.53 This objective is closely linked to the previous objective "to avoid an increase in provincial debt." In order to meet that objective, it was necessary to have debt issued by a third party. The debt could have been issued at the provincial borrowing rate had the Province chosen to guarantee its repayment. However, this would have precluded meeting the first financial objective because the full amount of the sub-lease commitment would have had to be recorded as debt. Conversely, had the Province guaranteed repayment of the debt, or had debt been issued directly by the Province, a "cost of funds" objective would not have been needed.

Other government project objectives as documented in the request for proposals

Project Objective 1, "To ensure the safety of the travelling public."

5.54 The provincial white paper *"Highways for the Next Century"* that was released on 28 September 1993 identified safety as a major concern with the existing highway between Fredericton and Moncton. It was felt that by expanding the Trans-Canada Highway to four lanes, it would be safer for travellers. We did not attempt to identify alternative highway structures or determine if statistical evidence supported the improved safety claims surrounding the four-lane option. As we have already stated, we feel that the basic goal of the project was to improve public safety. There is no reasonable alternative to this objective.

Project Objective 2, "To ensure that the Highway is developed, designed, constructed, operated, managed, maintained and rehabilitated in a manner that meets or exceeds current Provincial standards."

5.55 The reference to provincial "standards" refers to the New Brunswick Department of Transportation (DOT) standards. An evaluation of DOT's standards was beyond the scope of our work, so we are assuming that they are appropriate in the circumstances. Therefore, we feel that there is no reasonable alternative to this objective.

Project Objective 3, "To ensure that the Highway is developed, designed, constructed, operated, managed, maintained and rehabilitated in an environmentally responsible manner."

5.56 "Environmentally responsible manner" is defined for purposes of this objective as complying with provincial environmental laws and regulations. As with the DOT standards, it is beyond the scope of our work to evaluate provincial environmental standards. Therefore, we are assuming that they are appropriate in the circumstances and that there is no reasonable alternative to this objective.

Project Objective 4, "To share the risks of the Project between the private and public sectors."

5.57 This objective was developed once it was decided to consider adopting a public-private partnership model for this project. Since all highway projects completed in the Province involve the sharing of risk to some degree with the private sector, the objective appears reasonable as written. However, it appears that the intent is more in line with one of the financial objectives provided to RBC Dominion Securities Inc. by the Province in their engagement to analyze the feasibility of applying a public-private partnership approach to the Fredericton to Moncton Highway project. That objective was "to achieve an optimal degree of risk transfer." Therefore, it appears that the definition of Project Objective 4 exceeds traditional DOT practice. The RFP summary of various risk components of the project and who will bear them confirms this interpretation.

5.58 Much of the risk sharing analysis that was completed was performed by RBC Dominion Securities Inc. pursuant to the assignment discussed above. However, we found no indication that cost benefit analyses were performed by RBC Dominion Securities Inc. or the Province covering the transfer of additional risks to the private sector. Additionally, we saw no evidence that other risk transfer options were considered. We were told that departmental representatives and outside consultants held extensive discussions relating to risk transfer and felt the objective selected was most appropriate in the circumstances. However, this decision was not supported by documented analyses.

5.59 We did some quantitative analysis on financing risks transferred that is discussed later in this chapter.

Project Objective 5, "To obtain optimal value for money for New Brunswick Highway Corporation (NBHC)."

5.60 CCAF/FCVI defines value for money as *"the term that summarizes three separate but interrelated values: economy, efficiency, and effectiveness..."* For this project, departmental representatives told us that it was initially defined as *"lowest cost, best quality with consideration of risk."* It was subsequently changed to make it more specific, but not until after the RFP was finalized. We feel that the Province should always strive to achieve optimal value for money in every project it undertakes. In our opinion there does not appear to be a reasonable alternative to this objective.

Project Objective 6, "To minimize the financial contribution of NBHC to the Project."

5.61 Our understanding is that this objective means to minimize gross provincial payments to the Project Co. through NBHC. The objective does not factor in the cost of tolls to provincial taxpayers. Additionally, it does not consider the netting effect of concession fees (i.e. excess toll revenues) to be paid to NBHC by Project Co. This second omission is discussed later in this chapter.

5.62 A reasonable alternative to this objective would have been "to minimize the financial contribution of New Brunswick taxpayers to the Project." As the provincial government represents the taxpayers of the Province, we would have expected this option to have been considered. However, we found no evidence that this or any other alternative was considered. Additionally, we saw no quantitative or qualitative analyses supporting the objective that was selected, and no evidence that Executive Council was made aware of the effect their selection of this objective would have on other decision-making for the project.

Departmental comments

5.63 *The RFP was issued on the premise that, if the Project proceeded, it would be a toll highway. In that context minimizing the financial contribution of NBHC minimizes the cost to taxpayers. To the extent that budgetary expenditures are lowered, the taxpayers benefit….*

5.64 *It was estimated that use of the highway will provide savings approximately equal to the cost of the tolls for commercial vehicles. For non-commercial users, since there is an alternate route, motorists choosing to use the four-lane highway will do so because they consider the benefits to equal or outweigh the cost of the toll.*

5.65 *It should also be recognized that to the extent that a number of users of the highway will be from out of province, this would transfer cost and risk from New Brunswickers.*

Project Objective 7, "To open the entire Highway for safe operation by November 30, 2001 and to fully complete the Highway by June 30, 2002."

5.66 It has been publicly stated that the rapid construction was due to the Province's concern for public safety on the route. Therefore, the decision to set an objective to have the highway completed within four years appears to have been due to the requirement to build the highway as quickly as possible. According to DOT engineers, four years was the minimum time in which the route could be completed, given the complexity of certain aspects of the highway construction (i.e. bridge construction). Obviously there are many other alternatives for the timing of completion of this highway up to and including the fifteen years identified as being the time to complete the highway under traditional practices. The option of building the highway in sections according to relative safety risk could also have been considered. However, we were unable to determine if other options for completion date were considered or what effect they might have had on the cost of the project. We did not see any cost/benefit analyses comparing alternative completion dates that would have been used as input to this decision.

Project Objective 8, "To defer payments by NBHC for the Project (other than on account of highway operations and maintenance) until after the opening of the completed Highway."

5.67 This objective was intended to defer the start of operating sub-lease payments by NBHC to Project Co. until a point after the full traffic availability date for the highway. Provincial representatives felt that it would be prudent business practice to defer payments on the highway until after the completion of construction. Additionally, they noted that at the time this objective was being set, it was felt that four years out the provincial surpluses would be in the range of $60 to $75 million. Those surpluses would cover the costs of the highway when sub-lease payments began in 2003. We were not provided with documentation to support this opinion. Additionally, we saw no evidence that other alternatives were considered for a start date on sub-lease payments. We did note that the gross interest cost between the issue date for the lease-based debt of 19 February 1998 and the commencement of repayments was approximately $214 million on the original $540 million debt. We feel that cost benefit analyses of various commencement dates should have been completed and provided to decision-makers.

Project Objective 9, "To maximize the economic and industrial benefits to the citizens and industries of New Brunswick."

5.68 This objective deals with the economic development benefits to the Province from the Fredericton-Moncton Highway project. This objective would have had cost consequences for the project, since it would somewhat limit the use of suppliers, sub-contractors, etc. by restricting their ability to find the lowest cost providers. However, to the best of our knowledge, analyses of these cost consequences were not prepared and no other options were considered. It may well be that the "price" of this economic development opportunity was quite low for the Province, but we would have expected it to be analyzed before this objective was decided upon.

Departmental comments

5.69 *The Government wished to ensure that New Brunswick benefited from the construction of this project. Compliant proposals were evaluated on the basis of lowest overall net cost for the Project. Economic and Industrial Benefits were to be used only in the event of a "tie". Therefore, while it required proponents to make a commitment to this objective and to their plan for Economic and Industrial Benefits we believe there was little if any additional cost to the Province resulting from the adoption of this objective.*

Project Objective 10, "To provide a high level of service to the Highway users at a low cost."

5.70 This objective established that the highway would be tolled. It related project objective two *"To ensure that the Highway is developed, designed, constructed, operated, managed, maintained and rehabilitated in a manner that meets or exceeds current Provincial standards"* to a user pay system of tolls. The tolling option was first raised in the 1993 provincial White Paper.

5.71 The effects of charging user tolls on the highway were analyzed for the reference of decision-makers. Specifically, it was determined that toll revenue at the levels proposed would lead to operating lease treatment for the project on the provincial books. This would allow the achievement of one of the financial objectives previously discussed, namely, "*to avoid an increase in provincial debt."* Additionally, a toll highway would contribute to the achievement of project objective 6 as interpreted by the Government, *"to minimize the financial contribution of NBHC to the Project."* Departmental representatives also indicated that it was felt that a system that required users to make a contribution was desirable in that it would somewhat reduce the burden on New Brunswick taxpayers in other parts of the Province who would not be using the highway. We did not see analyses documenting the net benefits of a tolling system (i.e. gross toll revenues less related costs).

5.72 A reasonable alternative to this objective would have been to have no tolls on the highway. This would have required either increased federal funding or an increase in planned provincial sub-lease payments. We saw evidence that additional federal funding was pursued and that tolling was seen as an option if federal funding was not available. The Province was unable to obtain additional federal funding during the period in which decisions were being made about the Fredericton-Moncton Highway. However, we saw no evidence that the option of larger sub-lease payments was considered. Actual provincial sub-lease payments are expected to be in the order of $58 million per annum with the tolling system now in place. Projected sub-lease payments without tolling would have been approximately $71 million per annum.

Departmental comments

5.73 *The decision to toll falls out of the government financial objectives not out of this objective. This objective was achieved by* *establishing standards for the Developer and the Operator and through the use of the Toll Protocol to ensure reasonable toll rates.*

Recommendations Government objectives for the project

5.74 Because of the importance of selecting appropriate project objectives, we would like to make the following recommendations to apply to the selection of objectives for future public-private partnerships and government decision-making in general.

- **For each type of objective under consideration, alternatives should be identified, where applicable.**
- **Each alternative should be analyzed for its effect on the cost of the project, its effect on the structure of the project, and its effect in helping achieve the planned outcome of the project. These analyses should be clearly documented for reference by decision-makers.**
- **Consideration of the alternatives by decision-makers should include reference to analyses and the rationale for decisions taken should be documented.**
- **The Province should ensure for accountability purposes that the list of project objectives is complete, clearly documented and that objectives are clearly understood by all parties involved in the project.**

Departmental response

5.75 *It is our position that the issues you have raised were addressed through consultation with the appropriate experts and discussion with senior management and the Government. We are confident that alternatives, issues and risks were properly considered in reaching all decisions.*

Project Structure

5.76 RBC Dominion Securities Inc. proposed and analyzed three structural alternatives for the project. They were:

- New Brunswick Highway Corporation issues stand alone revenue bonds;
- arm's length entity owns, finances against tolls and provincial lease; and
- private sector owns, finances against tolls.

5.77 An interim report was issued by RBC Dominion Securities Inc. on 28 October 1996. In it they recommended the second option and documented a model for how the arrangement should be structured. Their report stated:

> *"Given the Province's three financial objectives for the highway project …. a business and financial model was developed utilizing an arm's length not-for-profit corporation funded through debt raised by the successful RFP proponent and through debt raised by this Project Company against a*

long-term operating lease commitment of the New Brunswick Highway Corporation."

5.78 It went on to say:

"In summary, our analysis of the Fredericton to Moncton Highway project indicated that a public private partnership approach could be used to achieve:

i) construction cost savings estimated by ADI Ltd. of $60 million;

ii) time savings estimated by the Department of Finance of 14 years;

iii) meaningful risk transfer to the private sector in both the construction and operating phases of the project;

iv) no direct increase in provincial debt; and

v) a cost of funds 36 to 38.5 basis points greater than the Province's rate for long-term government bonds."

5.79 Based on our understanding of the government's financial objectives for the project, a public-private partnership that involved leasing appears to have been the only structure under which the project could have proceeded. The objectives as set precluded alternatives such as:

- public-private partnership for all aspects of the project except financing;
- public-private partnership without tolls;
- straight contracts for design, construction, and operation; and
- straight contracts for design, construction, operation, and tolling.

5.80 Under terms in the final agreement, the Province has the option of buying back the highway at the end of the lease term at fair market value instead of for a nominal amount. What makes that option unusual is that the lease-based and toll-based debt will be paid off by the end of the lease term. The requirement to have the final agreement structured this way was clearly specified in the recommendations contained in the RBC Dominion Securities Inc. report. The only apparent reason for this requirement relates to accounting rules for operating leases. An arrangement does not qualify for operating lease treatment for accounting purposes if there is any sort of "bargain purchase option" available at the end of a lease term. As has already been discussed, this arrangement had to qualify as an operating lease or the project would not have proceeded.

Request for Qualifications

5.81 A Request for Qualifications (RFQ) was issued on 18 December 1996 to identify parties qualified to be the private sector partner for the project. At the time of the announcement of the RFQ, the Ministers of Transportation and Finance indicated that a public-private partnership approach had been selected. The project structure described in the RFQ (and later in the RFP) mirrored the model laid out in the RBC Dominion Securities Inc. report.

5.82 Five submissions were received in reply to the RFQ. Once the submissions were received, there was a clearly laid out process, with groups being assigned specific duties.

5.83 As noted in Appendix I, the process consultant involved in the design and implementation of the RFQ and RFP processes was KPMG. In a letter dated 4 May 1998, KPMG provided the following opinion to the Department of Transportation.

> *"Based on our review and our involvement in the matters discussed in this letter .... we are of the opinion that the evaluation process leading to the selection of the preferred proponent was:*
>
> - *designed to be fair and equitable in its treatment of proponents and their proposals,*
> - *conducted in accordance with a pre-established process,*
> - *carried out using pre-established criteria, which were consistently applied.*
>
> *And that as a result, the evaluation and selection process was undertaken in a diligent, fair and equitable manner."*

5.84 We were told that the Province was strongly advised by its hired consultants to select three proponents to advance to the RFP stage. It was felt that because of the cost to bidders of preparing an RFP submission, the Province would get more competitive bids if the field was limited. The Minister of Transportation announced the three finalists in the Legislative Assembly in February 1997 and the three short-listed proponents were sent a copy of the Request for Proposals on 27 March 1997. The remainder of this chapter deals with the decisions made translating project objectives into terms in the Request for Proposals.

Request for Proposals

5.85 Once the government's project objectives were finalized, it was necessary to translate them into detailed specifications for the project as shown in the RFP. Contents of the RFP were prepared by staff of various government departments, along with representatives of various private consultants hired to provide input to the project.

5.86 For purposes of our review of the decision-making process for the RFP, we looked at several key areas. These areas included risk sharing, design-build, operations and maintenance, tolling, financing, and final authorization of the RFP contents. These key areas covered certain of the project objectives as previously discussed. We wanted to examine in more detail how these objectives were rolled out into the RFP and how that decision-making process worked.

Risk transfer

5.87 According to the Province's recently-released guidelines for public-private partnerships, *"The essence of a public-private partnership arrangement is the sharing of risks. Central to any successful public-private partnership initiative is the identification of risk associated with each component of the project and the allocation of that risk factor to either the public sector, the private sector or perhaps a sharing by both. Thus, the desired balance to ensure best value (for money) is based on an allocation of risk factors to the participants who are best able to manage those risks and thus minimize costs while improving performance....The transfer of risk for various elements has a value that must be quantified where possible."*

5.88 The provincial project objective regarding risk transfer was *"to share the risks of the Project between the private and public sectors."* The Province clearly specified the risks to be transferred to the private sector, and those to be retained by the Province, in a table near the front of the RFP document. That table divided project risks into four categories:

- development, design and construction risks;
- demand risks (related to tolling);
- operation and maintenance risks; and
- financing risks (related to debt issuance).

5.89 From our review of the risk transfer table with departmental staff, we feel that the RFP does provide for the transfer of significant additional risks to the private sector over the traditional DOT approach. However, we were not provided with analyses supporting the decision to transfer those risks on cost benefit or other bases, and we were unable to develop any substantive evidence supporting risk transfer decisions on our own. We had to rely on anecdotal evidence from the departments. Departmental representatives stated that they wanted risk to be assigned to the party best able to bear it, thereby lowering the overall cost of the project. They also indicated that all risk-transfer decisions were subject to intensive discussion between themselves and hired consultants prior to being made.

5.90 We were also unable to compute the ultimate cost of risks transferred or establish whether the cost was reasonable, except for the financing area. Results of that analysis are presented later in this chapter. Risk transfer as it relates to specific areas of the RFP is covered further in the sections that follow.

Development, design and construction risks

5.91 For this project the Province decided to transfer more risk to the private sector in this area than the traditional DOT practice. Normally design work, operations, and maintenance on highways in the Province are done separately, mainly by DOT staff. However, in the case of the Fredericton-Moncton Highway, the Province wanted to transfer risk by including all phases of highway work in the RFP. Aside from preliminary surveying work and preliminary soil tests, the RFP made bidders responsible for everything including final detailed surveys, soil tests, and all design work. There were also a few risks transferred in construction, most notably "weather risk" which was to be borne by the successful bidder, but is normally the responsibility of the Province. It was not possible to determine how much it ultimately cost the Province to achieve this degree of risk transfer as it was built into the MRDC bids for design-build and operations and maintenance. However, we feel that the decision to reduce risk by combining the design-build and maintenance components of the project into one agreement provides some protection for the Province against unforeseen future maintenance expenditures.

Operation and maintenance risks

5.92 We were told that the rationale for including operations and maintenance on the highway along with the design-build component was to reduce the risk to the Province of design or construction deficiencies. Design or construction deficiencies subsequently discovered would be the responsibility of the successful bidder under the operations and maintenance part of the agreement. That is because the exact amount to be paid by the Province, and the level of service to be provided, would have already been established.

5.93 Operations and maintenance agreements as proposed in the RFP were divided into two sections, highway operations and maintenance, and tolling operations and maintenance.

5.94 The RFP required a twenty-year time commitment from bidders to highway operations and maintenance. There were no analyses prepared supporting this position. However, departmental representatives indicated that the decision was subject to extensive discussion prior to being taken.

5.95 Our concern is that there are no hand-back standards in the RFP for the end of year 20, even though the initial maintenance agreement ends at that point. Hand-back standards were only set for the end of year 30 or in the event of a default by the successful bidder under the RFP. The successful bidder will continue to maintain the highway during years 21 to 30, but the cost schedule will have to be negotiated between the successful bidder and the Province at that time. Therefore, we feel that despite the standards that are to be met on a year-by-year basis as documented in the RFP, some risk remains that some maintenance activities will be postponed by the successful bidder until after the initial 20-year period has passed. Whether this will have a significant dollar cost to the Province during the period from year 21 to year 30 is not possible to estimate at this point. The Province expects that much of the major maintenance work required during the first 30 years will have been covered by the end of year 20 (e.g. replacement of bridge decks). However, if the intention of the RFP was to ensure that the Province got what it paid for (ie. a four-lane highway with a thirty year life) we feel that a thirty year highway maintenance agreement would have been more appropriate.

Recommendation

5.96 We recommend that where future public-private partnerships "bundle" construction and ongoing maintenance activities for bidding purposes, either:

- **a fee schedule for maintenance activities should be set at the beginning of the agreement to cover the term of the agreement; or**
- **hand-back standards should be included in the agreement for the date at which the initial maintenance agreement ends.**

Departmental response

5.97 *The optimal length of the initial fixed cost period for highway operations and maintenance was set at 20 years after lengthy discussions with the consultants. The difficulty of projecting maintenance costs so far into the future was recognized. Project staff and consultants agreed that a 20 year period was realistically the maximum time period that should be considered. It was agreed that a substantial premium would be paid for committing a developer to a longer term. Automatically setting the term of the fee schedule to match the term of the agreement could result in an arrangement that is not cost-effective.*

5.98 *While recognizing that there is risk in trying to look forward 20 or 30 years, the contract as you note does contain standards regarding ongoing maintenance and rehabilitation which protect the Province.*

5.99 The RFP also required a ten-year commitment from bidders for tolling operations and maintenance. The rates specified in the agreement covered that ten-year period. The rates for subsequent five year periods have to be renegotiated and the Province has the option of seeking an alternate operator of the tolling system after the first ten years of the agreement. The shorter time frame for tolling operations and maintenance was due to recognition of likely technology changes in future that would reduce costs. Since the Province assumed that costs of tolling would actually drop over time, they did not want to "lock in" tolling operations and maintenance payments over a longer term. Again there were no analyses supporting this decision. However, the verbal explanations we were given were reasonable.

Demand risks

5.100 The demand risks covered in this section refer to the risk that tolling revenues collected will not be as high as projected, thereby impacting on the availability of that stream of revenue for toll-based debt servicing and concession fees. This risk can be broken down into two components, the risk that there will be problems in collecting monies due, and the risk that traffic volumes will be lower than expected. We do not expect collection risk to be significant. However, we have some concerns regarding the conclusions drawn about traffic volume risk.

5.101 The planning estimate of likely toll revenue over the first 30 years of highway operation was $650 million. This revenue stream was to be used first as a source of funds with which to service the toll-based debt, and second as a pool of "excess toll revenues" to be paid to the Province as concession fees. Toll-based debt servicing was projected as totalling $329 million over that period. "Excess toll revenues" were estimated to be approximately $321 million.

5.102 A traffic study of the Fredericton-Moncton corridor by Wilbur Smith and Associates estimated that about 58% of toll revenues (i.e. about $377 million) will come from commercial traffic. The other 42% will come from non-commercial traffic. Since commercial traffic is obliged to use the toll highway, it is practical to assume that commercial toll revenue is guaranteed. Based upon these estimates, even if there was no non-commercial traffic, toll-based debt could be serviced. The effect of short term fluctuations in toll revenue would be mitigated by the tolling reserve fund which will be sufficient to cover one year of toll-based debt servicing and must be fully funded before excess toll revenues are paid to the Province. Even with the effects of a serious recession, we feel that a minimal level of non-commercial traffic would ensure sufficient revenues to cover toll-based debt servicing. Therefore, in our opinion, the possibility of toll revenues not being sufficient to cover toll-based debt servicing is remote. Consequently, we feel that little demand risk has been assigned to the toll-based lenders.

5.103 On the other hand, the Province loses $1 for every $1 drop in toll revenue from $650 million down to the $329 million required to service the toll-based debt.

5.104 This opinion contradicts what is documented in the RFP risk transfer schedule. It appears that the Province believed it was transferring significant demand risks to the toll-based lenders and had paid a risk premium on interest rates to cover that risk transfer. In fact toll-based lenders may well have built a very low risk premium into their interest rates relating to demand risk, although we have no way of confirming if that was the case. There is also no way to determine what effect a more equitable sharing of demand risks for the Fredericton-Moncton project would have had on the interest rates on the toll-based debt.

Recommendation

5.105 We recommend that care be taken in the RFP to accurately identify risks being transferred between the Province and their private sector partner pursuant to the terms of the RFP.

Departmental response

5.106 *Presenting the toll-based debt service and the estimated excess revenues in nominal dollars is misleading. These amounts are very different as the larger excess toll revenue amounts are in the later years. A net present value calculation for each would be more appropriate.*

5.107 *The comment that: "….it is practical to assume that commercial toll revenue is guaranteed." is incorrect. Although trucks are required to use the highway, the amount of toll revenue anticipated to be generated from trucks is only an estimate. The toll-based lenders are the only lenders who are bearing the demand risk. The only source of funds for the payment of interest and principal on their investment is the toll revenue. If there are not sufficient funds to pay those amounts, they will lose their interest income as well as their initial investment. Toll revenue in excess of that required to service the toll-based debt accrues to the Province since it is providing the right of way upon which the highway is being built.*

5.108 *Demand risk was transferred to the toll-based lenders as indicated in the RFP. The market is efficient and prices such risk. Had the market perceived that there was little risk transfer, the interest rate on the toll-based debt would have been lower.*

5.109 *The comments on demand risk also ignore the risk associated with any development of alternative transportation routes or methods.*

Financing risks

5.110 The terms documented in the RFP transfer some financing risk away from the Province. They require all debt funding for the project to be issued by a third party. They also specifically identify how the repayment of that debt is to be funded and when and under what circumstances repayments are to commence.

5.111 The lease-based debt was to be issued by the Project Company. The Department of Finance was to provide assistance in identifying parties willing to invest in the lease-based debt. It will be repaid commencing in November 2003 through sub-lease payments received from the Province. Provincial payments are subject to statutory appropriation, meaning that they do not have to be voted on by the Legislative Assembly each year. This constitutes, in effect, a guarantee to lease-based bondholders that the Province will make sub-lease payments regularly once the highway is completed. The Minister of Finance made the following statement in the Legislative Assembly on 19 December 1997 when referring to the lease-based debt. *"…. By doing it through statutory appropriation, we bring the risk down in the minds of the bankers and the bondholders. If it is done through statutory appropriation as opposed to yearly budgeting, there is a lower cost."*

5.112 The interest rate on the lease-based debt ultimately turned out to be 33 basis points above the provincial rate because it was issued by Project Company. The cost of this decision therefore turned out to be

$25 million in 1998 dollars, meaning that where Project Company was able to borrow $540 million, the Province would have been able to borrow $565 million with the same repayment schedule.

Departmental comments

5.113 *The interest rate on the lease-based debt issued by the Project Company was higher than the Provincial borrowing cost for a number of reasons: the lenders accepted completion risk, the issue contained an amortizing feature, the issue was relatively large, etc. It is therefore inappropriate to compare the issue to a typical Provincial debenture issue.*

5.114 The Province received two benefits from the decision to have lease-based debt issued by Project Company. First, they were able to transfer the risk of non-completion of construction of the highway to the bondholders. In other words, if the highway is not completed, the Province will not have to make scheduled sub-lease payments. Second, having the debt issued by an arm's-length organization (i.e. Project Company) and partially funded by revenue sources from outside the government was necessary to ensure that it would not show up as provincial debt for accounting purposes. There appears to be no ongoing financing risk transfer related to lease-based debt once construction of the highway is completed. However, interest rates will be higher for the duration of the repayment period.

5.115 The toll-based debt was to be placed by the successful bidder on behalf of Project Company. Toll-based debt was broken down into senior and subordinate groupings. The interest rates for senior toll-based debt totalling $149.5 million ultimately turned out to be 60 (for $138.0 million) and 100 (for $11.5 million) basis points above the provincial borrowing rate. The interest rates for the two groupings of subordinate toll-based debt totalling $25 million will be 286 (for $15 million) and 486 (for $10 million) basis points above the provincial borrowing rate when they are issued.

5.116 The Province received three benefits from the decision to have toll-based debt issued by Project Company. First, as for the lease-based debt, they were able to transfer the risk of non-completion of construction of the highway to the bondholders. In other words, regardless of whether the highway is completed or not, the Province will never be liable to make toll-based debt repayments. Second, the bondholders bear a small percentage of the traffic and collection (i.e. demand) risk as previously discussed, because the only source of funds for repayment of toll-based debt is toll revenue. Third, having the debt issued by an arm's-length organization (i.e. Project Company) and funded by revenue sources from outside of the government was necessary to ensure that it would not show up as provincial debt for accounting purposes.

5.117 MRDC arranged the toll-based debt structure. For its part, the Province has tried to make the toll-based debt issues as attractive as possible to potential lenders by managing construction risk through bonding, insurance, and developer selection, by establishing a clear tolling protocol and by pre-funding a debt service reserve fund before taking any concession fees.

5.118 As is now stated in the recently-released provincial guidelines for public-private partnerships, we feel that the optimal allocation of risk between partners in a public-private partnership must be based upon which partner is best suited to manage and/or mitigate each risk. We feel, in general, that the partner best suited to deal with risk will be the one who can deal with it on the lowest cost basis. On that basis, it appears that the Province was best able to deal with the financing risk on this project because it had access to the most favourable financing rates. The Province did receive some benefits from additional costs incurred and it did take all possible steps to lower financing costs. However, as analyses comparing the extra cost of funding with the benefits received were not prepared, we cannot confirm that the decision to have debt issued by a third party was appropriate.

Recommendation

5.119 We recommend that the Province prepare cost benefit analyses prior to making the decision to have project debt issued by third parties for public-private partnerships when financing costs will be higher than provincial rates. Specifically, the cost of higher interest rates should be compared with the benefits accruing from this decision.

Departmental response

5.120 *Consultants were hired to bring a broad based knowledge of the alternatives and the associated risks. The fact that the financing cost of the lease-based debt was higher than the Province's borrowing cost indicates that risk was transferred and that a cost was placed on that transfer by the market. Capital markets are viewed to be efficient; therefore the risk transfer was properly priced.*

5.121 In our 1998 Report we indicated we would try to determine the rationale and potential consequences of issuing most of the debt required for the project in advance. In fact, the model for the public-private partnership, as presented by RBC Dominion Securities Inc. in their 1996 interim report, actually recommended this approach. "…. *our financial model envisions borrowing 100% of the requisite debt at the outset of the project, to lock in current rates and to fully transfer financing risk away from the Province. There is a cost to the negative carry on undrawn debt, minimized by short-term investing and any tolls collected as segments of the road are opened.*"

5.122 The benefit of this decision to the Province was that it would lock in interest rates, thereby eliminating one aspect of financing risk for the project (i.e. the risk that interest rates would go up during the period when debt was being issued). Representatives of the Department of Finance informed us that this is no different than what the Province does on its own debt issues. This approach appears to be reasonable. It also appears, based on the statement by RBC Dominion Securities Inc., that the cost of this decision would be reasonable and manageable.

Other Issues

Minimum level of toll-based debt

5.123 The RFP required that the successful bidder guarantee the placement of at least 13% (i.e. $114.01 million) of the total capital cost of the project of $877 million as toll-based debt. The Province appears to have had three reasons for making this requirement:

- to transfer repayment risk in the event toll revenues would not cover toll-based debt repayment to the bondholders, thereby addressing the project objective of sharing risks between the private and public sectors;
- to ensure that the transaction was treated as an operating lease for accounting purposes, thereby addressing the project objective of not adding debt to the Province’s books; and
- to reduce the provincial sub-lease payment to Project Company to as low a level as possible, thereby addressing the project objective of minimizing the financial contribution of NBHC to the project.

5.124 We question the rationale for the decision to allow the successful bidder to issue more than the minimum required level of toll-based debt. Because of the way in which debt servicing payments are made, it appears that it will, in fact, increase net costs to the Province. By allowing additional, higher interest rate toll-based debt to be issued in lieu of the same amount of lower interest rate lease-based debt, the overall total cost of debt servicing is increased. Departmental representatives were unable to describe tangible benefits accruing from this decision.

5.125 Using actual numbers, a total of $174.5 million in toll-based debt has been or will be issued for this project. That means $60.49 million more toll-based debt than was required was placed by MRDC. To date $149.5 million of toll-based debt has been issued, $35.49 million over the 13% minimum. Based on the difference between the lease-based interest rate of 6.47% and the toll-based rates of 6.74% and 7.14%, the extra cost of financing has a net present value of $2.2 million in 1998 dollars. This extra cost figure will be substantially increased when the additional $25 million in toll-based debt is issued before the end of the construction phase of the project. That toll-based debt will bear interest rates of 9% and 11% and will be held by the successful bidder, MRDC.

5.126 Since the extra toll-based debt servicing cost comes directly from toll based revenues, it has the effect of reducing the excess toll revenues (i.e. provincial revenue) that would otherwise be paid to the

Province. This reduction in excess toll revenues will exceed the reduction in provincial sub-lease payments. Therefore, the net effect to the Province of this decision is negative. We feel that this effect would have been noted had a cost benefit analysis been prepared. However, such an analysis was not completed prior to the issuance of the RFP.

Recommendation

5.127 We recommend that cost-benefit analyses be prepared prior to finalizing RFP terms where they would provide significant decision-making information.

Departmental response

5.128 *The bidding structure allowed for as much toll-based debt as possible from an estimated stream of revenue. It was not known at the time of release of the RFP that Government would receive the excess toll revenue as bidders were given the opportunity to suggest a sharing arrangement for any excess toll revenue. None of the bidders proposed a sharing mechanism so any excess accrues to the Province.*

5.129 *Anticipated total toll revenue was based on estimates only and therefore there is no guarantee that the Province will receive any funds. However, the amount of lease-based debt is known and the annual sub-lease payment is fixed. Therefore, the risk and the cost to the Province are reduced by a lower amount of lease-based debt.*

Toll rates

5.130 Decisions relating to toll rates were intended to address the project objective of providing a high level of service to highway users at a low cost. They also addressed the objective of mimimizing the provincial contribution to the project. Decision-making with regard to toll rates appears to have adequately addressed applicable provincial project objectives.

5.131 In September 1996 ADI Limited was contracted to conduct a traffic study of the Longs Creek to Moncton corridor in conjunction with Wilbur Smith and Associates of New Haven, Connecticut. As part of their work, they suggested maximum toll rates for the Fredericton-Moncton Highway. A departmental representative told us that these rates were believed to be too high by the Premier and Minister of Transportation. Therefore the rates approved for inclusion in the toll protocol in the RFP were somewhat lower. At the time the RFP was being prepared, toll revenues to be collected over the thirty years of the sub-lease agreement were estimated to be $650 million.

5.132 As part of the decision-making process for toll rates, an analysis was prepared comparing proposed Fredericton-Moncton toll rates with those in other jurisdictions in North America. Proposed rates for the Fredericton-Moncton Highway equated to 3.5 cents per kilometre. This rate was comparable with other surveyed highways such as the Maine (3 cents per kilometre) and New Hampshire (6 cents per kilometre) turnpikes and the Coquihalla highway in British Columbia (5.1 cents per kilometre). Based on this analysis, proposed Fredericton-Moncton Highway toll rates appear to be reasonable.

5.133 RFP terms made the Project Company responsible for initiating toll rate increases. The RFP limited toll rate increases to 90% of the increase in the Consumer Price Index (CPI), and only allowed toll rate increases to be made after the highway was completed. The RFP also stated, *"The Project Company may choose to implement toll rates which are below those permitted under the Toll Rate Protocol, provided that such decisions achieve an objective of maximizing gross toll revenues net of collection costs."* So, once toll rate increases are permissable, Project Company must raise toll rates annually by 90% of the increase in the CPI unless they can prove that a lower or no increase will improve net toll revenues. Without such a term, Project Company would have had no reason to raise toll rates. Because toll-based debt repayment amounts are fixed over the life of that debt, we feel that 100 percent of the benefit of toll rate increases accrues to the Province.

Departmental comments

5.134 *The Project Company might default on the toll-based debt or the toll-based debt might not have been raised. The rate increases do not necessarily 100% benefit the Province. The increases in toll rates might or might not compensate in bad years for lower than anticipated volumes. Relating toll fee increases to changes in the NBCPI was part of the toll protocol considered by the lenders in pricing and sizing the toll-based debt.*

5.135 The Province cannot raise toll rates itself. However RFP terms require the maximization of toll revenues by Project Co., thereby covering fixed toll-based debt servicing requirements and maximizing concession fees to be paid to the Province. This RFP term therefore addresses the provincial project objective of minimizing the financial contribution of the Province to the project by maximizing the concession fee they will receive from Project Co. It also protects the interests of the toll-based lenders and would likely have had an impact on the interest rates they offered.

Concession fee

5.136 The RFP does not define the terms "concession fee" or "excess toll revenue." However, they are referred to in Section 4.4.3, *"Use of Toll and Ancillary Revenue."*

> *"Gross toll revenue and ancillary revenue will be available to service Toll Based Debt. Any toll and ancillary revenue not required to service the Toll Based Debt will be for the account of the Project Company. Such revenue net of payments made pursuant to any incentive arrangement will be used to reduce subsequent sublease payments by NBHC. ..."*

5.137 Departmental representatives explained that the concession fee is intended to be a way of making toll revenue not required for debt servicing available for provincial use. The concession fee was not just intended to be a fair market value payment for the use of the provincial land corridor upon which the highway is built. It is to pay for all rights conveyed to the Project Company with respect to the project. This becomes apparent when you consider that the total cost of land acquired for the highway by NBHC was in the range of $12.1 million, while the estimated concession fee over 30 years is $321 million.

5.138 During the construction period, excess toll revenues will be used to build up a reserve fund on behalf of toll-based lenders. The reserve fund is to be enough for two years' toll-based debt servicing during the construction period and one year's toll-based debt servicing when the highway has been completed.

Authorization of Project Decisions

5.139 In completing our review of decision-making for this project up to the Request for Proposals stage, we wanted to ensure that key decisions had been properly authorized. We feel that the recommendation to proceed to the RFP stage with a public-private partnership arrangement and the recommended contents of the RFP should have been prepared for submission to an authorizing body (Board of Management/Policy and Priorities Committee/Executive Council) in accordance with the *"Procedures Manual for Executive Council Documents."* Authorizing bodies should then have properly approved these recommendations.

5.140 In our review, we noted that the Board of Management and the Policy and Priorities Committee approved a recommendation from the Committee of Deputy Ministers to advance to the RFP phase with a short list of three potential private sector partners. However, only certain of the tolling requirements, as documented in the RFP, were approved by the Board of Management. Specifically, they approved the tolling protocol and certain other items pursuant to their approval of "Financial Parameters for the Fredericton to Moncton Project - Finance" on 27 February 1997. Otherwise, the contents of the RFP were not approved by the Board of Management or Executive Council. Those bodies relied on departmental staff and hired consultants to ensure the RFP contents were appropriate. We feel that Executive Council approval of the contents of the RFP prior to issuance would have been desirable in order to ensure that government objectives for this important project were properly reflected in the terms to be met by the bidders.

Departmental comments

5.141 *A number of presentations were made to Cabinet to keep them informed and to obtain approval at key points in the process. The material in the RFP is complex and involved several binders. The government depended on the experience of its staff and the experts it engaged for this complex project.*

New Government Guidelines

5.142 We were pleased to note that the Province released a document on 28 January 1999 entitled *"Public-private Partnerships (Guidelines* *and Protocols).”* Under the “guiding principles” section of that document, the following comments were made:

> *“As with any proposal, the first step is a full evaluation to determine whether it is a government priority. A public-private partnership may be pursued only after alternative methods of delivering the project have undergone careful evaluation, it has emerged as the best alternative, and where it offers the best solution demonstrated through a sound business case……*
>
> *All public-private partnerships will be based on the following guiding principles:*
>
> 1. *Project definition: the project is of sufficient size and/or complexity to provide opportunity for the private sector to demonstrate its initiative, innovation and expertise in providing best value to New Brunswick.*
> 2. *Competitive private sector market: sufficient qualified private sector proponents exist to ensure a competitive process.*
> 3. *Shared rewards: the public receives “value for money” from the initiative, while the private sector can reasonably expect to receive a fair return on its investment.*
> 4. *Premise of risk transfer: risks are allocated to the partner best suited to assume the risk.*
> 5. *Procurement process: must be fair and transparent and will be subject to due diligence.*
> 6. *Signed contract: the acceptance of a usually long-term relationship established through signed contractual arrangements.*
> 7. *Communications: a proactive, ongoing and transparent communications plan designed to keep people informed is implemented.”*

5.143 We feel that the document will provide a useful benchmark for future public-private partnership initiatives undertaken by the Province.

Conclusion

5.144 In June 1996, the government announced its intention to pursue a four-lane highway project between Fredericton and Moncton. In our opinion, the decision-making process after that date was effective in translating government objectives into specific requirements for the project. However, we are less comfortable with the process that lead up to the June 1996 announcement. Government objectives were set prior to that date which severely limited the ability of departmental staff to adopt flexible approaches in pursuing the project. Setting these objectives was certainly a very important part of the decision-making process for the project. For that reason we feel that objective-setting by the government should have been subject to the same rigor and analyses that was applied in later decision-making by departmental staff and consultants. We would encourage future decision-makers to adopt a more formal approach to decision-making and to adequately document the rationale for their decisions.

Appendix I

Fredericton-Moncton Highway Project Chronology

The provincial white paper *"Highways for the Next Century"* was released on 28 September 1993. It formally introduced the idea that the government of New Brunswick would be considering partnership arrangements with private sector interests to build and finance certain portions of planned highways. It also indicated that the government would actively pursue the implementation of tolls on portions of new highways so that traffic which benefits from the new transportation links would share in the cost of the project.

The final report of the Select Committee on New Brunswick's Highway Policy (All party committee) was presented on 8 April 1994. The Committee recommended that appropriate funding mechanisms to allow the completion of the national highway system be determined and agreed upon in the near future. They also recommended that the Province obtain a significant commitment of funds from the federal government.

In June 1994, the report *"Feasibility Study for Toll Highways and Private Sector Involvement for Highway Development in New Brunswick"* was completed for the New Brunswick Department of Transportation and the New Brunswick Department of Finance by ADI Limited, Price Waterhouse, and Transroute Consultants. It was prepared to examine the feasibility of toll highways and private sector involvement in highway development in the Province.

The Act creating the New Brunswick Highway Corporation was signed by the Lieutenant Governor on 29 March 1995. The Act introduced the concept of tolling into legislation. NBHC was intended to be abusiness enterprise established to design, construct, operate, maintain, toll and own certain highways. We made some comments relating to the intended purpose of NBHC in our 1995 Report.

The routing decision for the Fredericton-Moncton Highway project was announced on 11 June 1996. The Lieutenant Governor in Council approved the Trans-Canada Highway routing presented and studied in the Environmental Impact Assessment with certain provisos.

The official announcement that the project would proceed was made on 14 June 1996. It was announced that the four-lane section between Longs Creek and Moncton would be completed by 2000. It was also announced that RBC Dominion Securities Inc. had been engaged by the Province to do a financial feasibility study of the project. The Province identified federal-provincial funding as the preferred option. In the absence of federal funding, it was indicated that the Province was prepared to look at other options such as a public-private partership, tolls and/or gasoline and diesel fuel taxes.

On 26 June 1996, the Board of Management and Executive Council approved the engagement of RBC Dominon Securities Inc. to analyze the feasibility of applying a public-private partnership approach to the proposed Fredericton-Moncton Highway project. RBC Dominion Securities Inc. was provided with the following fiscal objectives of the Province, which had to be met by any proposed structure.

They were:
- to avoid an increase in provincial debt;
- to achieve a reasonable cost of funds; and
- to achieve an optimal degree of risk tranfer to the private sector.

On 2 July 1996 the Project Office was set up for the Fredericton-Moncton Highway project and various experts from across government were seconded to the project. Until that time, departmental involvement in the project had been limited to that of senior civil servants.

During summer and fall of 1996, four other key specialist consultants were retained including KPMG (public-private partnership process), Delcan (engineering), Goodman Phillips & Vineberg (legal), and Washburn & Gillis (environmental).

In September 1996 ADI Limited was contracted to conduct a traffic study of the Longs Creek to Moncton corridor in conjunction with Wilbur Smith and Associates of New Haven, Connecticut. The Toronto-based IBI Group was also involved.

The interim report on the Fredericton to Moncton Highway project for the Province of New Brunswick was issued by RBC Dominion Securities Inc. on 28 October 1996. It presented three structuring alternatives and indicated RBC Dominion's recommended proposal (a carefully-structured public-private partnership) that has subsequently been implemented.

A Request for Qualifications (RFQ) was issued on 18 December 1996 to identify parties qualified to partner for the project. At the time of the announcement of the RFQ, the Ministers of Transportation and Finance indicated that a public-private partnership approach had been selected. They also indicated that the highway would include user tolls. The revised deadline date for completion of the highway was announced as 2001.

By the deadline date of 23 January 1997, five RFQ submissions had been received. Four evaluation teams of government staff and consultants had been established to evaluate the five responses received to the RFQ. The teams included a development team, a technical team, a financial team, and an operational and maintenance team.

All four evaluation teams signed off on their evaluations of the five proposals on 19 February 1997. The Steering Committee also signed off, approving the advancement of three proponents to the RFP stage on the same date. The Steering Committee was primarily composed of senior officials from the Department of Transportation, but also included representatives of the Department of Finance.

The Committee of Deputy Ministers signed off approving the advancement of three proponents to the RFP stage on 21 February 1997. This committee was established for review purposes and was made up of the Deputy Ministers of Transportation, Finance, Justice and a senior representative from the Premier's Office.

On 25 February 1997, the Board of Management and Policy and Priorities Committee recommended to Executive Council that a shortlist of three proponents advance to the RFP stage in accordance with the process identified in the RFQ document. Included in the shortlist were the Maritime Highway

Corporation, the Maritime Road Development Corporation, and Peter Kiewit Sons Co. Ltd. The Executive Council approved the advancement of the three proponents to the RFP stage on the same date and a public announcement of the shortlist of proponents was made.

On 27 February 1997, the Board of Management and Executive Council approved the following financial parameters for inclusion in the RFP.

i) A ban on through trucks on the existing Trans Canada Highway. Special permits for trucks with local business.
ii) Government will make the Province's sub-lease payments a statutory appropriation.
iii) An initial minimum toll for trucks of $22 one way.
iv) An initial toll for cars in the range of $6.75 to $7.00.

A final traffic study report was issued by ADI Limited on 21 March 1997. It indicated the most likely toll revenue for the first 30 years of the sub-lease would be in the range of $650 million.

A Request for Proposals was issued to three short-listed proponents on 27 March 1997. On that same date an Order in Council proclaimed changes to the New Brunswick Highway Corporation Act and stated that the changes would come into force as of 27 March 1997. These changes gave NBHC the ability to contract with a private partner.