

PPP bidders' compensation: best practice or waste of public money?

More and more countries have started to compensate unsuccessful PPP bidders (or even rejected unsolicited proposal sponsors). The involved amounts are far from insignificant: as example, Canada Rail project paid up to US\$1.5 mln to cover an unsuccessful bidder's verifiable costs incurred during best and final offer stage. Not only the principle of compensation is subject of controversy but also - granted agreement on the idea - the amount of the adequate compensation has been subject of debate: insufficient compensation may jeopardise the purposes of the compensation, while on the other hand exaggerated compensation wasted away public funds, may result in increased costs of PPP project, motivate windfall profit behaviour from the side of the private sector and contribute to a lack of confidence in the entire PPP program. Let's try to put some light on this complicated matter. We shall go through the reasons for compensations, alternatives schemes and the potential options to answer the headline question.

Why compensate unsuccessful PPP bidders and unsolicited proposals sponsors?

Let us recall that most PPP tenders go through a two-stages process: the first stage is used to select a handful of qualified firms (or consortiums) to enter the second stage. In this second stage, the selected candidates are requested to propose full solutions to the contracting authority, including design work detailed enough to provide confidence in the ability of the proposed infrastructure solutions to generate the claimed performances. Obviously the preparation costs of the design of complex projects may amount to substantial capital expenses. This is even more true in the competitive dialogue approach where the proposed solutions may evolve as the tendering authority may come up with new requests during the tendering process. Another situation is the unsolicited proposal where a private sponsor proposes a fully developed infrastructure solution to the Government. In most jurisdictions, the legal framework compels Government to organize tenders in order to award the project. In those circumstances, it is good practice that the initial proponent of the project should find some encouragement, either as an advantage in the tender or as financial compensation.

High tender participation costs

Participations costs in a competitive dialogue may easily reach up to 0.5%-2% of the total investment, in certain cases even more.

According to a study requested by Infrastructure Australia to KPMG, following a detailed review of bidding costs for PPP projects, bidders typically spend about US\$2 million for projects with a capital value between US\$ 200-250 million, US\$4-5 million for a US\$800 million hospital, and US\$25 million or more for a large US\$ 1.5 billion plus economic infrastructure project.

The UK National Audit Office estimates that on average the bidding costs account for 2.5-3 percent of the total project costs. In the case of the Edinburgh Infirmary hospital PPP (Scotland), the bidding costs amounted to about USD 5 million, or 3.8% of the total investment cost.

The size of the project, its complexity, the duration of the dialogue, the level of definition of the propositions, the quality of teams and also the capability of the public sector to formulate its needs are some of the factors influencing the budget of a private sector partner.

The case for compensation

In view of these high costs, compensation is seen as a way to strengthen the attractiveness of the tender for the private sector and thus improve the quality of the proposed offers.

More specifically, compensation aims:

- To attract large enterprises active in the PPP sector on the global level. Those large enterprises tend to prioritise the most attractive markets, with full or partial reimbursement of tender costs considered as an attractiveness factor.
- To attract mid-size companies, which could experience difficulties in overcoming the losses if they are unsuccessful. Indeed, high bidding costs discourage potential bidders to an extent which is materially affecting competition and, consequently, the value for money which Governments can obtain from PPPs.
- To improve the quality of the presented offers, encouraging the participants to invest more in the preparation of their bids.
- To give credibility to public sector's initiative. Compensation represents a sign of strong commitment of the authorities in the PPP program, and their intention to go on with it (and not simply to "test the market" followed by tender cancellation).

Bid compensation doesn't necessarily mean increased project cost for the public partner, since in absence of the said compensation, all tender participants will incorporate their participation costs into their proposals, as well as the costs incurred on the other markets where they were unsuccessful. On the other side, public sector should avoid the situation when compensation works as an indirect grant to bidders simultaneously participating in tenders in different markets, resulting in an indirect subsidy to the markets that do not compensate bidders. Careful review of PPP markets should be carried out to make sure this is not the case.

Compensation is an exception to the principle not to remunerate the participants in the public procurements, since the costs of tender participation are usually considered as transaction costs borne by all the entrepreneurs. This exception is justified by the high preliminary expenses customary in PPPs projects with significant design requirements.

Why compensate a sponsor of an unsolicited proposal?

The case for compensation may look a little more difficult to make with regard to an unsuccessful unsolicited proposal.

However, it is generally agreed that the compensation for a proponent of an innovative idea serves as a sign of appreciation of private sector initiative from the Government side and encourages further submission of unsolicited proposals. It also serves as remuneration of the value of the intellectual property incorporated in the proposal. From the point of view of public finances, the indemnity to the unsuccessful bidder corresponds (at least partially) to the gain

or saving from the fact that one part of the project preparation was done by the proponent of the idea.

To pay or not to pay?

Bid costs compensation is not the only way available to reach certain objectives for the public sector. In any case it should not be granted automatically (the public sector should retain discretion to pay where and when it considers appropriate) and should be justified on a case by case basis. We suggest considering:

- The expected competition. Are we looking to attract local/national SMEs? Is there any risk that the project won't attract any interest on the local market?
- Incentives to improve the quality of the offer. The compensation may induce the candidates to present more elaborated, more innovative bids, sometimes with the elements of intellectual property for which the compensation may represent a sort of indemnity and increase the chances to gain Value for Money. If the project is particularly demanding in this area, compensation may play a positive role.
- Cost of preparation. If the project is characterised by a particular complexity or it is anticipated that the competitive dialogue will be unusually long then compensation might be more useful than in other situations.

Once again, compensation is only an option, not an obligation for the public sector, and should be paid only in case when the public sector appreciates the value of the proposal and wishes to encourage the efforts of the private sector.

In case of an unsolicited proposal, the compensation should be paid only at the end of the award process, when the proponent of the innovative idea participated in the ensuing tender but did not win it. Obviously if the proponent of an unsolicited proposal is awarded a contract, preparation costs are not to be specifically compensated. If it is eliminated, a compensation could be paid under conditions that (i) the public sector considered the idea innovative before the launch of the tender, (ii) the proponent presented a compliant bid, responding to the requested criteria, and (iii) the tender authority decided to pay a compensation.

No compensation should be paid in case of direct negotiations, since it would encourage opportunistic behaviour from the private sectors side.

Lastly, it could be argued that it is easier for high income countries to provide for bidders' compensation than for low income countries where fiscal resources are scarce. However, this view is mitigated by the fact that in most cases the project may generate the resources necessary for the compensation. It is interesting to note in this regard that the South African Development Community (SADC) has enacted guidelines for unsolicited proposal which allow Public authorities to compensate sponsors of unsolicited proposals under certain conditions, even in the case the authority does not carry out further negotiation or tendering.¹ We have not been able to assess how much these opportunities have been implemented in practice.

¹ Cf. http://www.sadcpppnetwork.org/wp-content/uploads/2015/02/general_unsolicited_proposals_guidelines.pdf

How much to pay?

It is important to calibrate the amount of the compensation: a low amount may fail to reach the compensation's initial objectives, on the other hand an exaggerated amount will create inefficiency of public expenses, increase the price of the PPP project, motivate windfall profit behaviour from the private sector side and might negatively affect the PPP program in its whole.

The public sector should estimate the percentage of costs that it is going to pay to the bidders. In practice an indemnity in the range of 20%-50% of the incurred costs may represent a sufficient amount.

What method to use to calculate the amount of the compensation?

International practice as demonstrated in OECD countries proposes two major methods to calculate the amount of indemnity:

- One solution is a fixed amount "honorarium", which is widely considered as a "simpler" solution for reimbursing unsuccessful bidders.
- Alternatively, the compensation may be calculated as a percentage of expenditures. The incurred costs should be properly proven. and the amount covering the costs is also limited by a certain cap.

Both methods have their advantages and disadvantages. A "honoraria" may look like a simpler option but setting the fixed amount is not easy and definitely demands certain experience to avoid opportunistic behaviour from private sector. On the other side the disadvantage of the incurred costs method is its complexity and reduced private side incentive to control expenses.

If the percentage of incurred costs method is chosen, how to audit the expenses? The public sector might need to hire an external auditor or assess itself the submitted expenditures to verify the reality and reasonability of expenses, whether they are linked directly to the offer and only to this offer, and whether they contributed directly to its quality. To ensure consistency, the public sector should verify simultaneously the costs submitted by all the bidders. This approach will allow to identify possible substantial differences between bidders, which in certain cases may seem unjustified.

If the proponent of innovative idea participated in the tender but was eliminated, the level of innovation may also influence the compensation amount: the public sector should either identify the value of the proposal for the Government or define the development costs of similar offer if it would have been completed by the public sector, which is not easy. Additionally, the public sector should take into account that the proponent can commercialise the innovation on the international market. In this case the incurred costs for a design that can be marketed internationally should not be covered by the domestic authority.

Solving the Hamlet dilemma

Bidders compensation is one of the most acute PPP controversies, along with the desirability of unsolicited proposals. This article hopes to have made the case for a well thought and carefully considered bidders costs compensation policy. Bid compensation to the proponent of an unsolicited proposal subsequently eliminated during the tender process is a complicated issue and should be treated with additional care. Transparency, publicity as well as regular review and evaluation are key pillars to solve the Hamlet like dilemma that

Governments face on a daily basis: to pay or not to pay, and most importantly, understanding why and how. In any case we would encourage Government or regional organisations to provide more detailed guidelines on this topic, which would help in improving the PPP framework, the quality of unsolicited proposals as well as attracting more investors and participants to tenders.