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FEDERAL COMMERCIALIZATION IN CANADA

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FEDERAL COMMERCIALIZATION IN CANADA

Commercialization:	to apply business-like approaches and to allow market forces, incentives and mechanisms to affect the delivery of government services. Commercialization models can incorporate different degrees of private sector involvement ranging from full privatization of a Crown corporation to simply demanding more self-sufficiency with respect to department services (e.g., introducing user-pay initiatives).(1)

INTRODUCTION

In the past, government ownership of industries was generally motivated by the existence of one or more of the following conditions:

- government ownership was necessary so that public policy objectives could be met;
- the risks were too great and/or the financing requirements were too large for the private sector to make the optimal level of investment;
- the supply of goods or services in a critical sector would not otherwise be provided;
- a particular industry sector or region needed stimulus; or
- a natural monopoly existed.

By 1983, federal and provincially owned enterprises comprised an estimated 26% of net fixed assets in Canada.(2) The federal government was part or total owner of businesses producing goods or offering services in fundamental sectors of the economy, such as energy, communications and transportation.

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(1) Insight Information Inc., *Commercializing Government Operations: Canadian Examples and Experiences*, Toronto, 1995.

(2) Economic Council of Canada, *Minding the Public's Business*, Ottawa, 1986.

Commercialization emerged as a federal policy consideration in the mid-1980s for a number of persuasive reasons. Perhaps first and foremost, the level of the deficit put the federal government under tremendous financial pressure to reduce expenditures. Secondly, the market failures that justified government ownership had largely been corrected and/or the guiding public policy objectives had declined in importance. As an example of the latter: if private-sector competition develops an industry that was once dominated by a government-owned monopoly, the federal government may question its role in competing against the private sector. While continued government operation in accordance with commercial principles is an option, it may not be as efficient as transferring either ownership or operation of the government enterprise to the private sector. It was increasingly recognized that the private sector could adhere more strictly to commercial principles than the government in the provision of services and infrastructure. Since the government was involved in the provision of electricity, gasoline, rail and air transportation, upon which much of the economy depends directly or indirectly, a lower-cost supplier of equal or greater quantities of goods and services in these sectors was expected to boost the economy on a very broad scale.

This document reviews the ways in which the federal government, since the mid-1980s, has divested itself of its ownership and/or operational responsibilities in enterprises where continued government ownership was difficult to justify on public policy grounds. The following sections: describe two forms of commercialization commonly used in Canada; explain their advantages and risks; outline the processes by which commercialization was carried out; and provide examples of Canada's commercialization efforts. One arrangement increasingly used to introduce private-sector discipline into *new* government projects is the "public-private partnership," which is briefly explored in the final section.

COMMON FORMS OF COMMERCIALIZATION

The objective of the policy broadly referred to as commercialization is to apply business-like approaches and allow market forces, incentives and mechanisms to affect the delivery of government services.(3) One type of commercialization that has been popular in Canada is privatization – the transfer of ownership of a Crown corporation, corporate holding or

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(3) Insight Information Inc. (1995).

government service to private interests. Examples of privatized federal enterprises include de Havilland Aircraft, Teleglobe Canada, CN Hotels, Air Canada and Petro-Canada. Privatization was first introduced as a federal policy in Canada in the 1985 Budget under Conservative Prime Minister Brian Mulroney. The 1995 Budget Speech, delivered by Finance Minister Paul Martin, indicated that privatization was an ongoing priority for the Liberal government as well.

The other popular form of commercialization practised by the federal government is referred to in this document as "establishing an authority" that balances stakeholder interests and the new policy imperatives of the government. The federal government commenced establishing authorities to manage and operate transportation infrastructure (e.g., airports, ports and the St. Lawrence Seaway) on a not-for-profit, non-share capital basis during the early 1990s. The authorities typically leased the federal assets and property from the federal government over an extended term with an option to renew.

There are also variants of federal government commercialization that combine the change-of-ownership concept of privatization with the not-for-profit aspect of establishing an authority. For example, NAV Canada was allowed to purchase the land and assets of the civil air navigation system from the federal government, but it is a non-share capital, not-for-profit corporation. Therefore, some might call NAV Canada a privatized enterprise despite its being more like an authority than a private corporation.

POTENTIAL BENEFITS AND RISKS OF COMMERCIALIZATION

A. Benefits

One important benefit expected from commercialization is a reduced demand on the decision-making apparatus of the state. The federal government may then be able to devote freed-up resources to programs in priority public policy areas.

Another key benefit is the expected improvement in cash flow for the federal government. Commercialization can generate cash either as a lump sum through the liquidation of assets and enterprises as a result of privatization, or as a stream of income from the authorities that lease those assets. For example, to date the federal government has collected some $12 billion from the proceeds of privatization and over $1.5 billion in lease revenue from the airport authorities. Moreover, even if the underlying net worth of an asset and/or enterprise is low, the government still expects to benefit from the financial self-sufficiency of the new owner or local authority established to manage and operate the asset. Private management, guided by business principles, is expected to improve the financial performance of public infrastructure and make it self-sustaining.

Commercialization is also expected to result in lower prices and equal or greater levels of service, thus benefiting users and consumers generally. This is because the private sector has more incentives and freedom than the government to take advantage of market opportunities to grow its business. Higher corporate earnings, more employment and more rapid economic growth should result from such increases in economic efficiency. These increases in earnings, employment and economic growth benefit, in turn, the federal government through the associated expansion of the tax base (increased revenue) and a reduction in demand for income assistance (reduced expenditure).

B. Risks

Some of the risks associated with commercialization are simply the opposite of the benefits, but some are less intuitive. Obviously, the federal government could end up worse off financially as a result of commercializing an enterprise or asset that was undervalued at the time of sale or lease contract negotiation. Similarly, if the expected efficiency gains under private management are not realized, then there may be no boost in economic activity and growth.

Less obvious are the risks associated with selling or leasing a Crown corporation or asset for too high a price. An unexpectedly high price could indicate that insufficient regulation was put in place prior to commercialization, leaving public policy objectives vulnerable to the pursuit of profitability. In this case, the benefit to the government from the excess revenue could be offset by losses in consumer welfare, environmental degradation or other negative consequences. There is also the risk that the commercialized corporation might fail, leading to job losses, leaving society temporarily without a key service and potentially causing the federal government to renew its involvement in the enterprise/activity.

THE PROCESS OF COMMERCIALIZATION

The process of privatization generally had three stages: selecting the corporation or departmental service to commercialize; assessing its financial viability; and preparation and execution of the commercialization. If public ownership of a corporation or government provision of a service was not necessary to support government policy and the new entity could be effectively regulated, it was considered a candidate for commercialization. At this stage, the effect of a sale on employees' pension rights and other benefits would also be analyzed. Then, the department responsible would conduct an assessment of the profitability of the private-sector corporation or self-sufficiency of an authority. If financial viability looked assured, options for commercialization would be considered. If financial viability was in question, the corporation or service would be restructured prior to commercialization. Finally, the corporation or service would be valued, the intent to commercialize would be announced and interest would be solicited from potential purchasers or groups that wished to form a local authority.(4) Often, divestiture legislation had to be drafted and passed prior to the sale or lease of the government enterprise.(5)

Major privatizations preceded the wave of authorities created in Canada. Following the 1985 Budget, the privatization program was managed by the Office of Privatization and Regulatory Affairs (OPRA) until 1991. At this time, its responsibilities were rolled into other central agencies such as the Treasury Board and the Department of Finance. The establishment of authorities in the 1990s was generally carried out by the line department whose assets were affected, once the Department of Finance had given its approval.

Through commercialization and the enabling legislation, the federal government effectively transformed its role from direct provider of goods and services to regulator and monitor. In the case of authorities, the enabling legislation often provides that the federal government continue to own key assets and land, dictate the corporate architecture and name most appointments to the board. Furthermore, the federal government may: legislate limits on

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(4) In the case of privatization, the government had to decide on the format of sale. Among the various options available, the federal government usually chose either to sell to a single bidder or to offer some or all shares in the enterprise on the public market.

(5) Examples of divestiture legislation include the *Air Canada Public Participation Act*, the *Canada Marine Act*, the *CN Commercialization Act*, the *Airports Transfer (Miscellaneous Matters) Act* and the *Civil Air Navigation Services Commercialization Act*.

the authority's financing and certain operations; specify accounting procedures to be used in annual reports; make regular consultation with government and/or stakeholders mandatory; and entrench job security. The divestiture legislation for privatized corporations is somewhat less restrictive, but usually some conditions are imposed on these former Crown corporations that are not imposed on other private-sector enterprises. For example, the divestiture legislation for a privatization often contains a provision capping foreign ownership in the new corporation and provides that the *Official Languages Act* continue to apply as if the new corporation remained a federal institution. In the case of both Air Canada and Canadian National Railways, the privatized enterprises are obligated by their divestiture legislation to maintain their corporate headquarters in the Montreal Urban Community.

EXAMPLES OF COMMERCIALIZATION

Nearly 30 federal Crown corporations, valued at approximately $12 billion, have been privatized in Canada since 1985. Many of the early privatizations, such as that of Northern Transportation Company Ltd., de Havilland Aircraft of Canada Ltd., Pêcheries Canada Inc. and Canadian Arsenals Ltd., were sales to existing private businesses through a competitive bidding process. Some of the larger Crown corporations, including Air Canada, Petro-Canada and Canadian National Railways, were privatized through public share offerings. The government's sale of its remaining shares in Petro-Canada in late September 2004 was the most recent transaction and, at $3.2 billion, was the largest share offering in Canadian history.

The vast majority of Canadian privatizations survived the transition from a Crown corporation with mixed public- and private-sector objectives to a private corporation with private-sector objectives.(6) Some particularly successful federal privatizations that not only survived the transition but also became more competitive and efficient under private ownership include:

- *Canadair Inc.* Bombardier Inc. purchased Canadair Inc. for approximately $286 million in 1986 and established it as a subsidiary. Bombardier provided new commercial opportunities for Canadair, and it became more competitive and was able to expand its product line to meet the growing needs of the aerospace market. Canadair Regional Jets make up a large share of the international market for 50- to 70-seat jets today.

(6) One notable exception is CN Route, a trucking subsidiary of CN Rail, which went bankrupt less than two years after divestiture in 1986. The provincial trucking industry was deregulated at the time, leading to many failures and consolidation in the industry.

- *Canadian National Railways* (CN). Although CN operated efficiently under government ownership, the public policy objective of owning a freight railway had disappeared and so it was slated for privatization. The federal government sold CN through a public share offering in 1995. It was the second-largest federal privatization ever, yielding approximately $2 billion, although $900 million was used to retire the company debt. Since privatization, CN has expanded into the United States and rationalized its Canadian network.

- *Petro-Canada*. The sale of Petro-Canada, through share offerings between 1991 and 2004, is the largest federal privatization to date, yielding over $5.7 billion. The total gross proceeds to the government from the sale of Petro-Canada are estimated to have exceeded taxpayers' total investment by almost $750 million. Furthermore, prior to privatization, Petro-Canada was widely regarded as inefficient, oversized and debt-ridden. Within a few years of the first share issue, Petro-Canada had reduced its assets by 10% and cut its workforce by over 40%.

A chronological list of significant federal privatizations is provided in the Appendix with the year of the sale, the buyer and the purchase price.

Throughout the 1990s, the federal government established authorities to manage and operate nearly all of Canada's 26 major airports, 19 major seaports and the St. Lawrence Seaway.

- Commercialization of major airports in Canada, which took place between 1992 and 2003, was the result of the cumulative effect of new national airports policies. Airports with annual passenger traffic in excess of 200,000 and airports serving provincial capitals were considered candidates for commercialization by authority.(7) A 60-year Ground Lease agreement was negotiated separately for each airport; the agreements set out the terms of each transfer, including the formula for lease payments on the infrastructure.

- Ports that were financially self-sufficient, were of strategic significance to trade, had diversified traffic and were linked to a major rail or highway network were transferred in 1998 to port authorities. Part 1 of the *Canada Marine Act* (CMA) includes provisions detailing the terms of transfer (governance, capacity and powers, etc.), which apply equally to all port authorities under the Act. Port authorities also had to apply for Letters Patent under the *Canada Business Corporations Act*; the contents of the Letters Patent are described in the CMA. Regulations under the CMA govern port authority management and operations.

- The St. Lawrence Seaway was taken over by a not-for-profit corporation in 1998. A 20-year agreement was struck between the Minister of Transport and the St. Lawrence Seaway Management Corporation under Part 3 of the CMA. The agreement includes provisions respecting the transfer of land, management, operations, construction and maintenance of the Seaway, and other matters.

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(7) Airports serving the territorial capitals were the exception: they were sold to the territorial governments instead of being commercialized.

PUBLIC-PRIVATE PARTNERSHIPS (PPPs) IN CANADA

The Canadian Council for Public-Private Partnerships defines a public-private partnership (PPP) as:

> A cooperative venture where there is an allocation of the risks inherent in the provision of a public service between the public and private sectors. A successful PPP builds on the expertise of each partner to meet clearly defined public needs and provide a net benefit (or value for money) to the general public though appropriate allocation of resources, risks and rewards.(8)

PPPs can range from contracts for the maintenance and/or operation of existing facilities to contracts for developing, building, financing and operating new facilities.

A. Potential Benefits and Risks of PPPs

In the development of new infrastructure, private companies may complement the public-sector investor by providing:

- new sources of capital for financing;
- more rapid and lower-cost construction and operations due to flexible contracting and procurement and innovative practices;
- potential for increased project revenue through user fees or secondary developments (value capture); and
- potential for increased government revenue through profit sharing or lease or franchise agreements.

Most importantly, because the public sector shares risk with private companies, new projects that offer significant public benefits but are inherently high-risk are more likely to be undertaken. As a result, society at large benefits from new projects that might not have been pursued if not for the PPP model.

(8) See the Council's Web site at http://www.pppcouncil.ca/aboutPPP_definition.asp.

The advantages of PPPs in the development of new infrastructure come with risks for both private- and public-sector partners, however. Usually, private-sector partners are in jeopardy if construction or operating costs exceed projections and if regulatory changes have a negative impact on the business environment. The finances of both public and private partners are at risk if project revenues are lower than anticipated. Also, private financing is typically more expensive than public borrowing, which could reduce the cost savings expected from commercialization. There is also a risk that information disparities between the public and private partners could make developing an effective agreement difficult.

B. Process of Forming a PPP

A potentially successful partnership allocates the inherent responsibilities and risks to the partner best suited to managing them. The responsibilities arising from a new project would include: projection initiation and planning, design, financing, construction, ownership, operation and revenue collection.

With each responsibility comes risk; Table 1 presents the optimal allocation of risk in a PPP that plays to each partner's strengths. Risks due to cost management are best suited to the private sector since private investors contribute their own resources, creating a strong incentive to manage project costs properly in order to recover the investment plus a return. On the other hand, risks due to regulatory changes should be allocated to the government.

Table 1
Optimal Allocation of Risk Between Public and Private Partners

Risk Category	Examples	Partner Likely Suited to Bear Risk
Technical	Engineering or design failures	Private
Construction	Cost escalation due to faulty technique or delays	Private
Operating	Costly operation and maintenance	Private
Revenue	Deficient revenue owing to low volume or price	Public/Private
Financial	Costs of inadequate revenue hedging, debt management	Private
Force Majeure	Losses from war, acts of God	Public/Private
Regulatory/Political	Changes in law or policy that undermine project finances	Public
Environmental	Damage though adverse environmental impacts/liability	Private
Project Default	Failure to complete project	Public/Private

Source: Finn Poschmann, *Private Means to Public Ends: The Future of Public-Private Partnerships*, C.D. Howe Commentary, Toronto, June 2003.

The division of rewards from a project is also critical in creating an agreement that provides efficiency incentives. For example, performance-based rates of return tend to induce cost-minimization, whereas input-based returns may not.

C. Examples of PPPs

Relatively few PPPs exist in Canada today, but some that were considered successful in the past include:

- *Toronto Pearson Airport terminal building projects (1988).* Transport Canada gave Airport Development Corporation (ADC), a private developer, the right to design, build, finance and operate Terminal 3. ADC assumed the financial risk of the project, which included a terminal, parking facilities and a hotel. It finished 18 months ahead of schedule and kept costs significantly below Transport Canada's projected budget.(9)

- *Charleswood Bridge in Winnipeg (1994).* Private developer DBF Ltd. designed, built and financed the project. The bridge is leased to the city, but for 30 years DBF will be responsible for major maintenance. The City estimated that project cost savings were in the order of $1 million (10% of project costs) and that it was completed two years faster than if the City had done it.(10)

- *Highway 104 (Cobequid Pass) in Nova Scotia (1997).* Atlantic Highways Corporation designed and built the toll highway and will operate it for the first 30 years; however, the assets belong to the province. The province estimated that capital cost savings amounted to 8% of project costs ($10 million) and reported that the project was finished two weeks ahead of schedule.(11)

CONCLUSION

Two common forms of commercialization in Canada are privatization of government enterprises and the establishment of not-for-profit authorities to manage and operate assets on a lease. These were employed by the federal government in an effort to improve its short- and long-term financial position and to boost economic performance both in the sector affected and economy-wide.

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(9) Simon Hakim, Paul Seidenstat and Gary Bowman, eds., *Privatizing Transportation Systems*, Praeger Publishers, Westport, CT, 1996.

(10) Canadian Council for Public-Private Partnerships, *Successful Transportation Public-Private Partnerships in Canada and the USA*, Toronto, November 2002.

(11) *Ibid.*

Canada's experience with commercialization has generally been positive. Federal privatizations in Canada seem to have been successful inasmuch as the former Crown corporations, the majority of which were sold in the late 1980s and early 1990s, are still operating in the private sector today. As such, the primary objectives of privatization – reducing the federal administrative and financial burden while continuing to provide goods and services to the public – were achieved. The establishment of not-for-profit authorities has had the desired effect of stimulating capacity growth at ports and airports, even if it is still not clear whether the federal government benefited financially from the commercialization. There are lingering allegations that authorities are not accountable enough and lack cost-saving incentives, which may become an issue for government in the future.

Looking ahead, the most significant role for the private sector will likely be in the construction of new public infrastructure through partnership agreements with the federal government. The Canadian Council for Public-Private Partnerships believes that PPPs will be necessary to address the infrastructure deficit in Canada, which is estimated at between $50 billion and $125 billion.(12) It is also possible that the government may choose to go one step further with the major airports and privatize them, as has been done in the United Kingdom and Australia.

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APPENDIX

GOVERNMENT OF CANADA PRIVATIZATION INITIATIVES, 1985-2004

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GOVERNMENT OF CANADA PRIVATIZATION INITIATIVES, 1985-2004

Corporation	Buyer	Year	Price
Northern Transportation Company Ltd.	Inuvialuit/Nunasi Corporation	1985	$27 M
de Havilland Aircraft of Canada Ltd.	Boeing Company	1985	$155 M(1)
Pêcheries Canada Inc.	La co-opérative agro-alimentaire Purdel	1986	$5 M
Canadian Arsenals Ltd.	SNC Group	1986	$92 M
Canada Development Corporation (47% interest)	Public and private share offerings	1986-1987	$361 M
Nanisivik Mines Ltd. (18% interest)	Mineral Resources International Ltd.	1986	$6 M
CN Route	Route Canada Holdings Inc.	1986	$29 M
Canadair Ltd.	Bombardier Inc.	1986	Approx. $296 M(2)
Northern Canada Power Commission – Yukon	Yukon Power Corporation	1987	$76 M
Teleglobe Canada	Memotec Data Inc.	1987	$608 M
Fisheries Products International Ltd. (62.6% interest)	Public share offering	1987	$117 M
Varity Corporation (8 million purchase warrants)	Public and private share offerings	1987-1991	$9 M
CN Hotels	Canadian Pacific Ltd.	1988	$265 M
Northern Canada Power Commission – NWT	Northwest Territories Government	1988	$54 M
Northwestel Inc.	BCE Inc.	1988	$200 M
Terra Nova Telecommunications	Newfoundland Telephone Company Ltd.	1988	$170 M
CNCP Telecommunications and Telecommunications Terminal Systems (50% interest)	Canadian Pacific Ltd.	1988	$235 M
Air Canada	Public share offerings	1988-1989	$707 M(3)
Petro-Canada	Public share offering	1991-1992-1995 and 2004	$5,707 M
Cameco	Public offering and sale to securities firm	1991-1992-1993-1994-1995	$444 M
Nordion International Inc.	MDS Health Group Ltd.	1991	$165 M

Corporation	Buyer	Year	Price
Telesat Canada	Alouette Telecommunications Inc.	1992	$155 M
Cooperative Energy Corporation	Public offering	1992-1993	$75 M
Canadian National Railways	Public offering	1995	$2,079 M
CN Exploration	Smart on Resources Ltd.	1995	Undisclosed
Civil air navigation system (departmental service)	NAV Canada	1996	$1,500 M
Canarctic Shipping Company Ltd. (51% interest)	Fednav Ltd.	1996	$0.3 M
Canada Communication Group	St. Joseph Corporation	1996	$11 M
National Sea Product (10.5% interest)	Scotia Investments Ltd.	1997	$6 M

(1) $90 million on closing and $65 million over time.

(2) Sale price included cash on closing, future royalties and the proceeds from a lawsuit.

(3) Proceeds from first offering recapitalized the company and the $473 million from the second share offering went to the government.