

Methodology for Quantitative Procurement Options Analysis – Discussion Draft: Feedback

Introduction

Partnerships British Columbia (PBC) released this draft paper in August 2009 and has invited comments on it to be submitted by November 24. As an individual familiar with major project procurement options, related risks and benefits as well as issues related to public-private-partnerships (PPPs), I will respond to the invitation with a few comments here.

General Comments

In general the Methodology paper is very useful in that it sets out a rigorous standard for comparing traditional government capital projects procurement with other forms of procurement involving various PPP structures. While the paper notes that there is a “range of procurement options that are generally accepted to be PPP structures [which] include:

- Design build (DB)
- Design build finance (DBF)
- Design build maintain (DBM)
- Design build finance maintain (DBFM)
- Design build finance operate (DBFO)”

the paper focuses to a large extent on options other than DB. That may not be appropriate for a number of government projects. Some projects are mandated by the BC government to be operated and maintained by

government agencies so that DBM, DBFM and DBFO are not feasible options.

In addition, while a number of project risks may be transferred to PPP proponents in the operations phase, in many large, complex capital projects most of the significant risks will arise during the design, construction and commissioning phase, before operations begin. A properly constructed DB contract with a reputable contractor can achieve a substantial amount of risk transfer in this critical phase as well as innovation, design quality and required performance. With such a contract the design/construction entity can be held financially responsible for design, construction cost, schedule and performance for a period several years after project commissioning, when most of the potential problems should appear. These benefits are not generally available in traditional design bid build (DBB) procurement.

While the paper does identify DB as a possible PPP structure in one place (section 1.2), it also throws DB in with DBB in another place (section 3.1.1) as an existing procurement practice. There have been a few BC government DB projects in recent years but it is hardly a common existing procurement practice. DB is not traditional procurement; it has many benefits and may be better accepted by various stakeholders than those involving long term financing, maintenance and operation. DB should be considered a serious PPP procurement option in government capital projects.

Public Sector Comparator (PSC) and the Shadow Bid

The methodology laid out in the PBC paper for procurement options comparison briefly is to:

- Estimate the capital cost of a PSC project (traditional government procurement practices)
- Estimate all other related project costs over the life cycle
- Identify risks and quantify them
- Discount all costs, risk adjusted, to get a net present cost (NPC) for the PSC.
- For a Shadow Bid take the PSC capital cost estimate and make informed estimates of potential efficiencies that could alter the cost estimate
- Consider which project risks can/should be borne by the government, transferred or shared
- Quantify these risks and adjust the PSC cost
- Discount all costs at the same discount rate (the assumed cost of capital) to arrive at a Shadow Bid to provide the project service over time
- Compare the Shadow Bid and the PSC to determine relative values for money and possibly proceed to solicit PPP bids

This approach may produce a fairly reliable comparison, although a lot of judgment and estimation is involved. The PBC paper notes that the estimates and assumptions made may have to be revised once (or if) a preferred proponent for a PPP is selected. For example the cost of

capital is to be validated using the proponent's financial model (see section 5.1.4).

Another approach here, perhaps obvious but one that has been used for some BC Crown Corporation power projects, would involve first taking all of the steps shown above to arrive at the NPC for the PSC, including the determination, desired allocation and value of the project risks. Following this would come a solicitation of competitive bids, prescribing the risk allocation to the bidders. A relatively detailed project concept description is required, a statement of mandatory elements and performance requirements as well as a draft Form of Contract. Bidders in the bid process would provide their assessment and cost of the risks and their cost of capital. The NPC of the bids would be calculated for comparison with the NPC for the PSC. If lower, an award could be made to a bidder (the government reserves the right not to award) otherwise a traditional approach could be followed.

The advantage here would be a more reliable value to use in comparison with the PSC. The disadvantage may be that bidders would require an honorarium to induce them to bid. This approach should take no longer than the approach laid out in the paper.

Risk Transfer Zero Sum Game

It is often argued by government officials and others that any risk transfer from government to the PPP proponent is a zero sum game. Proponents will simply increase the price of their proposal by their expected cost of absorbing the risk. It is not clear if the Methodology paper implicitly makes the same judgment, see section 4.2.4. If so

“innovation” alone would have to be relied upon to tip the scales in favour of a PPP procurement option.

In deciding which risks should be retained, transferred or shared, a good rule is to assign risks to those who can best manage them. Tax changes, regulatory changes and First Nations actions, for example, may be able to be fully transferred to the proponent, but will be expensive to do so. In such cases the cost incorporated in a bid may substantially exceed the estimated cost of an event. Government has some control or at least better understands such risks and such risks should be retained.

On the other hand, certain risks identified and costed by government may be only partially reflected in a bid price. The reason here would be that the private sector believes it can manage the risk better than would be the case in traditional procurement. One large engineering firm active in BC government capital projects has said that in preparing a bid it will independently estimate the likelihood and cost of assuming a risk and include only 50% of such an estimate in a bid, believing it can avoid or manage the risk. Using the approach laid out in the paper this information would only become known after a preferred proponent was selected and a bid received. If no bid was received to validate the Shadow Bid and the PSC route was selected this information would not be known.

On a final point in this section it must be said that while the government may contractually succeed in transferring certain risks to the PPP proponent, it may turn out that after a risk event the government may end up bearing all or a portion of the risk. Why? First, no contract deals

with all possible events (“unknown unknowns”) and if not identified and transferred it will belong to the government. Second, even if a certain event is covered by the contractual language, there could be a dispute on intent or causation. In such cases arbitration is usually called for and arbitrator’s awards are often a matter of “cutting the baby in half”.

Conclusion

The PBC Methodology paper accomplishes what it sets out to do: “support a rigorous standard and consistent approach for undertaking procurement options analysis”. The comments offered here are only meant to provide a couple of other views on the subject.

These are:

- DB often will give significant value over DBB procurement and may be more feasible in a policy/politically constrained environment than DBF, DBM, DBFM and DBFO
- A better alternative to constructing a Shadow Bid using risk and relative cost estimates and assumptions may be to ask proponents to provide a project bid to compare with a traditional PSC cost estimate
- Risk transfer should not be a zero sum game if done correctly
- Transferred risks may not turn out to be so in a dispute resolution

I hope this is useful feedback.

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