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The Public Sector Comparator: Uses and Abuses

Prepared by: Alan D. Russell* and Cheryl Nelms*

*Department of Civil Engineering, University of British Columbia
6250 Applied Science Lane, Vancouver, BC Canada, V6T 1Z4

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Phelps Centre for the Study of Government and Business
Sauder School of Business
University of British Columbia
2053 Main Mall, Vancouver, BC V6T 1Z2
Tel: 604 822 8399 or e-mail: phelps_centre@sauder.ubc.ca
Web: http://csgb.ubc.ca/p3_about.html
The public sector comparator: uses and abuses

Alan D. Russell
University of British Columbia, Vancouver, Canada (email: adr@civil.ubc.ca)

Cheryl Nelms
University of British Columbia, Vancouver, Canada (email: cnelms@telus.net)

Abstract

Governments on a world-wide basis are exploring alternative modes of procurement for major infrastructure projects. One category of procurement models that has gained prominence is that of Public-Private Partnerships (P3). In deciding upon the most suitable procurement mode for a capital project, government seeks an answer to the question: which procurement mode offers the best value for money (VFM)? To help answer this question, the notion of a risk adjusted public sector comparator (PSC) has been utilized. While in theory appropriate uses of the PSC are clear, the authors have observed in practice a lack of clarity as to the uses to which a PSC can be put, and in terms of the agendas of both advocates and opponents of P3s, a number of abuses. This paper explores both, with emphasis on two different philosophies on how best to use the PSC in the search for best VFM, the pros and cons of each philosophy, the legitimacy of adjusting the PSC throughout the procurement process, and the validity of making comparisons between hypothetical and actual numbers in post mortem analysis.

Keywords: public sector comparator, public-private partnerships, decision making.

1. Introduction

Governments at all levels are highly motivated to explore alternate procurement methods for public infrastructure because of high debt loads, the desire to achieve greater efficiencies in project delivery and operation, an insatiable demand by the public for more physical infrastructure and services, and a change in philosophy on the part of government towards purchasing infrastructure services with price certain as opposed to being responsible for the financing, design, construction, operation and maintenance of physical infrastructure and many of the attendant risks. As a result, the concept of public-private partnerships (P3) has gained prominence. Given a project context, government needs a methodology to assist it in assessing how best to procure the project using a procurement tool kit that ranges from traditional, government led project delivery through to complete private sector delivery, with government being limited to a regulatory oversight role. The notion of a risk-adjusted public sector comparator (PSC)
has been touted as the means for helping government make procurement decisions and assessing value for money (VFM). VFM is both difficult to define and demonstrate objectively as it involves assessment under uncertainty, valuation of both quantitative and qualitative factors and the inclusion of the governmental value system. In theory, quantitative evidence to support judgment that VFM has been achieved is provided through the use of a comparator [1], [2]. However, the PSC is not a complete surrogate for VFM, especially when complex government and stakeholder value systems are involved. Arguments made in support of using P3 relate to the capacity for innovation on the part of the private sector along with its focus and discipline in the delivery and operation of projects, which together lead to more cost effective procurement of projects, better management of risks, more cost-effective operation and maintenance, better identification and exploitation of revenue generating opportunities, and the freeing up of the borrowing capacity of government. A challenge in assessing VFM is how to reflect these claims in the decision making process, especially in PSC analysis.

The context of interest in this paper is where acquisition of the infrastructure is highly likely to proceed, subject to affordability constraints, using either traditional or P3 procurement, as opposed to the situation where lack of funds on the part of government precludes construction of the infrastructure unless a P3 is used. We examine two different philosophies associated with a PSC as part of the procurement mode decision making process, the pros and cons of each, issues associated with making adjustments to the PSC during the procurement process, and finally, the validity, if any in a post mortem analysis, of comparing hypothetical numbers associated with the PSC with the actual outcome of a successful or failed negotiation. Parts of the discussion are illustrated using aspects of a simplified yet realistic project scenario which captures several of the substantive differences between public versus private sector led delivery.

In examining uses and abuses of the PSC, we neither argue the case for or against P3. Our perspective is that it is simply another procurement mode that can be used, depending on project context. We do not concern ourselves with issues of discount rate, other than to say that we assume that in developing the risk adjusted PSC, risks are priced out in the numerator of the equation for net present value (NPV) for the case of a revenue generating project or net present cost (NPC) when no revenues are involved, as opposed to being priced in the discount rate [3], [4]. Further, we assume that in developing a risk adjusted PSC, the full spectrum of risks will be treated through the application of a rigorous approach to risk modeling and analysis. We mention the foregoing, as we have observed the use of hybrid analyses for actual projects which consist of a combination of a deterministic analysis for base project scope and a probabilistic analysis for discrete risks transferred, and use of a discount rate for the private sector viewpoint which includes a risk premium, even though risks are also explicitly priced in the numerator of the relevant present worth equation.
To date, a number of authors and government bodies [2], [3], [4], [5], [6], [7] have written about the formulation of a PSC. The National Audit Office [8] in the United Kingdom defined a PSC as follows: “A public sector comparator is a benchmark against which value for money is assessed. It is typically a cost estimate based on the assumption that assets are acquired through conventional funding and that the procurer retains significant managerial responsibility and exposure to risk.” Development of a PSC is discussed in some detail in Treasury Taskforce [9], where it is defined as: “a hypothetical risk-adjusted costing by public sector to an output specification produced as part of a PFI procurement exercise”, in which “costs have to be expressed in net present value terms based on recent actual public sector methods of providing that output and take full account of the risks that would be encountered by that style of procurement”. Central to the concept of a PSC is a comparison of like things – i.e. the scope and quality of services remains constant, independent of procurement mode.

Despite a considerable amount of PSC ‘how to’ literature, there is not a significant body of work dealing with its strengths and weaknesses. Grimsey and Lewis [10] provide a number of references to those who have questioned the PSC approach, and also identify VFM practices in various countries. They summarize the primary concerns expressed with PSC and VFM evaluations as relating to: the inconsistent use of assumptions in the financial analysis particularly with respect to the treatment of risk; the discount rate does not adequately account for the social time preference; the cost of uncertainty ultimately falls to bear on the public; and, the challenge and ambiguities associated with a financial analysis over long time periods and accounting for qualitative factors. The rationale to develop a PSC is best expressed by Partnerships Victoria [3] as a method that promotes full cost pricing early in the procurement phase, provides a test for VFM and a consistent benchmark and evaluation tool, generates confidence that financial rigour and probity principles have been applied which encourages competition in the bidding process and provides a management tool for the procurement process that focuses on risk allocation, output specification, and comprehensive costing.

2. Background project scenario

We make use of a simplified yet realistic scenario which provides a useful backdrop to the discussion in the next section. A complete description of the scenario with accompanying data, risk analysis approach, public vs. private sector averseness to risk, and discussion of results may be found in [11]. Our perspective is that of government doing the data collection and analysis as of time now (i.e. all estimates are projections of future events) for purposes of making decisions as to the best procurement mode and allocation of risks. The type of project selected involves a revenue function that has both a user pay component, as well as a direct subsidy from government. For the P3 option, the private sector is bidding on the annual subsidy that it requires.
Briefly, the scenario is as follows. Based on a policy to attract high technology industries to the region, government wishes to assist high-tech start ups by providing 600,000 ft² of inexpensive rental accommodation. The government has determined that a subsidized lease rate would help attract high tech industry to locate in the region. While the lease rate will be known with certainty, the occupancy or vacancy rate is highly uncertain, and is subject to the vagaries of the high-tech sector. The rental accommodation will be situated on a large piece of land already owned by government, which has an appraised value of $25 million and which previously has been occupied by various process industries. As-built information pertaining to existing underground utilities is sketchy, there is a contaminated soil problem, and soil bearing capacity is highly variable and hard to predict.

Government is faced with deciding whether to procure the facility using a traditional procurement mode in which it owns and operates the facility, or to procure it using a FDBOM (finance, design, build, operate & maintain) mode of procurement. Under a traditional arrangement, except for normal construction risks, risks to be retained deal with underground utilities, contaminated soil, bearing capacity problems, financing, revenue, and operation and maintenance. The criterion adopted for a go versus no-go decision using traditional procurement is that the probability that NPV is below the current value of the land must be less than or equal to 25%. Under a P3 arrangement, government wishes to transfer all underground, financing, revenue and operating and maintenance risks. The risk averseness of the private sector is expressed as follows: it requires an annual base subsidy level such that the probability that NPV is less than zero at a discount rate equal to the expected cost of borrowed funds is not more than x% (thresholds of 10%, 20%, and 30% are used).

3. Uses / abuses of the PSC

Figure 1 depicts a number of steps involved in the decision making processes used to assess whether a project should proceed or not, and if yes, issues surrounding the selection of the most suitable procurement mode. It is not meant to be a definitive flow chart encompassing all steps in the decision making processes involved. Our primary focus is on steps 1 through 10, with the remaining steps reflecting use of traditional procurement in the event of its superiority to P3 in terms of VFM or failed P3 negotiations. We assume that the outcome of steps 1 through 3 demonstrates the need for the project, and that timeliness and budget implications have been blessed by the relevant government body. In getting through steps 1 through 3, a number of studies will have been conducted, ranging from environmental and geotechnical investigations, program requirements, scope issues and possibly rough conceptual design(s), schedule, project stakeholders and stakeholder issues, and so on. A considerable body of information gets assembled at this stage. Shown in the bottom half of Figure 1 in
Figure 1 Overview of steps in procurement decision process, alternative paths, and generation of information – North American context
conceptual form is the evolution of information with time, with the assumption being that a P3 procurement mode is eventually determined to be the best way to achieve VFM. Thus, in the earliest stages of the overall decision making process, government possesses the most knowledge about the project. However, once the decision is made to proceed with the project, and in particular, with a P3 procurement mode, the knowledge advantage shifts to the private sector, as it develops far more specific information about the project, especially in regard to design, construction, operation and maintenance, and risk matters. This has significant implications for PSC analysis, what adjustments are valid for such an analysis at later decision making stages, and how the PSC can be used in the negotiating process. Here, we wish to traverse the upper diagram in Figure 1 with step 4 being our main focus, and highlight the pros and cons of two different approaches to decision making as to the best procurement mode, assumptions involved, and appropriate vs. inappropriate uses of information.

Step 4 indicates two different approaches to assessing which procurement mode will yield best VFM. We note that other tests such as multiple criteria analysis may be pursued. Our main focus here is on the role that the use of a PSC plays. We look in turn at two alternative approaches, as represented by steps 4(a) and 4(b).

Step 4(a) represents a 3-part approach to selecting the preferred mode of procurement by comparing the PSC using ‘traditional’ procurement vs. the cost / revenue to government using P3 procurement – i.e. the PSC plays a central role in deciding upon the preferred procurement option. We note that Partnerships Victoria [4] is not in favour of this approach, while it forms the backbone of the approach used in the Provinces of British Columbia, Alberta and Ontario, Canada. The three parts are:

(i) The first part involves establishing the benchmark to beat, the so-called public-sector comparator, which we call PSC\(_T\) for ease of reference. This involves pricing out a government led project delivery using the information identified in steps 1 through 3. The first duty of government is to seek the most appropriate mode of delivery which, depending on project type, market conditions, and project constraints, could be traditional design-bid-build with operation and maintenance by government, through to design build with private sector operation and maintenance. Independent of procurement mode selected, the goal should always be to maximize value for money. We note in passing that under ‘traditional’ procurement, a significant transfer of risk can occur. In computing costs, allowance should be made for all cost categories, and for experience gained on previous projects of a similar type. For example, the cost to government of the construction phase should include base contract cost (which corresponds to the engineers estimate with appropriate contingency allowance) plus an allowance for owner induced/designer error change orders plus an allowance for changed
conditions as set out in the contract, plus an allowance for claims, to which has to be added other owner costs for management/oversight, etc. Similarly, estimates for future costs should include allowances for the complete spectrum of costs normally associated with the type of facility under consideration, and even more importantly, reflect the same operation and maintenance levels required of a private sector operator, not withstanding government’s penchant for deferring maintenance and/or under funding operating and maintenance budgets, which has the potential for introducing into the PSC\textsubscript{T} artificially low estimates for these costs. Ideally, output from this part of the analysis is expressed in the form of a cumulative distribution function (CDF), and a statement of the major contributors to the spread in the CDF. As an example, Figures 2(a) and 2(b) provide the PSC\textsubscript{T} CDF for our background scenario and the contribution of risk sources to the spread in the CDF, respectively, based on parameter estimates for traditional procurement, a subset of which are shown in the left hand side of Table 1.

(ii) The second part of step 4(a) involves preparing a shadow bid that reflects the viewpoint of a concessionaire competing for the project under a P3 procurement mode, with an assumed level of risk transfer / risk sharing. Typically, this risk transfer is more extensive than the traditional procurement option for two reasons: first, the spectrum of services requested of the private sector is expanded leading to a broader assignment of risks, and second, a subset of the risks normally shared with or assigned solely to the public sector client are now assigned to the private sector. Since risk transfer is a key consideration in assessing alternative procurement modes, an important component of the analysis should be the ‘optimization’ of risk transfer which includes identifying the most appropriate assignment of risk events to the private sector. This process may involve some soundings of the private sector and other experts, in order to assess attitudes toward risk and capabilities, and to avoid surprises later in the negotiation phase, if a P3 procurement mode is selected. (In practice, the optimization process seems to involve shifting as much risk as possible to the concessionaire based on expert advice, and then modifying the assignment depending on the amount of push back through the RFP and negotiation phases (steps 6 through 8)). The challenge for government in preparing a shadow bid derives from the need to assess the synergies that might be achieved from bundling all services required into one concession agreement, and the need to assess and price innovation potential for the dimensions of financing, design, construction, and life cycle performance. This is one of two Achilles heels for the process represented by step 4(a), with innovation/efficiency numbers seemingly being drawn out of thin air at times (e.g. use 17% because that is what the Arthur Anderson/Enterprise LSE study [12] says – numbers ranging from -5% through to +20% can be found in the literature [13]). As an example, see the quantification of efficiencies and innovation potential for our background scenario which relate to unit construction costs, development phase
time variables, and base operating and maintenance costs, as shown in the right hand side of Table 1. The estimates used are in line with savings cited in the literature, but the body of evidence supporting these numbers is thin at best. The other is the need to adopt a private sector perspective as to the project’s risk profile, how best to manage it, and aversion to risk. Implicit assumptions often made, mostly of necessity, by those preparing a shadow bid include: (i) the risk sets from the perspectives of the public and private sectors is the same, (ii) the likelihood of occurrence of a risk event is the same, (iii) the values for risk events outcomes are the same, and (iv) the averseness to risk is the same for both sectors. These assumptions in general are not accurate, because of the very different levels of information available to the parties, especially at the time of negotiations, and differing abilities to absorb risks. The propensity of the private sector to accept risk can be overestimated, and in some cases, it does not matter how much the government would be willing to pay, the private sector simply will not accept certain risks. Based on the risks assigned to the private sector and its attitude toward risk, the shadow bid is used to provide an estimate of the payment stream required from or to government, depending on project context.

(iii) The third part of step 4(a) involves taking the finding from part two in the form of price certain for the payment to be made or received by government, which is then combined with all remaining expenditures and risks retained by government. The net present worth of the corresponding cash flow, \( PSC_{P3} \) is then computed, and compared with the value \( PSC_T \) computed in the first part. Note that given a rigorous analysis, both \( PSC_T \) and \( PSC_{P3} \) are described in the form of cumulative distributions or density functions. Then answers to one of several questions could be pursued, along the following lines: What is the probability that \( PSC_T \) is less than \( PSC_{P3} \)? Then depending on the government’s risk tolerance level \( \phi \) (e.g. If \( \text{Prob}[PSC_T - PSC_{P3} < 0 .GT. \phi] \) select the P3 option), a choice can be made between ‘traditional’ and P3 procurement, and the corresponding processes initiated, as shown in Figure 1. For our example, Figure 2(a) depicts the CDFs for \( PSC_{P3} \) for three FDBOM scenarios, corresponding to different levels of risk averseness on the part of the private sector. Note what P3 procurement achieves for government – a very real steepening of the CDF, providing a narrower range of outcomes. However, removing risk comes at a price, and for our example, except for the least level of risk aversion (lowest subsidy level), the government would likely reject use of P3. Risk sharing might make P3 more attractive – see [11].

Several pros and cons accompany the 3-part approach associated with step 4(a). For purposes of brevity, we list them in bullet form. Advantages include the following:

- Use of a PSC forces government to examine critically its traditional procurement options and optimize them to the extent possible;
Table 1 – Selection of parameter values for traditional delivery vs. P3 delivery for background scenario

<table>
<thead>
<tr>
<th>Item</th>
<th>Units</th>
<th>Traditional Delivery</th>
<th>Shadow Bid</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>E[X]</td>
<td>σX</td>
<td>E[X]</td>
</tr>
<tr>
<td>Development Phase</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$, millions</td>
<td>25</td>
<td>0.0</td>
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<tr>
<td>RFP/negotiate phase - time</td>
<td>years</td>
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<td>N/A</td>
</tr>
<tr>
<td>RFP/negotiate phase – current $</td>
<td>$/year</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Design/approval/tendering - time</td>
<td>year</td>
<td>1.296</td>
<td>0.236</td>
</tr>
<tr>
<td>Design/approval/tendering – current $ cost</td>
<td>$, millions</td>
<td>6.06</td>
<td>0.462</td>
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<tr>
<td>Fast-track (fraction of design time)</td>
<td>fraction</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Construction duration exclusive of discrete risk events</td>
<td>years</td>
<td>1.432</td>
<td>0.128</td>
</tr>
<tr>
<td>Time allowance for discrete risk events</td>
<td>years</td>
<td>0.352</td>
<td>0.127</td>
</tr>
<tr>
<td>Total construction duration</td>
<td>years</td>
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<td>1.602</td>
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<tr>
<td>Base unit constant $ construction cost</td>
<td>$/ft2</td>
<td>100.93</td>
<td>7.70</td>
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<tr>
<td>Base constant $ cost</td>
<td>$, millions</td>
<td>60.555</td>
<td>4.615</td>
</tr>
<tr>
<td>Constant $ cost of discrete risk events</td>
<td>$, millions</td>
<td>1.438</td>
<td>1.201</td>
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<tr>
<td>Total constant $ construction costs</td>
<td>$, millions</td>
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<td>4.768</td>
</tr>
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<td>Current $ PM costs during development</td>
<td>$/year</td>
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<td>236396</td>
</tr>
<tr>
<td>Duration of development phase</td>
<td>years</td>
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<td>2.777</td>
</tr>
<tr>
<td>Operating Phase</td>
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<tr>
<td>Operating duration</td>
<td>Years</td>
<td>20</td>
<td>0.0</td>
</tr>
<tr>
<td>Annual debt servicing of construction loan</td>
<td>$/year</td>
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<td>5830630</td>
</tr>
<tr>
<td>Unit constant $ O&amp;M cost</td>
<td>$/ft2</td>
<td>4.59</td>
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</tr>
<tr>
<td>Unit constant $ rental rate, start of operation</td>
<td>$/ft2</td>
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<tr>
<td>Occupancy rate</td>
<td>Fraction</td>
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<td>0.1007</td>
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<tr>
<td>Constant $ cost of Mgt/oversight</td>
<td>$/year</td>
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<td>141838</td>
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<tr>
<td>Revenue subsidy as of start of operation</td>
<td>$/year</td>
<td>N/A</td>
<td>N/A</td>
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<tr>
<td>Annual land lease cost (current $)</td>
<td>$/year</td>
<td>N/A</td>
<td>N/A</td>
</tr>
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</table>

Figure 2(a) CDF for PSC<sub>T</sub> and CDFs for PSC<sub>P3</sub> for different private sector risk aversion levels; 2(b) contribution of different risks to CDF for PSCT.

- The need to formulate a PSC forces government to examine the true cost of ‘traditional’ procurement, both capital and operating and maintenance (O&M). This is not something that government is necessarily willing to share, or may even know with respect to past projects. It also forces government to articulate O&M...
performance metrics, and then assess the level of resources required to achieve these performance levels as opposed to the level it currently allocates;

- Proper formulation of a PSC requires the formal treatment of risk (identification, analysis, mitigation) for all phases of a project and allows for a re-examination of traditional contractual language dealing with the treatment of risk – a side benefit is improved risk management practices by government on major projects;

- Use of a PSC forces greater accountability and transparency in decision making and the choices made by requiring the articulation of project objectives and related performance metrics, justification of scope, and hard vs. soft constraints – this assists in independent reviews by third parties such as the auditor-general;

- The need to formulate a shadow bid as well as the PSC provides an opportunity for early consultation with the private sector to help gauge current market realities, attitudes toward risk and willingness to accept certain risks, the kind of synergies that the private sector may be able to bring, and a more holistic understanding of the total project, as opposed to the silo mentality that often exists in government because of the division of responsibilities – this process also helps with testing assumptions embedded in the PSC;

- The process of formulating a shadow bid assists in preparing for negotiations, should a P3 procurement mode be selected; and,

- Formulation of a shadow bid allows relatively easy termination of the process if it becomes clear that the difference in VFM offered by the two approaches is minimal or a distinct advantage exists for traditional delivery. The costs to the private sector for this scenario are small, and government is not likely to lose credibility.

Disadvantages of the approach, some of which can lead to abuses include:

- A bias toward one procurement mode being preferred to the other can lead to manipulation of the PSC and/or the shadow bid. For example, a bias in favour of P3 can lead to a non-optimal choice of ‘traditional’ procurement mode, and an over specification and pricing of risks retained by government, while at the same time, very optimistic estimates of efficiencies and innovation potential can be incorporated into the shadow bid;

- It is difficult for the public sector to adopt or possess a private sector mindset in formulating a shadow bid, making problematic the assessment and pricing of risk from a private sector perspective; and,

- For both paths 4(a) and 4(b) is an abuse by opponents to P3, who try and use the PSC and results of the shadow bid to discredit the use of P3 based on the results of negotiations post the RFP step, whether successful or not, by comparing estimates of a future outcome frozen at a point in time with the actual outcome which is based on much more information and its evolution over an extended time period.
With respect to the last bullet, we touch only briefly because of space constraints upon the important issue of ‘updating’ the PSC, and shadow bid if it exists. Our view is that the PSC will continue to evolve until the decision about preferred procurement mode is made, at which time it becomes frozen (early in step 6). After that, the only time that it should be modified is in a post mortem analysis, where lessons learned from the process can be captured for use on future projects. For the shadow bid, modifications may be made throughout the process, both to reflect any substantive new information that becomes available through the RFP process and in anticipation of negotiations. This would help with the potentially difficult decision of terminating the P3 process before completion should assumptions and estimates in step 4 prove to be demonstrably wrong.

If path 4(b) is used instead of 4(a), only part (i) of 4(a) applies, with the decision about VFM and other metrics being made independent of the formulation of a PSC, and seemingly in some cases on philosophical or ideological grounds. There is some sharing of advantages with path 4(a), but with the loss of some of the advantages cited for the shadow bid process. On the other hand, an advantage of approach 4(b) is that it avoids the need to quantify efficiency and innovation potential and the pricing of risks on the part of the private sector, thereby sidestepping two thorny issues and providing potentially less ammunition to opponents of P3. However, having decided to proceed down the path of P3, the enormous amount of momentum that is developed makes it difficult to abort the process if P3 does not demonstrate VFM when bids are received, with the government’s concomitant loss of face and credibility in the eyes of the private sector. The negotiating position of government may also be weakened without the additional insights provided by a shadow bid, especially if it is updated during the RFP phase as new information / clarifications unfold.

4. Conclusions

In this paper, the authors have explored two approaches to the use of a public sector comparator (PSC) in making a decision about preferred procurement mode, and pros and cons with each. The first approach involves developing a benchmark, the PSC, and then comparing it with the results of a shadow bid prepared to reflect the viewpoint of the private sector, assuming P3 procurement. The approach offers several advantages, with the main one being that the P3 choice can be eliminated early on if it does not show VFM compared to traditional procurement, thus saving large expenditures by the private sector on a process that will not have a successful outcome. Selection of the preferred procurement mode without use of a shadow bid has the advantage of not having to make a large number of assumptions as to how the private sector is likely to price a P3 proposal. But it comes with a significant risk that the private sector will have expended significant resources on a project best suited to traditional procurement. The topic of updating the PSC and related protocols needs more investigation.
References


