



Good Debt vs Bad Debt across the public infrastructure space

Debt for all sectors is an essential, accepted form of good business, particularly for big-ticket items such as infrastructure. Good debt assists in the generation of income and (generally) increases the net worth of the responsible entity.

This discussion paper outlines the burgeoning crisis facing us all in the public sector infrastructure space; as it relates to an ever-mounting deficit in backlog maintenance of assets, hard targets of energy and greenhouse gas reductions, balanced against competing demands for budgets. This crisis existed pre-Covid19, however our urgent need to head off a catastrophe around public sector infrastructure deficit is more pressing than ever. To address this issue, the paper reinvents an existing solution, building upon existing tried and trusted delivery mechanisms to align more closely with today's needs and drivers for public accountability and increased efficiencies around spending within the public sector.

The recommendations are drawn from direct observations and advisory studies across the public sector and promotes joint working practices and ventures between public and private entities, so that together we can appropriately allocate risk and share in the prevention of a calamity that if not addressed soon, we will be handing to the generations to come.

There are many definitions outlining what "good debt" and "bad debt" are, but the following brief descriptions are a good start:

Good debt is that which increases net worth and/or helps to generate value.

Bad debt, in contrast, is that which does not increase wealth and/or is used to purchase goods or services that have no lasting value.

For many public-sector bodies, incurring debt is considered irresponsible, exposing taxpayers to unnecessary risk. Many public entities build in an overly cautious risk factor to approaching their debt ratio limits, with an absolute limit placed no matter how just the cause.

Debt ratio

Debt cannot be considered in isolation, and it is prudent when looking at good and bad debt to also have regard to debt ratio—how credit financing compares to assets, calculated by dividing total liabilities by total assets, and this really depends on the context in which it is analyzed. To incur good debt in the prevention of the deterioration (and therefore depreciation) of an asset is at the very least contributing to maintaining a good debt ratio.

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The opportunity

We are in the age where the public sector is increasingly being asked to do more with less, to find efficiencies, and to use existing resources more effectively. Central funding is limited, highly competed for and when available, does not always match the priorities of local or regional governments. This drives the need for finding smarter ways to finance public assets.

This presents us with an opportunity. A colleague of mine uses the phrase "current solution, current results-new solution, new results." Therefore, since the current solution has led to a significant backlog of maintenance across the public sector (as well as year-on-year short falls in funding) and increasingly missed energy and GHG reduction targets, we need a new solution.

A potential solution

The solution identified is supported by access to good debt by the public sector. We do this by leveraging asset portfolios to make them work more efficiently and economically, transferring infrastructure debt to financial debt.

So how does it work in practice? Approximately \$350 million of public sector procured projects are carried out each year using this structure, yet it is still one of the best kept secrets in the public sector space, with tens of \$ billions of untapped potential across Canada. Many public entities are using money that is already being spent in a more efficient manner to free-up additional capital that can be allocated to support core programs within the public sector entity.

Firstly, through the implementation of a comprehensive energy-efficiency refurbishment program, it is possible to quantify through benchmarking and capture through performance measures considerable savings on the current cost of utility payments. A portion of these savings are redirected into the asset portfolio to address backlogged maintenance and energy upgrades-in turn generating additional savings. Both the program and savings are *guaranteed* (underwritten) by the private sector, guaranteeing a rate of return on revenue for the public sector.

Additionally, working with a private sector performance contracting firm (referred to as an "Energy Services Company" or "ESCO"), it is possible to blend low-cost public sector debt with that of private sector debt, largely from institutional investors, at a ratio of three (and sometimes four) to one. The debt is serviced over a period of between 10 and 20 years, optimizing the balance of debt repayment with cyclical returns on asset investment. The debt service period will be shorter or longer as appropriate to the individual entity, its specific asset portfolio needs and extent of refurbishment work carried out. The outcome is to service as much as possible, if not all of the debt repayment from the avoided utility costs through energy saved, and to protect the public sector entity from a debt liability risk with a private sector guarantee on the energy savings.

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The results

By incorporating good debt into our model, we are in fact able to deliver more and produce higher savings for the public entity, which can be reemployed to reduce backlog maintenance liability, undertake life-cycle replacements and fund much-needed capital programs.

There are two important factors regarding public-sector risk:

The debt-service costs associated with the incremental debt (principal **and** interest) are already built into the public entity's operating budget as it would come from avoided utility costs; and

The risks associated with ensuring the debt is retired from operating savings within the prescribed term is transferred to the private sector by mandating capital upset cost and savings performance guarantees.

In addition, there are many additional, not-immediately-apparent benefits, such as reduction in emergency repairs, less downtime of the assets, the transference of resilience risk, and more job opportunities across the program.

It is known that fiscal debt is a key consideration for the rating agencies when considering a public entity, but they will also take into consideration capital programs, deferred maintenance, and future capital planning. The rating agencies will also differentiate between tax or discounted supported debt and that of self-supported debt. Interestingly, there is a conversation to be had with the ratings agencies and their approach to infrastructure debt over fiscal debt in-light of recent Covid related events, indeed we have already seen a number of Municipalities across Canada have their ratings downgraded as debt has increased or expected revenue has been wiped out. There must come a point where a public entity will be downgraded if its assets become so poorly maintained as they impact the overall liabilities for the organization. I predict that when it comes to the materiality around infrastructure debt and fiscal performance, deferred maintenance will play an increasingly larger factor going forward.

Above all, the intrinsic capital value of the asset is protected and our generational inheritance is enhanced. This has the effect of increasing the public entity's ability to maintain a good debt ratio without placing additional burden on taxpayers.



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