New and Improved: How Institutional Investment in Public Infrastructure can Benefit Taxpayers and Consumers

Institutional investors have a strong desire to invest in both existing and new Canadian infrastructure. Governments at all levels need to create the right conditions to build more infrastructure and improve existing assets using private investment.

Benjamin Dachis
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The Study In Brief

Canadian governments are on the verge of the largest infrastructure spending increases in decades. The challenge for policymakers at all levels of governments is to decide whether they should seek more private funding.

Canadian institutional investors – notably the seven largest Canadian public pension plans as well as global investors – are looking to participate in new user-fee-supported infrastructure: both in existing assets and in new projects. To provide Canadian retirees with the best possible returns, Canada’s largest pension plans have invested $87 billion of their $1 trillion-plus in assets in infrastructure, but mostly abroad. Meanwhile, Canadian and foreign institutional investors such as pension funds and insurance companies would likely place a high value on Canadian user-fee financed infrastructure, but Canadian governments have opened few opportunities for such investment. Indeed, this Commentary argues that government ownership of infrastructure has led to inefficient management, poor project selection, and higher risks on taxpayers disguised by low government borrowing costs.

To provide opportunities for investors to meet beneficiaries’ needs through financing infrastructure, Canadian governments should create policies that support institutional investment in both existing assets and for new infrastructure. Existing government-owned, user-fee-financed assets offer the greatest potential for government revenue from asset sales, including partial sales in which governments retain economic control. Governments could use the proceeds from such institutional investment to fund new infrastructure – particularly social-service infrastructure like schools and hospitals and other non-fully-self-financing infrastructure – alongside institutional investors. Taxpayers would benefit from better use of existing assets, as would users of more efficient infrastructure.

The federal government recently announced plans to create an infrastructure bank that it would initially bankroll, but with a mandate to foster institutional investment capital for new public infrastructure. It is critical that Ottawa get right the design details of such a bank as well as other related institutions. There are differences between private investment in new versus existing infrastructure. But many policy issues are the same. In addition to an infrastructure bank, Canadian governments should take the following steps to encourage more institutional infrastructure investment:

• where necessary, create independent regulatory bodies to oversee infrastructure assets that ensure their owners, either government-owned corporations or institutional investors, act in the public interest ahead of private profit and for long-term sustainability;
• open infrastructure investment opportunities to the highest bidder among domestic or foreign investors and do not require any provincial or federal pension funds to invest. This requires the federal government to have expertise it can lend to smaller communities on business cases for institutional investors;
• seek out opportunities to “recycle” user-fee financed assets at their maximum value to taxpayers or allocate contracts to operate new non-full-user fee assets that provide the highest savings or cost-avoidance; and
• provide financial encouragement to provincial and municipal governments to work with the federal infrastructure bank since they own the vast majority of existing and potential user-fee financed infrastructure of interest to institutional investors.

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Canada is about to embark on one of the largest infrastructure investment programs in recent history. Upon the advice of a high-profile group of economic policy advisers (Advisory Council on Economic Growth 2016), Ottawa is considering attracting institutional investment in both existing and new infrastructure. Is this a good idea? Why? How should it work?

Canadian governments own many kinds of major infrastructure. In 2016, more than half of the more than $155 billion under construction in major private and public Canadian infrastructure was financed directly by taxpayers. Such taxpayer-funded investment has a broader cost to society through the risk of cost overruns, the burden that taxation places on the broader economy and the politicization of infrastructure investment decisions that can lead to poor choices and lower-productivity infrastructure. As a result, policymakers have been looking for ways to finance infrastructure without relying on taxpayers.

One alternative is public-private partnerships (P3s), which have been a great success in Canada. P3s have been useful in transferring some of the construction risk (i.e., delayed delivery, scope-creep and cost overruns) from taxpayers to the private sector. However, governments can have Canadian P3s and institutional investment go further. Many existing Canadian P3s have the key problem that taxpayer funds are still required to maintain and make available the final product upon eventual delivery. Indeed, when governments rely on taxes instead of user fees, it makes the wider economic cost of government financing and risk on taxpayers higher than private-sector investments backed by future user fees.

While Canadian governments worry about their limited ability to raise taxes and borrow for infrastructure investment, major Canadian institutional investors are investing in infrastructure abroad. Institutional investors seek such opportunities for reasons ranging from low rates of return on traditional investments to better managing the risks of inflation and exchange rates. Such institutional investors – the largest group consists of Canada’s seven biggest public pension funds – have invested $87 billion in infrastructure worldwide. These major investors, as well as private companies, smaller pension funds, sovereign wealth funds and insurance companies, are all eager to invest in Canadian infrastructure.

A Solution for Governments and Institutional Investors Alike

Canada’s four largest provinces, along with the federal government, are planning infrastructure investment of more than 2 percent of GDP. That is more than double the average infrastructure spending as a share of GDP between 2000 and 2014. The question that governments must answer is how to finance this new infrastructure.

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One solution for institutional investors seeking domestic infrastructure investments and governments looking to finance new infrastructure is to use institutional investment for public asset recycling; i.e., selling equity stakes in public infrastructure to institutional investors. Governments could then use the proceeds from such sales to invest in new infrastructure, either alongside investors or in a P3 model in user-fee-financed infrastructure or in projects without sufficient revenues that investors would not pursue (Fenn 2014, 2015).

The asset recycling opportunity is immense. The three levels of Canadian governments across the country own about $150 billion worth of user-fee-supported assets such as electricity, water and transportation infrastructure. However, some government assets are more amenable to institutional investment than others. The potential sale value of these assets ranges from $67 to $100 billion (Robins 2017, forthcoming). In many other areas not amenable to asset recycling, governments can instead maintain ownership and rely on contracting, leasing or expansive P3s to take advantage of institutional investment opportunities. However, governments must create the institutions that will allow them to both maximize the sale value of existing infrastructure and ensure that institutional investors act in the public interest of long-term economic efficiency.

Governments should review the root policy reasons of why they currently own infrastructure assets and determine whether they can still meet these goals if institutional investors own the asset. Governments have traditionally built and owned infrastructure assets that institutional investors, if left to themselves, would not build or might operate as monopolists. However, governments do have a number of tools, such as contract design, creating competition, subsidies and regulation of the institutional investor to make institutional investment adhere to policy goals.

Creating the Institutions to Make Institutional Investment Happen

The federal government, upon the advice of its Advisory Council on Economic Growth (2016), has committed to creating an “infrastructure bank” in its Fall Economic Statement, with at least $35 billion in public funds and a plan to attract up to four times that amount from institutional investors. The government also promised that details of the bank’s structure will be announced in the 2017 budget (Canada 2016).

When designing its infrastructure bank, the government must also create other institutions to tackle existing regulatory and economic hurdles to institutional-investment infrastructure ownership. These issues apply regardless of whether governments involve institutional investors in new infrastructure or in recycling existing assets. Other studies have stressed the importance of dealing with asset-management frameworks, accounting and budgeting policies, successor-rights labour legislation and creating central agencies to manage asset recycling (Fenn 2014, 2015. Ditta, Fenn, Mendelsohn, and Puentes 2015).

1 This Commentary argues that governments should encourage widespread institutional investment in existing and new assets by taking the following steps.

- Create regulatory bodies that are independent of government decisionmaking, akin to how other countries have created regulators for sectors such as water, airports, electricity and much more.
- Open infrastructure investment opportunities to any willing, responsible investor, both foreign and domestic. At the same time, the infrastructure bank should be a centre for expertise on structuring investment opportunities on behalf of other governments and should neither prefer nor compel specific institutional investors to invest in existing or new infrastructure projects.
• Ottawa should create an organization to manage contracts with institutional investors, seek out opportunities to recycle assets at the maximum value to taxpayers, manage a partial or majority government ownership stake in some assets, and aid in ensuring that governments re-invest their money wisely.

• Finally, the federal government should also fund asset-recycling initiatives from lower levels of government using a formula, building on what Australia has done, that prevents lower-tier government revenue loss from asset sales and rewards lower-tier governments for the economic efficiency benefits of reducing the wider economic harm of taxation-financed infrastructure.

Direct funding from governments and Crown corporations is the largest source of infrastructure funding. Of $155 billion for all 2016 projects, Canadian governments and Crown corporations directly funded $83 billion, or more than half. That is down from the $91 billion, or three-quarters, of publicly funded projects underway in 2012 (Figure 1).

While the largest amount of public funding is for energy projects – $44 billion in both 2012 and 2016 (Figures 2 and 3), provincial and municipal governments also dedicate a large amount of direct funding to transportation projects. Combined, governments directly financed $35 billion of such projects in 2012 and $30 billion in 2016. That drop in direct transportation financing was more than made up by the increase in P3 funding, increasing from $6 billion to $38 billion. Only in Alberta does private infrastructure investment represent a large share, 58 percent, of total infrastructure financing. Quebec and British Columbia still provide more than 80 percent of their funding for infrastructure projects – particularly in energy and partly for transportation – through public funds, with P3s representing the majority of the small amount of infrastructure not directly financed by government.

Canadian governments turn to P3s mostly at the early stages of design, building and financing to protect taxpayers from bearing the risk of

Canadian Government and Institutional Infrastructure Investment

While Canadian governments invest a large amount of public funds in domestic infrastructure, Canadian institutional investors invest large amounts of Canadian money in infrastructure outside of Canada.

Canadian Infrastructure Investment Patterns

The 100 largest infrastructure projects underway in Canada in 2012 and 2016 (ReNew 2012, 2016)² are the kinds of investment projects that appeal to institutional investors (Blatchford 2016). They range from hospitals, roads and airport expansion projects worth between $300 million and $400 million to major transit and hydroelectricity projects worth more than $9 billion each – and most have some kind of user fee. These projects have three financing/ownership models:

• direct funding from governments or Crown corporations;
• public-private-partnerships (P3s), in which governments contract with private builders and financiers, but own the infrastructure; and
• private finance, in which private companies finance and own the infrastructure.

² The ReNew magazine list of the Top 100 Canadian infrastructure projects mostly consists of infrastructure available for public use, but also includes some infrastructure for the private use of a single company such as mining, electricity transmission, or natural gas facilities. I also categorize airport authority capital projects as private investments, as the debt that airport authorities issue is not issued by government.
construction overruns and delays. After completion, governments have typically taken back infrastructure ownership and long-term operating risk. Ontario and British Columbia have led the way in using P3s, initially to build public buildings such as hospitals and justice facilities, but recently to include transportation and other civil infrastructure projects. The model has largely been a success in its application so far. Of 30 P3s in Ontario since 2007, 29 were completed below budget and 22 opened on time (Siemiatycki 2015).

One P3 selling point comes from the appropriate party bearing the risk it is best suited to; e.g., private construction companies are often best suited to dealing with construction risk, as long as they place some of their own resources at risk (Poschmann 2003). Limiting P3s to only the design, building, and financing of projects does not match the investment interests of long-term investors. Canadian governments have traditionally relied on these limited P3s, but more P3s are increasingly including a maintenance and operation component that makes them more suited to institutional investors. Still, P3s are not ideal for all kinds of projects. They are most effective for projects costing $50 million or more. For smaller projects, the costs of arranging contracts may not be worth the savings.

Figure 1: Financing Source for 100 Largest Canadian Infrastructure Projects, 2012 and 2016

Note: Totals exclude uncommitted funding. All amounts in nominal dollars.
Source: Author’s interpretation of ReNew Canada (2012, 2016).
Canadian Institutional Investments in Infrastructure

Canadian pension funds and other long-term investors, henceforth called institutional investors, are major infrastructure financers. Canada’s seven largest pension funds hold about $1.1 trillion in assets. Of that amount, $86.6 billion is invested in infrastructure assets, both in Canada and abroad (Table 1). The Canada Pension Plan Investment Board (CPPIB) holds the largest portfolio of infrastructure investments, over $20 billion. The Ontario Municipal Employees Retirement System (OMERS), the Ontario Teachers’ Pension Plan (OTPP), and the Caisse de dépôt et placement du Québec (Caisse) hold the next largest infrastructure portfolios, with between $16 and $15 billion in investments.

The main types of infrastructure investments that pension funds make are in transportation, telecommunications, energy and other utilities such as water and waste services. The largest transportation holdings are in toll roads, such as the CPPIB’s investments in Australia, Chile and Virginia, followed by airports, with the OTPP and Public Sector Pension Investment Board (PSPIB) holding large stakes in airports across Europe, and railways, such as stakes by OTPP and OMERS in the British High Speed 1 Rail between London and the English Channel.
Meanwhile, many Canadian pension funds work together to own international assets. For example, the Alberta Investment Management Corporation (AIMco), OMERS and OTPP and others own the London City Airport. And the CPPIB, OMERS and OTPP each bought one-third of the company that operates the Chicago Skyway toll road under a concession agreement until 2104.

Pension funds are not alone in investing in global infrastructure. Brookfield Infrastructure, a subsidiary of Canadian-based Brookfield Asset Management, is part of a consortium (which includes British Columbia Investment Management Corporation, the pension fund for BC government employees, along with other parties) that has invested $12 billion in a major Australian seaport and rail operator. Brookfield also holds major investments in natural gas pipeline infrastructure around the world, telecommunications infrastructure in France and ports in Brazil.

For their part, Canadian insurance companies also seek out infrastructure investments, as their long-term risks of paying out benefits matches the long-term infrastructure revenues. For example, Manulife has invested about 2 percent, or $6 billion, of its $300 billion investment fund in infrastructure (Manulife 2016).

Although Canadian pension funds have a large number of investments abroad, few have major infrastructure investments in Canada, especially

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**Figure 3: Financing Source, by Sector, for 100 Largest Canadian Infrastructure Projects, 2016**

Note: Totals exclude uncommitted funding. All amounts in nominal dollars.
Source: Author’s interpretation of ReNew Canada (2012, 2016).
Table 1: Canadian Pension Fund Infrastructure Investment

<table>
<thead>
<tr>
<th>Pension Fund (by size of infrastructure investments)</th>
<th>Fair Value of Infrastructure Investments ($ Billions)</th>
<th>Infrastructure as Share of Asset Mix (percent)</th>
<th>Components of Infrastructure Investment</th>
<th>Examples of Infrastructure Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada Pension Plan Investment Board (March 2016)</td>
<td>20.4</td>
<td>7.6</td>
<td>Not reported. n/a</td>
<td>Highway 407 (40%). Toll roads in Sydney, Virginia (25%), Chicago (33%), Chile (50%); electric grid in Chile (28%); electric utility in Washington (32%); water utility in eastern England (32%); ports in UK (34%) and Australia.</td>
</tr>
<tr>
<td>Ontario Municipal Employees Retirement System (December 2015)</td>
<td>16.3</td>
<td>16.4</td>
<td>Not reported. n/a</td>
<td>Bruce Power (49%); Confederation Bridge (34%); Detroit River Tunnel (84%); Enersource (10%). High Speed 1 Rail in UK; UK Ports; gas and electricity transmission in Czech Republic, Texas (10%), Scotland and southeast England (25%), Finland, Sweden (50%); toll road in Chicago (33%).</td>
</tr>
<tr>
<td>Ontario Teachers’ Pension Plan (December 2015)</td>
<td>15.2</td>
<td>9.0</td>
<td>Transportation &amp; Logistics. 64 Container terminals at Port of Vancouver (100%).</td>
<td>High Speed 1 Rail in UK; airports in Belgium (39%); Copenhagen (30%); Birmingham, UK (48%); Bristol (100%); toll road in Chicago (33%); container terminal in New York.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Energy. 20</td>
<td>Electricity in Chile (50%); gas distribution in Scotland and southeast England (25%).</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Water and Waste. 16</td>
<td>Water in Chile (90%+), Sydney (50%) and UK (25%).</td>
</tr>
<tr>
<td>Caisse de dépôt et placement du Québec (December 2016)</td>
<td>14.6</td>
<td>5.4</td>
<td>Utilities. 42 Gaz Metro (27%).</td>
<td>Australian electric grid (25%).</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Industrials. 34 Montreal transit (in development) and Vancouver’s Canada Line (33.3%).</td>
<td>Heathrow Airport (13%); Eurostar (30%); Keolis: major transport operator in Australia, Europe and US (30%); Port of Brisbane (27%).</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Energy. 21</td>
<td>Fluxys: natural gas distribution in Europe (20%).</td>
</tr>
</tbody>
</table>

Notes: The Caisse, PSPIB and AIMco also report a small amount of “other” infrastructure investments.

Source: Author’s interpretation of pension fund annual reports.
<table>
<thead>
<tr>
<th>Pension Fund (by size of infrastructure investments)</th>
<th>Fair Value of Infrastructure Investments</th>
<th>Infrastructure as Share of Asset Mix</th>
<th>Components of Infrastructure Investment</th>
<th>Examples of Infrastructure Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Month of Reporting)</td>
<td>($ Billions)</td>
<td>(percent)</td>
<td>Infrastructure Class</td>
<td>Mix of Infrastructure Investments (percent)</td>
</tr>
<tr>
<td>Public Sector Pension Investment Board (March 2016)</td>
<td>7.8</td>
<td>6.3</td>
<td>Transportation.</td>
<td>47</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Energy.</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Telecommunications.</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Water and Waste</td>
<td>3</td>
</tr>
<tr>
<td>B.C. Investment Management Corporation (March 2016)</td>
<td>7.1</td>
<td>5.9</td>
<td>Not reported.</td>
<td>n/a</td>
</tr>
<tr>
<td>Alberta Investment Management Corporation (December 2015)</td>
<td>5.2</td>
<td>5.7</td>
<td>Transportation.</td>
<td>48</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Energy.</td>
<td>38</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Telecommunications.</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Water and Waste</td>
<td>7</td>
</tr>
</tbody>
</table>

Notes: The Caisse, PSPIB and AIMco also report a small amount of “other” infrastructure investments.
Source: Author’s interpretation of pension fund annual reports.
in categories usually owned by government. The rare examples include the CPPIB’s minority stake in Ontario’s Highway 407 ETR, a toll road in the Greater Toronto Area, and a stake by OMERS in Bruce Power, which operates a large Ontario nuclear power facility. OMERS also holds a long-term concession to operate the Confederation Bridge between Prince Edward Island and New Brunswick and has an ownership share in a rail tunnel between Detroit and Windsor as well as in Enersource, the local electricity distribution company owned by the City of Mississauga. Lastly, the Caisse has an ownership stake in the company that built and still operates the light-rail commuter Canada Line in Vancouver and will be the majority owner and operator of a proposed Montreal commuter rail system.

The Ideal Nature of User-Fee Infrastructure Investments for Institutional Investors

Canadian institutional investors seek infrastructure investments for a number of reasons.

- They provide a reasonable amount of certainty regarding long-term revenues. For pension funds, that certainty is useful in matching future distributions to participants.
- Many pension funds are in a position to invest now and are not worried about having to sell large investments, like infrastructure assets, for many years. That short-term cash flow allows it to invest now in large upfront expenses. This demographic-driven window of opportunity for purchases will eventually close, meaning governments should act soon to attract investments from Canadian pension funds.
- The value of infrastructure assets and their revenues, unlike traditional investments such as stocks and bonds, typically does not drop dramatically in economic downturns because demand for basic services like water often does not drop with the economy (OECD 2011). As a result, pension funds are usually able to pay out pension benefits without relying on selling assets at depressed prices during market downturns.

- The persistent low, and sometimes even negative, rate of return on traditional investments like bonds has meant that institutional investors are seeking out new assets, like infrastructure, to generate sufficient returns to meet their liabilities.

Because Canadian institutional investors have not been able to invest in many domestic infrastructure opportunities, they have not been able to take advantage of potential benefits that specifically come from domestic investments. For example, the regulated price that owners of user-fee financed infrastructure are able to charge often rises with the rate of inflation. Therefore, investments in Canada would allow pension funds and insurance funds to avoid the risk that they face abroad when Canadian inflation is greater than that abroad – their retiree payouts are tied to the Canadian inflation rate.

Second, pension fund investments abroad are subject to an exchange-rate risk. If the Canadian dollar appreciates, investments abroad will produce lower returns for Canadian pensioners. However, if Canadian pension funds were able to invest in more domestic infrastructure projects, they would be able to reduce such risks.

Canadian institutional investors will also often have the most expertise in domestic infrastructure policies. Canadian investors will also likely understand the political risks of investing in Canadian infrastructure, which is apparent in Canada just as much as other nations with governments often changing the term for long-term investments.

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3 As of February 2017, Enersource was undergoing a merger with other government-owned distribution companies to create Alectra Utilities.
The Opportunities for Institutional Investment in Canada

How significant is the opportunity for institutional investment in Canadian infrastructure? The potential net asset value of major Canadian user-fee supported assets is about $150 billion (see Table 2). Some assets are particularly attractive for governments to sell stakes in. The potential sale value of these assets, which takes into account their potential cash flows, is between $67 and $100 billion, as estimated by Robins (2017, forthcoming). The largest potential sale values are in provincial electricity infrastructure, between about $43 and $62 billion in British Columbia, Saskatchewan, New Brunswick, Ontario and Quebec. Other assets such as federally owned airports and municipally owned electricity distribution services are particularly attractive asset recycling opportunities. Other assets – such as public transit – are less amenable to asset recycling, and are more amenable to the governments still owning the asset, but involving institutional investors in long-term operation, such as design-build-finance-operate-maintain P3s or contracting.

The Canadian infrastructure assets in Table 2 are largely or entirely financed by users, such as through electricity or water rates, passenger fares or other fees. But Table 2 is only a partial list of the assets that governments should consider as part of an institutional investment program. Indeed, municipalities and provinces hold parking authorities, transit services, highways that could become toll roads and lucrative alcohol distribution systems that could be subject to sale or redevelopment or long-term contracting.

The Economics of Infrastructure Investment

Why have Canadian governments not taken advantage of the opportunity to sell existing government assets to institutional or private investors?

The Economic Hurdles for Institutional Investment

Market Power

One concern with selling government-owned infrastructure to private or institutional investors is the risk that the profit-oriented operator would act like a monopolist. It could then raise prices in a way that is, from a public perspective, not the most economically efficient outcome.

However, there are a number of potential positives from such market power. For example, a transit monopoly with a seamless network – in which users travel on buses, trains or other transit within the same regional fare system – can create numerous benefits for travellers and operators alike. Indeed, those benefits may be so large as to make competing forms of public transit uneconomical.

As well, although a single transit network might be able to monopolize the specific service it provides, it might still have to compete with other networks that offer similar services, constraining its market power. Public transit is increasingly in competition with car-sharing services like Uber. Airports and railways might look like monopolies in their own modes, but they compete with each other as well as with other modes of transportation that constrain the market power of incumbent infrastructure owners.

4 Municipalities do not list debt or liabilities related to waste or water systems because these are integrated operations within municipal governments.
Some types of infrastructure might be a monopoly as a whole, but with some aspects that are competitive. In public transit or postal services, for example, only one organization is best placed to set a fare or rate policy for a region or country. However, it can still enter into contracts with private operators to provide specific services on a contracted basis. In such situations, governments could limit the market power of service providers by allocating sub-contracts across a wide range of companies.

Table 2: Asset Values of Government-owned, User-fee-supported Infrastructure

<table>
<thead>
<tr>
<th>Government-owned Assets</th>
<th>Net Asset Value</th>
<th>Potential Sale Value ($ Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Federal Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eight largest airports</td>
<td>2</td>
<td>7-17</td>
</tr>
<tr>
<td>VIA Rail</td>
<td>0</td>
<td>Little for existing whole operation.</td>
</tr>
<tr>
<td>Four largest salt-water ports</td>
<td>2</td>
<td>2-3</td>
</tr>
<tr>
<td><strong>Total federal assets</strong></td>
<td>4</td>
<td>9-20</td>
</tr>
<tr>
<td><strong>Provincial Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ontario electricity infrastructure (Ontario Power Generation and remaining public stake in Hydro One)</td>
<td>18</td>
<td>12-15</td>
</tr>
<tr>
<td>Hydro Québec</td>
<td>20</td>
<td>25-33</td>
</tr>
<tr>
<td>BC Hydro</td>
<td>4</td>
<td>6-12</td>
</tr>
<tr>
<td>Others (NB Power, SaskPower)</td>
<td>2</td>
<td>0-3</td>
</tr>
<tr>
<td><strong>Total provincial assets</strong></td>
<td><strong>44</strong></td>
<td><strong>43-62</strong></td>
</tr>
<tr>
<td><strong>Municipal Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alberta electricity utilities (Epcor and Enmax)</td>
<td>5</td>
<td>4-5</td>
</tr>
<tr>
<td>Ontario municipal electricity infrastructure</td>
<td>4</td>
<td>11-15</td>
</tr>
<tr>
<td>Ontario solid waste infrastructure</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Ontario water, storm water and wastewater infrastructure</td>
<td>48</td>
<td></td>
</tr>
<tr>
<td>Ontario transit services (Excludes Metrolinx)</td>
<td>7</td>
<td>At current service prices, more amenable to contracting or design-build-finance-operate-maintain P3.</td>
</tr>
<tr>
<td>Alberta water, storm water and wastewater assets</td>
<td>18</td>
<td></td>
</tr>
<tr>
<td>B.C. water, storm water and wastewater assets</td>
<td>15</td>
<td></td>
</tr>
<tr>
<td><strong>Total municipal assets</strong></td>
<td><strong>100</strong></td>
<td><strong>15-20</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>148</strong></td>
<td><strong>67-102</strong></td>
</tr>
</tbody>
</table>

Source: Author’s calculations from financial statements from respective 2014/2015 or 2015 fiscal years. Ontario municipal water and electricity assets as of year-end 2014 include Hydro One Brampton but do not include announced sales to Hydro One. Eight largest airports (Toronto, Montreal, Vancouver, Calgary, Edmonton, Ottawa, Winnipeg and Halifax) represent 90 percent of Canadian passenger enplanements. Four largest salt-water ports (Vancouver, Montreal, Halifax, and Prince Rupert) represent 70 percent of total Canadian Port Authority revenues.
When competition or contracting for services is not sufficient to achieve economic efficiency, governments can instead rely on contracts that limit market power, retaining a majority ownership stake, or on regulation. The two most common models are rate-of-return and price-cap regulation. With rate-of-return regulation, regulators set prices so the overall shareholder return does not exceed a given rate. However, regulators usually have an information disadvantage relative to the infrastructure operator.

Under price-cap regulation, regulators set a maximum annual price increase for user fees, taking into account factors such as expected inflation and productivity gains. However, if regulators set maximum prices too low, that can either lead to congestion of the assets or insufficient rates of return for investors. In sum, regulation may be a necessary option for some kinds of assets such as water, storm water and wastewater and electricity distribution that do not face obvious competition from other services. Internationally, independent regulators have been successful with both rate-of-return and price-cap regimes at reducing costs for infrastructure users and incenting performance improvement, such as in the case of water regulation in the UK and EU airports (Dachis 2014, Bel and Fageda 2010).

Incomplete Contracts

A key challenge of institutional investment in publicly owned infrastructure involves the contractual relationship with government. These contracts can cover everything from the rules of basic operation, to constraining market power in place of regulation, to explicit fines for poor performance, to bonuses for meeting government goals. Negotiation works best in instances when institutional investors want the right to obtain future assets. They would know that any breach of contract could lose them the right to future investments.

Another government option is to offer longer-term ownership concessions, or franchises. Concessions or franchises differ from contracting. At the end of the lease term, the private concession or franchisee returns the asset to the government, or sells it back to the government. One example is the Confederation Bridge, which will be privately operated until 2032, at which time the Government of Canada will own and operate it.

Returning assets is not ideal for all types of assets. There is a risk that a franchise’s owner will reduce short-term costs by not properly maintaining the facility. However, a contract could require the necessary state of a facility, such as a simple bridge or road, upon turnover. With more complex infrastructure or infrastructure in which the future state of assets or liabilities is unclear, such as airports or public transit, such requirements would be more difficult to enforce.

Externalities (Positive and Negative)

Governments also tend to own some forms of infrastructure because doing so allows them to subsidize — or in some cases, restrict — the service in the public interest. For example, public transit can have a broader benefit if it connects a larger number of people, because such an asset operated on a full cost-recovery basis would underserve society (Dachis 2013). Government ownership of transit, for example, makes it easy to use public funds to subsidize and control the construction and operation rather than to subsidize a private provider.\footnote{Another example is with government ownership of alcohol distribution systems. They can then restrict access, limit advertising and raise the cost to the public to curb usage of a product with social harms through direct government policy more easily than if they were to regulate private sellers.}
However, the existence of public goods, or harms, is not a sufficient argument for government to take on public investment in place of private or institutional investors. Governments can still subsidize infrastructure construction through grants or subsidize operation if they use contracting. For example, they can designate that certain postal services, recycling policies or public transit routes are socially worthwhile, but still have them delivered privately. In these cases, governments can auction the right to provide these services but have governments still finance the services instead of users.

Another alternative for engaging the private sector in a public service is a P3. This has been a common approach in building public hospitals and schools with the government taking ownership after construction. This is often justifiable because of the broad social benefits of healthcare and education that a private owner might not provide. Any kind of user-fee financing for many health and K–12 education services would not be acceptable to the Canadian public, meaning that government subsidies would be necessary to provide the appropriate service level. Governments could include institutional investors in non-user-fee-financed infrastructure projects by providing an “availability payment” contingent on investors providing the service or ensuring the state of the asset by including long-term maintenance and operation in the P3.

Realizing Opportunities

How do different kinds of potential market failures to provide public infrastructure present themselves in specific assets across Canada, and what can governments do to address them? Some types of infrastructure, such as water or electricity distribution, could easily become monopoly providers. In that case, the policy solution is to introduce a regulator.

Meanwhile, portions of publicly owned infrastructure – both new and existing – could have institutional investor involvement without the government selling other parts of the network. For example, the government could create contracts for individual transit routes or roads and integrate them into the overall network. Other existing assets, such as local water, wastewater and sewer water, or electricity distribution networks, are often best sold intact. Otherwise, contracting arrangements between different companies in the same network could be onerous.

Policymakers across Canada must assess whether the assets they currently own – or are looking to invest in – are necessary for them to own or instead might interest institutional investors. To aid policymakers in such an evaluation, Table 3 provides a colour-coded means of assessing whether, and how best, to use institutional investment if:

- there is an existing user fee that fully finances the asset (gold in Table 3). If not, if there is the potential for the government to introduce full user pricing or increase revenues through better fare policies and incentives or increased automation (blue in Table 3). If such an asset does not pose a risk of an institutional investor having market power that cannot be constrained in the conditions of sale, governments should consider immediately bringing in institutional investors (Column 1 of Table 3);
- the asset is currently or can be fully user financed. In such cases, there are some assets such as airports, water and electricity in which specific contract terms or a regulator are required to ensure the infrastructure owner acts in the public interest, including the sustainable interest of the infrastructure and its users (gold and blue in the second column of Table 3);
- full user-fee financing is not feasible, or desirable, in all cases. In these situations, such as public transit, the government can contract with the institutional investor to provide the service on a contract basis or a P3 that includes operation and maintenance while sharing the revenues that partially cover the cost of provision (black in the third column of Table 3); and
- governments want to retain ownership in assets in which there is limited or no potential for a user
fee to cover a significant share of costs. In such cases, governments instead rely on the limited P3 model in which private participants only design, build and finance. In areas with limited growth potential and limited past take-up of equity stakes by institutional investors (black in Table 3), institutional equity investment or operation is unlikely to be substantial. However, there will be substantial interest by other investors in purchasing bonds backstopping the investment.

A few examples of assets that are currently fully user-fee financed and ripe for institutional investment are: VIA Rail’s services in the Toronto-Montreal corridor; government-owned and operated toll bridges and roads, such as the 407 East extension in the Greater Toronto Area; and local arenas and recreational facilities.

Contracting out is also an option for many assets in which full user-fee finance would not be desirable, either economically, such as for public transit, or politically such as Canada Post, in which few policymakers seem willing to deviate from a long-standing policy of a uniform price for mail delivery. Long-term contracts in a number of these areas could provide government with cost savings.

### Table 3: How Governments can Include Institutional Investors in Canadian Infrastructure

<table>
<thead>
<tr>
<th>Policy Solution</th>
<th>Competitive Institutional Leasing/Ownership</th>
<th>Institutional Leasing/Ownership with Regulation or Limits in Contract Terms</th>
<th>Contracting/Franchising/Expanded P3 (Design, Build, Finance, Operate, Maintain)/Availability Payment</th>
<th>Limited P3 (Design Build Finance only)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Market Failure Addressed</strong></td>
<td><strong>No Clear Market Failure</strong></td>
<td><strong>Monopoly</strong></td>
<td><strong>Incomplete Contracts</strong></td>
<td><strong>Externalities</strong></td>
</tr>
</tbody>
</table>

Source: Author’s interpretation.

Gold ■: Ready for full institutional equity investment. Blue ■: Needs higher prices for full equity investment in this model. Black ■: Best suited for institutional investment in debt.
and institutional investors with long-term profitable business models.

Assets most attractive to institutional investors for recycling or taking on an ownership role, such as electricity and airports, would require some kind of regulatory oversight. Other potential investment opportunities, such as in new or existing local public and regional transit services and water, wastewater, and storm water infrastructure, would be of interest to institutional investors if user fees and other potential revenues increased to fully finance their operation.

Projects by organizations such as Infrastructure Ontario, a Crown corporation responsible for building, managing and financing provincial assets, have traditionally included P3 design-build-and-finance contracts for schools, hospital and other government buildings. These present limited additional growth opportunity for long-term institutional equity investors and organizations such as Infrastructure Ontario should look to expand the scope of P3 offerings to include long-term management.

**When Private and Institutional Investment Can Be Better Than Government Investment**

While there are challenges to fostering more institutional and private investment, there are also potential problems inherent in continued government investment, which amounts to a risk transfer onto taxpayers. It can result in higher-cost or lower-service infrastructure and has wider economic cost-impacts relative to investments made by private or institutional investors.

**The Risk to Taxpayers**

One of the most common arguments favouring government infrastructure investment is that it typically benefits from a lower borrowing rate compared to that available to the private sector (Ontario Auditor General 2014). However, this lower interest rate is a result of bondholders viewing taxpayers as the guarantors of any cost overruns or late delivery. The lower interest rate is an insurance benefit that taxpayers implicitly provide bondholders (Boyer, Gravel and Mokbel 2013).

P3s are a successful way of reducing risk in the design, finance and construction stage of infrastructure. Institutional investors, however, are not best placed to manage the construction risk in existing Canadian P3s and do not seek short-term investments. They have long-term investment outlooks that they want to match to their beneficiary obligations. Therefore, institutional investors are best placed to deal with the operational risks that occur over a long time horizon, given that they have a longer time period in which to manage those risks. As a result, governments should open up long-term infrastructure positions, not just short-term construction projects.

**The Economic Cost of Taxation**

When governments directly finance infrastructure from tax revenues, they impose a wider economic cost than if the cost were paid only by users. How much economic harm results depends on the specific type of tax the government uses. One measure of this harm is known as the marginal cost of funds (Dahlby 2009). When project financers receive funds from infrastructure users or investors who provide upfront money in hope of a commercial return, then the marginal cost is zero.

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6 Ignoring this reality is the mistake the Ontario Auditor General (2014) made when she said Infrastructure Ontario’s use of private-public partnerships has cost $8 billion more than traditional public financing.
Thus, if an institutional investor were to finance a project directly and recoup its investment with user fees, there is no distortion to work or investment through higher taxes.

**The Productivity and Project Selection Discipline of Institutional Investors**

Involving private or institutional investors can bring greater discipline to government infrastructure project selection and better long-term operation, leading to more efficiently run services. In public transit, for example, there have been numerous debates about the merits of some proposed new government-selected rail lines and transit stations. When policymakers alone make such investment decisions, it is up to the public to determine whether the promises of policymakers are sound. The public often lacks the knowledge and expertise to assess information such as ridership figures, costs and other project details.

Instead, if policymakers sought to bring private investors to share the operational and demand risk of a transit line, for example, their involvement might spur policymakers to select projects with more rigorous economic and business cases. The institutional investors would have a direct financial incentive to investigate the quality of the project. Furthermore, if it were to become normal for private investors to take part in such infrastructure projects, their refusal to take part or high borrowing costs for a specific initiative would be a clear public signal about the project’s economic merits.

On the minus side, the institutional investors’ perspective might push policymakers to projects with a large financial benefit over those with a society-wide economic benefit. Governments can still seek to reconcile these two goals by providing subsidies to achieve wider social benefits. Direct subsidies to support initial construction would make clear to the public the extent to which governments value the wider benefits of the project. Such support could be a role for the proposed federal infrastructure bank—deciding the level of a government contribution in addition to the institutional investor participation.

There is evidence that private operators can provide infrastructure services at a lower operating cost than a single public provider. Privately owned EU airports have lower aeronautical charges than publicly owned airports, according to one study (Bilotkach et al. 2012), while Bel and Warner (2008) show that competition for providing water services – not necessarily whether the service is public or private – results in reduced costs. Lastly, waste services can also be provided more efficiently by private operators, although the savings often arise when there is contracting in general, meaning competition, either to private operators or other governments (Dachis 2010).

Institutional investors can provide other benefits aside from cost reductions. Investor-owned infrastructure may be able to provide better-managed customer services, introduce technology that it is difficult for governments to fund and implement and have arm’s-length relationships with customers and suppliers, as opposed to depending on their votes. Perhaps most importantly, institutional investors with the ability to put a user fee on currently non-priced and congested infrastructure such as highways or transit can set prices to maximize the asset’s efficiency. The user-fee model also allows for penalties on infrastructure providers should the service not be reasonably available. For example, governments could levy fines for transit vehicles being out of service due to inadequate maintenance or failure to maintain cleanliness standards, a step the government could not take if it owned the asset because it would only be penalizing itself.

**Making Institutional Investment Work: In Canada and Around the World**

**Creating Regulatory and Corporate Institutions**

The first step that governments should take
before opening up infrastructure ownership is to create the appropriate regulatory environment. Creating an arm’s-length regulatory agency for major infrastructure can have numerous benefits, independent of whether governments sell a stake in an asset. Without such an independent body, governments have an inherent conflict of interest when they hold the powers of both operating infrastructure and regulating its operational standards in areas such as safety or price setting since weaker regulatory standards make the operations easier to manage. For example, the federal government owns Canada Post through a Crown corporation and sets regulations for how all carriers – both public and any competing private operators – deliver mail. In this case, the government can set regulations that hamper other competitors but benefit the Crown corporation. Creating an independent infrastructure regulator – for example, the UK created Ofwat for its water sector – can both address this conflict and monitor any potential private investors.

In many areas of public infrastructure, Canadian regulators either do not exist or do not have a mandate to provide price regulation for potential investor-operators. Policymakers should look to the numerous international examples of regulators in areas ranging from airports and water, to electricity and much more, instead of re-inventing the regulatory model (see Robins 2017 and forthcoming, for more details on sector-specific regulators.) In so doing, policymakers should weigh the merits of using either a sector-specific regulator or relying on general principles of competition enforcement with the Competition Bureau as the regulator. On the one hand, a sector-specific regulator can have the expertise necessary to monitor complex businesses, while the Competition Bureau is not well placed to impose detailed regulation such as price setting, should that be necessary. On the other hand, a sector-specific regulator could be harmful if the regulator condones anti-competitive practices that contravene and supersede the Competition Act (Duijm 2004).

Once a regulator is in place, it should focus on the goal of achieving economic efficiency while protecting the public interest (Church forthcoming). A sector-specific regulator might be tempted to pursue other goals, such as redistribution of economic benefits between users and providers. Governments can forestall this risk by setting economic efficiency as the singular purpose of sector-specific regulators and retaining the power to address distributional impacts and broader policy.

Governments should use the kind of regulation that best suits the sector at hand. In some cases, that will be rate-of-return; in others, price-cap regulation will be most suitable. In still other cases, different kinds of regulation like price monitoring or a simple system of resolving disputes between governments and contractors may suffice. A regulator that provides a predictable set of instructions to operators and a mandate to focus on protecting consumers in the interest of promoting overall economic efficiency would encourage institutional investment, while also providing assurances to the public about an investor-operated asset.

Lastly, government should organize their services in a way that makes clear what parts of the service are amenable for investment. For example, most municipal water utilities are departments within municipal governments (Fenn and Kitchen 2016). Cities should move these assets into

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7 The Competition Bureau would be well placed to address industry concentration issues that could emerge from institutional ownership. Azar et al. (2015) find that increased institutional ownership of US airlines has decreased competitive intensity.

8 One model is a formal arbitrator. For an example of a franchise operation for public transit, including dispute resolution rules, see http://content.tfl.gov.uk/dlr-franchise-agreement-redacted-version.pdf.
standalone, wholly owned corporations before any changes in the operation and management of these entities. Without clear delineation of services, governments will have a hard time putting a clear value on the services.

**Government Investment and Management Expertise**

To achieve their infrastructure objectives, governments must retain expertise on managing relationships with private investors. The focus should be to create auction and contracting mechanisms that apply across all types of government-owned assets. They should be especially careful when working with the pension plans they sponsor so the plans are not pressured to invest in poor projects that would harm the returns due to plan members.

The federal government’s proposed infrastructure bank has an immediate role to play in determining what assets it can sell while fielding unsolicited bids. It can also aid lower-tier governments in recycling their assets or advising on how much of the asset the government should retain since some provinces and most municipal governments, especially smaller ones, do not have the expertise to determine potential investment opportunities, let alone create the appropriate contracting relationship with providers.

A federal infrastructure bank could also help provinces and cities throughout the life cycle of institutional investment. It could assist local and provincial governments that seek expertise in contract design for a wide range of potential assets as well as provide advice on how best to use the proceeds from such institutional investment. The infrastructure bank could also bundle projects from smaller communities into a package that would be of sufficient scale to interest institutional investors. The bank could also assist smaller pension and institutional investors in supporting investments. As well, the bank itself could become the funder of local projects on the condition that projects it supports follow the best practices in cost-benefit analysis (Siemiatycki 2016).

**Earn the Highest Possible Value and Support New Investment with Asset Recycling or Contracting**

Specific institutional investors should not be given special treatment. Preferential sales would result in governments earning lower sale prices for their assets. Competition for asset sales should be as wide as possible, including existing government service providers who may prove to be the most cost effective.

Ottawa should use its proposed infrastructure bank to re-invest the sale proceeds of existing government assets into new infrastructure assets. However, the infrastructure bank should not necessarily link decisions to sell existing assets to new investments. The decision of whether governments should have the infrastructure bank invest in new government-owned infrastructure should be based on a cost-benefit analysis that also includes other options such as contracting infrastructure provision, or the government spending on non-infrastructure needs, or cutting taxes. On the other hand, creating a segregated fund that limits the use of asset-sale proceeds to a continuous pipeline of infrastructure projects can be useful in creating broadly based political support for the thornier political problem of asset sales.

Governments should carefully choose what projects to support so as to not dilute the importance of user prices as the best tool for financing and allocating infrastructure. Ottawa should give grants to cities or provinces for infrastructure that the lower-tier government could potentially support with user fees only on the condition that the project has a high degree of cost recovery with user prices that do not rely on ongoing subsidies (Clark 2017). That still leaves many other non-user-fee infrastructure investments that governments can support, such as schools, hospitals, and much
more. In those cases, governments can still leverage institutional investment through contracting and traditional or expanded P3s.

**Intergovernmental Relations with an Infrastructure Bank**

The federal government owns few assets attractive to institutional investors compared to the larger opportunities in provincial and municipal institutional investment (see Table 2). Although Ottawa could seek private investment in assets ranging from air and seaports Canada Post and VIA Rail, around 80 percent of the potential asset recycling value of user-fee-based assets is in provincial and municipal hands. The federal government’s role in their sale would be mainly limited to helping provincial and municipal governments pursue institutional investment.

Australia has taken the lead on creating institutions that support such institutional investment, especially for lower-tier governments. In its 2014/15 budget, the national government promised A$125 billion (C$121 billion) in infrastructure spending, around half of which it projected to come from state-level governments. In order to incent states to sell assets to meet that target, the federal government put A$5 billion toward an Asset Recycling Initiative, which it estimated would leverage a further $40 billion of state infrastructure spending (Fagan 2016). The five-year initiative provides states with project-specific federal funding of up to 15 percent of the sale value of an existing asset (Commonwealth of Australia 2014). The plan has since resulted in at least two state governments selling or leasing assets with the federal asset recycling fund supporting transportation investments in both Sydney and Canberra (Commonwealth of Australia 2015).^9^ How would such a federal-provincial program work in Canada? The main justification for federal government spending on local infrastructure is when there is some form of interjurisdictional spillover (Dahlby and Jackson 2015). For example, if a lower-tier government finances a portion of an infrastructure project with taxes, that economic damage harms other governments that collect revenues from the same tax base. If the provincial government were instead to finance the infrastructure with private or institutional investment, there would be no economic harm spillover.

The list of positive spillovers can be numerous, including the federal government collecting higher corporate income tax revenues or projects spanning political boundaries. Indeed, Ottawa could create a formula that quantifies how much of a spillover benefit it receives from lower-tier government investments using institutional investment and provide provinces and cities with the financial equivalent of that benefit. Such a formula would provide certainty for lower-tier governments seeking infrastructure funds and would be an appropriate use of federal funds for institutional investment.

Any federal grant raises a deeper problem about interprovincial negotiating positions regarding institutional investment. In response to the potential of such a federal promise to compensate them for financial barriers to sales, provincial governments could put up barriers to institutional investment – such as transfer taxes – arguing that a payment from higher levels of government is necessary to make such sales revenue neutral.

sale-by-sale negotiation about the amounts the provinces or local governments should receive in compensation may result in intergovernmental gamesmanship. Federal support should not be dependent on the net fiscal position of the lower-tier governments on a project-by-project basis. Ottawa should generate a formula based on the general net fiscal position of lower-tier assets plus the wider economic benefits of both a sale and the subsequent benefits of new investments supported by federal funding.

**Recommendations and Conclusion: Widen Ownership in Canadian Public Infrastructure**

Canadian governments across all levels can leverage their existing assets to finance the new infrastructure they desperately need. Federal, provincial and municipal governments should build an overarching framework to analyze their abilities to recycle assets of all kinds. The four key measures that governments should implement now to enable institutional investment are:

- establish independent regulators to monitor all infrastructure operators – public and private – in sectors in which governments are heavily involved and service provision cannot be managed by contract;
- empower a central organization to seek out infrastructure recycling opportunities, taking on contracting and franchising expertise to ensure taxpayers and governments at all levels get full value from assets and that the revenues are used wisely;
- maximize asset value through a competitive process with open bidding and competition from foreign and domestic buyers that will result in the highest return for taxpayers and ensure that institutional investors, pension funds in particular, put their plan beneficiaries’ financial interests first, ahead of government priorities on investment; and
- provide direct federal government support for provincial and local government asset recycling, including funding to compensate other governments for the wider economic benefits created by relying on less government spending to support institutional infrastructure investment.

**Conclusion: Moving Canadian Infrastructure Ahead with Institutional Investment**

Canadians have made it clear that they want their governments to invest in more infrastructure. Governments have responded so far with a mix of government-financed infrastructure projects and, more recently, providing infrastructure finance and construction management through P3s. Government spending has its inevitable limits, and government ownership of much of Canada’s major infrastructure is limiting the ability of governments to invest in the new infrastructure Canadians need.

A systematic policy in which governments seek to broaden the ownership of Canada’s billions of dollars of government user-fee supported assets would address this problem. It would also open investment opportunities for institutional investors keen to invest in Canadian infrastructure.
References


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