**Résidence Saint-Charles Relocation Project**
**(Québec-Sud)**

**Comparative study**
**of the traditional approach and the P3 option**
**by Mallette Services-conseils**
**(November 23, 2004)**

# HIGHLIGHTS AND COMMENTS

**By the**
**Research Branch (Contracting-out and Privatization)**
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## 1. Nature of the project

Construction of a CHSLD-type building to relocate the Résidence Saint-Charles based on the following parameters:

132 beds
Day center with a 50-'client' capacity
CLSC Limoilou point of service

Total space: 12,880 square meters

## 2. Terms of reference of Mallette Services-experts

Mallette: Consulting firm operating mainly in Quebec's eastern market (Quebec City, Saguenay, East and North-East of Quebec)

Client: Québec-Sud Health and Social Services Centre (CSSS)

Subject: Compare two options for the execution of the real estate project

a) traditional approach (public design, funding and operating), or

b) B.O.T. (build – operate – transfer)-type public-private partnership (P3) through which the private company builds, operates and funds the project and then transfers it to the public agency at the end of a 25-year contract. The public agency is responsible for health care and pays a rent (user charges) to the private company that operates and maintains the building.

Exclusion:

- Land acquisition (already owned by the Corporation d'Hébergement du Québec);
- Building design (pre-defined plans and specifications)

## 3. Method: Survey of potentially interested private companies

## 4. General comments of surveyed companies

- Project too limited:
    - The notion of transfer after 25 years lessens the interest for the private investor;

    - Pre-defined plans and specifications limit the efficiencies that could be generated during the construction phase by reducing, for instance, common areas (such as rest or reception areas) or by optimizing the private partner's existing real estate stock. The companies want to be involved in the design.
- Lack of interest in a bidding process involving the design phase:
    - Costly process (5 to 10% of a project's costs)
    - Loss of competitive edge (proposals are open to competitors)
- No benefit in including additional services (food, parking, laundry, etc.) in the P3. They only want the real estate aspect, all the rest would be contracted out as the public sector already does, according to them.
- The requirements for maintaining the building's quality could cancel any efficiencies in the construction costs.
- Return expected on the invested capital: 5 to 25% depending on the partner.
- Financing costs (loans): impossible to get a better rate than the government.

## 5. Risk transfer to private partner

Save for the construction cost estimates set at the signing of the contract, the study estimates that the risks are the same with the traditional and P3 options.

Assessed risks

- Design:

  Responsibilities are borne by the contractors (architects, engineers) as with the traditional approach;

- Construction:

  Except for the initial cost estimate, risk sharing is the same with the P3 as with the traditional approach for all other aspects of the construction phase.

  Examples of risks: delays in project delivery, unforeseen site conditions, site safety, neighbour claims, major force, legislative changes, taxation changes, poor project management, strike, etc.

  However, the authors estimate the risk of cost overruns with the traditional approach to be 24% of the initially established costs.

- Availability and performance:

  Risk sharing is identical with both options.

  Examples of risks: hidden defects, changes in the required specifications, poor management from a contractor, employees' failure to perform due to job action, failure to meet standards.

- Operating:

  No real advantage for the public since any increase in operating costs would result in the negotiation of a rent increase.

  Examples of risks: inaccurate service provision cost estimate, legislative changes, service taxation, energy efficiency standards, user injury.

- Variability of revenue:

  No risk with the traditional approach.

  Little or no risk with a P3 for the private partner since the government's rent is guaranteed for the duration of the contract on a pre-evaluated basis by the private partner.

- Early termination of contract:

  No risk with the traditional approach.

  Additional risk for the public sector with P3 (private partner can claim compensations).

- Technology and obsolescence:

  If the assets maintenance requirements are the same, the costs will be the same with both approaches.

- Reassignment of current human resources:

  The "union" risk is entirely borne by the public sector, who will be responsible for reassigning current employees (support and maintenance) elsewhere in the system or as part of an agreement with the private partner.

6. **Comparative costs of the Résidence Saint-Charles (CHSLD) project: P3 and traditional options (Scenario 1)**

## P3:

Assumptions:

- Project cost estimate: $17,565,514.00 + taxes = $20,204,732.00
- Life of P3: 27 years (construction = 2 years and operating = 25 years);
- Professional fees = 12% of costs before overhead and profits
- Total financing needed for construction costs, professional fees and transfer tax (property taxes) : $22,511,688.00
    - Capital invested by private partner:

      10% of total costs = $2,271,169.00

      Return rate estimated by Mallette: 12.5% annual;
    - Bank financing by private partner:

      90% of total costs = $20,240,519.00

      Loans in 2 phases:

      1st year: 40% = $8,176,208.00

      2nd year: 60% = $12,264,311.00

      Financial rate estimated by Mallette: 6.0%

      Repayment over 27 years
- Nominal value at the end of the contract (transfer to public agency): $1

Rent and taxes to be paid by the CSSS de Québec-Sud based on the above assumptions:

- Base rent estimated by Mallette to be paid by the public agency (CSSS de Québec-Sud) to the private owner, based on the foregoing:

  $155 per square meter adjusted at 10% at the end of the 5th, 10th, 15th, and 20th years.

  Total: $60,941,105.00$ over 25 years

- Additional rent (maintenance and operating) estimated by Mallette to be paid by the public agency to the private owner:

  Year 3: $113 per square meter adjusted each year to the target inflation rate estimated at 2% (excluding escalating clauses)

  Total: $46,618,348.00 over 25 years

- Taxes (GST and PST) due by the CSSS on the rents paid to the private partner:

  Taxes (GST + PST) : $16,160,808.00

Results for P3 project (based on Mallette's assumptions):

- In terms of costs borne by the CSSS de Québec-Sud:

  Total over 25 years: $**123,720,607.00$**

  Net current costs* (rate = 6%): $**56,625,370.00$**

  * After subtracting $4,595,515.00 in current value, recovered by the Quebec Government as taxes (PST) and income taxes.

- In terms of net profit after tax for the private partner:

  Total over 27 years: **$25,824,321.00**

  Net current value (rate = 12.5%): **$6,300,523.00**

## Traditional approach:

Assumptions:

- Estimated project costs: $17,565,514.00 (taxes non applicable)
- Duration contemplated by the study: 27 years (including 2 years for construction)
- Professional fees: 12% of costs before overhead and profits
- Management costs incurred by the CHQ: 1.5% = $263,483.00
- Total financing required for construction costs, professional fees, transfer taxes and management costs: $20,042,705.00

- Capital invested by the public agency:

  0% of total costs

- Bank financing by Financement Québec:

  100% of total costs = $20,042,705.00

  Loans in 2 phases:

  1st year: 40% = $8,017,082.00

  2nd year: 60% = $12,025,623.00

  Rate effective at the time of the study: 6.0%

  Repayment over 27 years

Rent and taxes to be paid by the CSSS de Québec-Sud based on the above assumptions:

- Base rent paid by the public agency (CSSS de Québec-Sud) equal to debt servicing (capital and interests):

  $118 per square meter over 25 years

  Total: $39,983,761.00 (= capital and interests over 27 years)

- Additional rent (maintenance and operating) based on Malette's assumptions:

  Year 3:$130.43 per square meter adjusted each year to the target inflation rate estimated at 2%

  Total: $53,807,557.00 (over 25 years)

- Taxes (GST and PST) payable by the CSSS: $0

Results for the traditional approach (based on Mallette's assumptions):

- In terms of net costs to be paid by the CSSS de Québec-Sud

  Total over 27 years: **$93,791,318.00**

  Net current costs (rate = 6%): **$42,245,478.00**

- In terms of net profits after taxes for the private partner:

  Total over 27 years: **$0**

  Net current value (rate = 12.5%): **$0**

## CONCLUSION FOR SCENARIO # 1:

Total costs (over 25 years) for the CSSS de Québec-Sud depending on the construction and operating scheme chosen for the Résidence Saint-Charles:

| | Nominal value | Actualized value |
|---|---|---|
| P3 | $123,720,607.00 | $56,625,370.00 |
| Traditional | $93,791,318.00 | $42,245,478.00 |
| Difference in $ | $29,929,289.00 | $14,379,892.00 |

Based on the Mallette study assumptions, it would cost **34%** more to taxpayers if the government decided to carry out the CHSLD project as a public-private partnership (excluding the high costs of negotiating a P3 contract).

## COMMENTS ON SCENARIO # 1:

### Assumptions unfavourable to the traditional approach

Mallette estimates that the Résidence Saint-Charles construction and operating project costs for the CSSS Québec-Sud would be 34% higher with a P3, in spite of several questionable assumptions by Mallette in favour of a P3 approach.

1. Expected return on the capital invested by the private partner:

   Mallette establishes the return expected by the private investors at only 12.5%. But most studies estimate this return at 15 to 25%. For instance, the Healthcare Infrastructure Company of Canada consortium – HICC – for the P3 hospital in Brampton, Ontario, expects a return on invested capital (equity) of 17.725 %!

In addition, by limiting the share of the capital invested by the private partner to 10%, the Mallette study ensures the main source of P3 costs is reduced to a minimum. In comparison, the capital invested by HICC in Brampton's P3 hospital is 15% of construction costs.

2. Bank financing rate:

   Mallette estimates that a 6.0% bank financing rate would be granted to private investors, the same as for the Quebec Government. But even the surveyed companies admit that it would be impossible for them to get a better deal than the governement in terms of bank financing costs. And every study shows that the rate for private companies in P3s is 1 to 3 % higher than for the governement. For example, again with the P3 hospital in Brampton, the bank financing rate extended to HICC was 1.17 % higher than for the Governement of Ontario at the same time (6.73 % compared to 5.56 %).

3. Maintenance and operating costs:

   Without any explanation, Mallette estimates the maintenance and operating costs for the private partner at only $1,455,445.00 for the first year of the project (year 3 of the project) compared with $1,679,895.00 for the traditional approach. This difference, combined with inflation (2%) for the duration of the project (25 years), creates a bias of $ 7,189,209.00 in favour of the P3 option.

Given the above, one can safely say that if Mallette's assumptions had been closer to the reality observed in other P3 projects, the cost increase of the P3 option for taxpayers would be closer to 50% than 34%.

The Mallette study examines, rather unconvincingly, three other scenarios that are likely to reduce the edge of the traditional approach over the P3 option, none of which make much sense.

## SCENARIO # 2:

### Risks due to construction costs overrun with the traditional approach

In an attempt to further reduce the edge of the traditional option, Mallette creates a second scenario in which the cost overrun risks and delays due to the public management of the construction project are

given a value of 24% of the construction costs. This is the only risk the study was able to show with the traditional approach and it is given the highest possible value. Indeed, the estimated value of such a risk is between 2% and 24% in other studies cited by Malette.

With this catastrophic scenario, Mallette manages to hike the actualized costs of the traditional approach to $44,331,437.00. But we are still far from the $56,625,370.00 a P3 would cost.

On the other hand, Mallette fails to integrate the major cost inflation between the initial bidding process and the final contract with the chosen private partner. This totals 53% for Brampton's P3 hospital and 70% for the P3 pavillion of the Royal Ottawa Hospital in Ontario.

## SCENARIO # 3:

### Potential cost reductions with the P3 construction project

Mallette examined a third scenario, whereby the private partner would be involved in the designing phase by reducing, for example, the rest and reception areas as well as other common areas, as suggested by the surveyed companies.

Whereas the surveyed corporations themselves only give a potential value of 10 to 15% for efficiencies in the construction costs to such a scenario, Mallette estimates them at 20%. Even with this generosity, actualized costs of the project with a P3 would only be reduced to $50,095,990.00, a figure still much higher than the $42 million estimated for the traditional approach.

## SCENARIO # 4: THE DEFINITIVE NONSENSE

From Mallette's own point of view, if a CHSLD project such as the Résidence Saint-Charles is to be as interesting for the CSSS de Québec-Sud (and the taxpayers) with a P3 as it would be with the traditional approach, both following conditions must be met:

First condition:

The private partner must expext a much lower rate of return than usual for its invested capital. This factor has the greatest impact on the value differential between a P3 and a traditional approach.

With the Résidence Saint-Charles project, if the return expected on the $2.2 million invested by the private partner (representing only 10% of total construction costs) went from 12.5 % to 5% (lower that the government's financing rate), the project's current costs would fall to $13,082,447.00 !!!

But event this reduction in the private capital's return would not be enough to make the P3 option more profitable than the traditional approach: $43,542,923.00 compared to $42,245,478.00 for the traditional approach.

Second condition:

The P3 construction costs must be 20% lower than the traditional approach.

Combined with the drastic reduction of the private capital investment return, the reduction of the construction costs would lower the P3 option's actualized costs to $39,819,712.00, a saving of hardly 5 % compared with the traditional approach.

(Editor's note: such a decrease of construction costs is very unlikely, unless the project itself is significantly reduced, in which case the comparison is useless).

## CONCLUSION

The comparative study of the P3 and traditional approaches for the relocation of the Résidence Saint-Charles carried out by the consulting firm Mallette on behalf of the CSSS de Québec-Sud is a blatant demonstration that the claims of the privateers of public services are baseless.

In spite of assumptions that are as unlikely as they are biased in favour of P3s (under-estimation of expected return, bank financing rate and operating costs), the Mallette firm only succeeds in showing that the traditional approach (public funding, ownership and operating) is by far better for taxpayers than a P3 solution.

According to the Mallette study, over a period of 25 years, the current cost estimate per bed at the Résidence Saint-Charles (132 beds) would amount to almost $430,000 with a P3 compared to $320,000 with the traditional option, an unjustifiable difference of $110,000 per bed.

The publicly avowed goal of Treasury Board Chairperson Monique Jérôme-Forget is to build or renovate up to 5,000 beds in CHSLDs through P3s. Given the Mallette study, one might think that she is considering a transfer of at least half a billion dollars more from the taxpayers pockets to big business investors.

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