

Chapter 4

Section 4.03

Brampton Civic Hospital Public-private Partnership Project

Follow-up on VFM Section 3.03, *2008 Annual Report*

Background

In 2001, the then Minister of Finance announced that public–private partnerships (P3s) would have to be considered when funding new hospitals. In 2003, William Osler Health Centre (WOHC)—now known as William Osler Health System—reached an agreement with a private-sector consortium for the development of a new 608-bed hospital in Brampton using the P3 approach, one of the first Ontario hospitals to do so. (In Ontario, this alternative to traditional procurement is now known as Alternative Financing and Procurement—AFP.) Under this arrangement, the consortium would design, construct, and finance the new hospital as well as provide certain non-clinical services. In return, WOHC agreed to pay the consortium a monthly payment over the 25-year service period of the arrangement.

The government of the day directed WOHC to follow the P3 approach before any formal comparison between it and the traditional design-build-operate approach was done. We concluded that the assessment that was done had not been based on a full analysis of all relevant factors and was done

too late to allow any significant changes or improvements to be made to the procurement process.

Over the approximately three-year construction period from 2004 to 2007, the total capital cost of the hospital came to \$614 million, comprising \$467 million in design and construction costs for the hospital, which was built on a reduced scale; \$63 million primarily for facility modifications (mainly to accommodate equipment installation); and \$84 million in financing costs.

We identified a number of issues in our *2008 Annual Report* that indicated that the all-in cost could well have been lower had the hospital and the related non-clinical services been procured under the traditional procurement approach. Our findings at that time included the following:

- A consulting firm engaged by WOHC estimated in September 2000 that the cost for the government to design and build a new hospital would be approximately \$357 million (updated to \$381 million in October 2001). A second consulting firm was engaged in January 2003 and estimated a cost of \$507 million (updated in November 2004 to \$525 million). WOHC did not question the large difference in the two estimates.

- The cost estimates for the government to construct the new hospital and to provide the non-clinical services the traditional way over 25 years were significantly overstated, in that depreciation was inappropriately included as a non-clinical service cost, as were utilities and property insurance—which WOHC would be responsible for regardless of who provided the non-clinical services.
- WOHC added to the estimates for the government to design and build a new hospital an estimated \$67 million, or 13% of the estimated total design and construction cost, as potential savings because the risk of cost overruns had been transferred to the private sector. We questioned the inclusion of such a large amount because a properly structured contract and sound project management under a traditional procurement agreement could have mitigated many of the risks of cost overruns.
- The province's cost of borrowing at the time the agreement was executed was cheaper than the weighted average cost of capital charged by the private-sector consortium—yet the impact of these savings was not included in the comparison costs between the traditional procurement and the P3 approach.

As with any new process, we recognized that there were inevitably lessons to be learned. In responding to our recommendations for future P3 projects, Infrastructure Ontario—the Crown agency established in November 2005 to manage many large government infrastructure projects—and its ministry partners indicated that most of the issues we raised were being handled differently from the WOHC P3 process to better ensure the cost-effectiveness of current projects.

The Standing Committee on Public Accounts held a hearing on this audit in March 2009.

Status of Recommendations

The Brampton Civic Hospital project was started before the creation of Infrastructure Ontario, and management of the P3 project was handled by WOHC. In response to our initial observations and recommendations, Infrastructure Ontario indicated that a number of the recommendations were already being addressed by processes it had put in place. Our follow-up focused mainly on changes that have occurred since the initial response in 2008. According to the information we received, Infrastructure Ontario and the Ministry of Infrastructure (known as the Ministry of Energy and Infrastructure prior to August 2010) have substantially implemented many of the recommendations in our *2008 Annual Report* that, if followed, would help to ensure the cost-effectiveness of current and future AFP projects. The status of the action taken on each of our recommendations at the time of our follow-up was as follows.

RECOMMENDATIONS FOR FUTURE P3 (AFP) INFRASTRUCTURE DEVELOPMENT PROJECTS

Decision to Adopt P3 (AFP)

Recommendation 1

The costs and benefits of all feasible procurement alternatives should be evaluated. Consideration should be given to expanding the involvement and expertise of Infrastructure Ontario to all infrastructure projects.

Status

Infrastructure Ontario indicated to us that the Ministry of Infrastructure recommends investment in particular projects through the government's annual budget planning process. The Ministry of Infrastructure provides ministries that are proposing capital projects with a technical guide that outlines early project assessment criteria against

which potential projects must be evaluated for AFP suitability. These criteria are used to make recommendations to Treasury Board of Cabinet on whether further work should be undertaken to assess a project's suitability as an AFP project.

Infrastructure Ontario conducts three value-for-money (VFM) assessments at different stages on every project that is assigned to it. These assessments compare the costs and benefits of a traditional procurement approach with an AFP approach in each assigned project. The first assessment takes place before the request for proposals (RFP) is released. According to Infrastructure Ontario, some projects that were identified as candidates for AFP have been reassigned to traditional procurement once this VFM assessment has been completed.

Recommendation 2

Before a decision is made to enter into an AFP arrangement, a comprehensive market assessment should be carried out.

Status

According to Infrastructure Ontario, a market assessment is routinely conducted before it proceeds with any project procurement. Infrastructure Ontario's staging plan is reviewed in light of the market assessment to take into account the market capacity of contractors, lenders, investors, skilled labour, and maintenance services.

For projects involving markets with which it has had limited experience, Infrastructure Ontario typically hires an external consultant to conduct a market assessment and to build Infrastructure Ontario's expertise to assess such projects effectively. Once this formal market assessment has been done, market assessments for similar projects are conducted internally.

Infrastructure Ontario indicated that evaluators' guidelines used in its request-for-qualifications process recognize bidders' AFP or other relevant experience, including experience outside Ontario and abroad, as fully weighted qualifications. This has allowed medium-sized firms, as well as inter-

national firms in joint ventures with local firms, to qualify to compete for and be awarded Infrastructure Ontario projects.

Value-for-money Assessment

Recommendation 3

Value-for-money assessments should have relevant and clear criteria, and should be conducted at the earliest stage of the procurement process.

Recommendation 4

Comparing costs under the traditional approach and the AFP approach should be an objective process to reduce the risk of any bias in comparison.

Status

VFM assessments are conducted at three stages during the procurement process: before release of the RFP, before awarding the contract, and after financial close. Infrastructure Ontario's VFM methodology calculates and compares the total discounted cost under traditional and AFP approaches. The calculation is intended to include all tangible costs as well as the value of potential risks of each approach. In this regard, Infrastructure Ontario recently undertook a review of its database of received bids and concluded that the risk premium added is a reasonable estimate. The overall criterion for the VFM assessment is the total discounted cost, and the approach that produces the lower total discounted cost is the one recommended.

Infrastructure Ontario indicated to us that, to ensure objectivity, the VFM methodology uses actual cost information from the bidders, and that published VFM reports are based on the actual total discounted cost of the project as of financial close. For each identified risk, after the probability and impact of occurrence are assessed, the cost of the risk is quantified using a computer simulation and the results are included in the overall cost of both the traditional and AFP approaches. Infrastructure Ontario indicated that it will continue to update its database on the risk premium used as each additional project is closed.

All anticipated costs and risks used in the VFM assessments are documented and reviewed by third-party advisers. Infrastructure Ontario also indicated that the Ministry of Finance Internal Audit Division had reviewed the VFM methodology and found it to be sound.

In early 2010, Infrastructure Ontario contacted other Canadian jurisdictions to review their methodologies for calculating VFM. These efforts allowed Infrastructure Ontario to validate its VFM methodology and procurement decision processes.

Recommendation 5

Appropriate and timely action should be taken on issues raised during the due-diligence process.

Status

Infrastructure Ontario indicated that it has established a process and project governance structure that manages and monitors key project approvals and related decision-making. It includes procedures to review, document, and follow up on lessons learned from project to project. In addition, management monitors project-related issues through various working groups and project reporting to ensure their timely resolution.

Recommendation 6

To ensure that all options are adequately considered, the decision to build and the decision to finance should be evaluated separately.

Status

The Ministry of Infrastructure evaluates individual projects against policy priorities, and investment decisions are made independently of decisions on procurement alternatives. Infrastructure Ontario has developed and published a standard VFM methodology that considers financing costs under both models—AFP and traditional procurement. The procurement decision is supported by the VFM assessment as performed by Infrastructure Ontario.

Recommendation 7

In assigning transferable risks, all relevant factors, including those that mitigate the risks, should be con-

sidered. As well, actual experience from previous AFPs should be applied wherever possible. The transfer of risk should be supported by the terms of the project agreement.

Status

Infrastructure Ontario indicated that it uses a risk allocation matrix based on empirical data to assign and quantify the risks retained under AFP and traditional procurement. The risks identified for a particular project are consistent with the risks identified for other similar projects. Risks would vary in probability of occurrence and impact depending on the nature of the project and the extent of Infrastructure Ontario's prior experience with such projects.

Infrastructure Ontario's project agreements are standardized so that the risk-transferring provisions are consistent among the various projects. Infrastructure Ontario indicated that where lessons were learned on earlier projects, agreements subsequent to those were revised to reflect this.

Recommendation 8

All significant costs of AFP should be assessed in the decision-making process.

Status

As part of the VFM assessment of procurement alternatives, Infrastructure Ontario includes the total costs of AFP, including transaction costs, financing costs, and contingencies. These costs are based on actual information contained in the bids received. The specific costs taken into account in the assessments include private-sector financing, private-sector contingencies, bid costs, and advisory fees. In addition, VFM assessments incorporate other project-specific costs not charged by the bidder in the form of ancillary costs, such as legal, consultant, and Infrastructure Ontario costs.

Advisers

Recommendation 9

To ensure that advisers are retained at the best possible price, a competitive selection process should be followed. The assignments should be defined with contracts that stipulate the exact deliverables. The work of the advisers should be monitored and a process put in place to ensure knowledge transfer.

Status

Infrastructure Ontario indicated that its procurement policy is consistent with the Management Board of Cabinet Procurement Directive. It specifies that, whenever possible, all contracts for advisers are to be procured as fixed-price contracts. A competitive process, either open competitive or invitational RFP, must be used for consulting irrespective of the value of the contract.

According to Infrastructure Ontario, advisory costs per project have continued to trend lower, dramatically in many instances. Additional savings have been achieved by bundling projects together and having internal staff take over capital market adviser positions.

Infrastructure Ontario informed us that the project governance structure is set up to review and document issues and to ensure that lessons learned are followed up on from project to project.

Contract Management

Recommendation 10

Hospitals should have adequate procedures in place to verify the performance of contractors. Any resulting adjustments to the unitary payment should be made on a timely basis.

Status

Infrastructure Ontario published a user guide in 2009 in order to support the hospitals in monitoring the performance of their contractors. Additionally, Infrastructure Ontario has expanded the term of its project delivery teams to enable them to

continue monitoring construction projects up to their completion.

William Osler Health System has developed and put in place the following procedures to monitor contractors' performance: Available in-house legal counsel and a designated director are responsible for liaison with the private sector for any issues that may arise. A dedicated analyst is used to review unitary payments to private contractors. Monthly meetings and reviews of operational and volume information are held with private contractors to review their performance. A parking, security, inventory, and environmental compliance review was recently completed for the 2009/10 fiscal year.

Local Share of the Capital Cost

Recommendation 11

Before granting approval for a new hospital, the government should carry out a more comprehensive assessment of whether the hospital has a realistic plan for raising its agreed-to local share of the funding.

Status

Each major health capital project has at least one local share plan, as required by the Ministry of Health and Long-Term Care (MOHLTC), that documents the hospital's analysis of how it intends to raise the local share of the cost of a proposed capital project. According to MOHLTC, the plan must contain sufficient detail to enable the Ministry to understand the risks, terms and conditions, and assumptions pertaining to the hospital's source of funds, and must be consistent with the hospital's plan for a balanced budget. MOHLTC reviews the local share plans for risks to providers' operations, risk mitigation strategies, and affordability to the local community.

In addition, hospitals are required to sign a Development Accountability Agreement that holds them accountable for securing and paying the local share of costs. Specifically, the agreement contains requirements for the management of a sinking fund by the hospital and a trustee. According to

MOHLTC, these measures, now in place with respect to all approved major health capital projects, help to mitigate the risks of hospitals not being able to fund their local share of project costs.

Accountability and Transparency

Recommendation 12

To ensure transparency, Infrastructure Ontario should establish and communicate a policy on disclosure of AFP information.

Status

Infrastructure Ontario indicated to us, as it did in 2008, that its disclosure policy is based on the principles of transparency outlined in the government's Building a Better Tomorrow framework. All requests for qualifications are posted on MERX, and all RFPs, project agreements, and VFM reports are posted on Infrastructure Ontario's website.