

The Progressive Case

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Public budgets are under pressure – made worse in this period of high inflation. These factors, combined with the increased need for infrastructure improvements, has prompted the public and private sectors to seek pragmatic ways to improve the procurement process for infrastructure P3s. Both sides are aligned on one thing: no one is interested in lengthy procurements, which tie up resources, incur excessive costs, and delay implementation of needed upgrades.

In essence, two alternative methods for project delivery exist for long-term P3s funded by the private sector: (1) the ‘traditional’ Design-Build-Finance-Operate/Maintain (DBFOM) process, where bidders offer fixed price contracts with committed financing at bid stage; and (2) the ‘progressive’ procurement, where the preferred developer is initially awarded the opportunity to negotiate a pre-development agreement with the grantor without firm contracts or committed financing, with the promise of a long-term concession to follow.

Traditional Procurement Model

The traditional procurement model potentially offers several benefits, the foremost, in principle, being certainty of cost and closing at time of award. Certainty under this model is achieved in part by requiring bidders to enter into a price competition, which entails obtaining guaranteed lump sum prices from Design-Build (if there is upfront capex) and Operations and Maintenance contractors for the life of the concession, together with funder commitments for long-term financing.

Pricing is based on the grantor’s general technical parameters, which require contractors to factor in contingencies arising in the design and construction process and during the operations period. These contingencies can include inflation, changes in labor and materials costs or availability, and unforeseen events that may not be reimbursable as “relief events”. Bidders also must obtain firm lender commitments to finance the project based on the project costs agreed with contractors. In theory, this competition results in the award going to a price-competitive bidder with a track record of success and relative certainty to achieve commercial and financial close a few months after award.

But there are challenges. First, grantors often provide only generic design and permitting parameters, making it difficult to develop competitive guaranteed prices for a complex project. Second, there are delays – between bid submission and award, and between award and closing – that put further pressure on the bidder’s crystal ball to assess contingencies. Similarly, the

bidders' lenders are asked to commit to interest rates and other financing terms for 180 days post-bid, if not longer.

All these risks – the real cost of which cannot be known – are priced into the bid (the so-called risk premium), inflating each competitors' prices to give them comfort that they won't lose their shirts if they win. Moreover, grantors in traditional procurement structures have been disinclined to offer the winner relief (whether compensation, or rights to delay completion) for delays in obtaining design approvals or permits, or to provide for cost escalation over the fixed price bid (other than perhaps a capped CPI or PPI element). Recently, grantors have started listening to pleas for price escalation, in light of the undeniable impact of supply chain and similar issues presented by the pandemic, and tariff wars during the Trump years, but the jury is not back on the issue industry wide.

All in all, shortlisted bidders must expend a tremendous amount of resources to complete a traditional procurement – whether win or lose – including not only tying up internal staff for long periods but also high out of pocket costs for financial, technical and legal advisors, as well as for design. Even though grantors increasingly offer a “stipend” to losing bidders, the amount offered is only a fraction of the bidders' real costs, with a 33% chance or less of winning.

What is the Progressive Bid Model?

Over the last few years, the “progressive” procurement model has been gaining traction for two important reasons: many market participants find that this model mitigates procurement risks, speeds bid selection and lowers costs - particularly in “social” projects. Examples of recent successful progressive procurements for social projects include the Long Beach Civic Center and the Travis County Courthouse. The progressive model has also expanded to the transportation sector, including Penn Bridges (now on hold), the Sepulveda Transit Corridor, and Maryland I-495/I-270.

The distinguishing feature of progressive procurements is the grantor's selection of a preferred proposer based primarily on three factors: (1) technical qualifications and track record of successfully financing and completing projects; (2) the cohesiveness and strength of the consortium arrangements; and (3) the proposer's acceptance and understanding of the grantor's needs for the project.

The progressive model does not require a complete committed design, construction, and O&M/facilities management price or committed financing at bid stage. Critics allege the model is perilous for the grantor due to cost uncertainty at time of developer selection. Supporters believe that as the preferred developer and the grantor flesh out the project goals and design, total project costs can be significantly reduced, particularly as contingencies are narrowed or knocked of one by one as the risks are better defined before pricing is locked in.

Progressive Model Pre-Development Agreement

The key to minimizing this risk is the negotiation of an agreement – often referred to as a “pre-development” (PDA) or “exclusive negotiations” agreement. Under a PDA, the proposer agrees to finalize detailed project design on an open-book basis and sets the other ground rules of what is hoped to be a collaborative row-in-the-same direction process. The exclusive negotiation period also can be used to facilitate permitting and completing the project's

technical and financial parameters.

Typically, a PDA will contemplate the payment by the grantor of a sum to compensate the preferred proposer for the design/permitting work. Grantors seek to cap this sum, both for certainty as well as to incentivize the proposer to move quickly to the construction phase. The developer is naturally aligned, wanting to minimize costs as much as possible through shortening the timeframe; developers don't want to assume much risk on the spend, and will shy away from taking a haircut in development costs.

Importantly, the PDA will typically recognize the preferred proposer's exclusive right to negotiate and execute a P3 agreement to take effect upon completion of the design work. By providing exclusivity, grantors ensure that the proposer's interests are aligned with the grantor's to reflect a true long-term partnership. Without exclusivity the approach is less attractive to investors. In most cases, the grantor prepares a draft P3 agreement, or an agreed set of heads of terms. Moreover, the PDA will require the proposer to achieve commercial and financial closing within an agreed term following execution of the P3 agreement.

Bidders can reap significant savings because they do not have to negotiate lump-sum design-build and O&M contracts or an interface agreement linking the two, or secure committed financing. Likewise, there will be no need for significant pre-bid financing costs as the need to prepare a detailed financial model, hire lender-side advisors, or negotiate committed financing terms will be postponed until well after one proposer has been selected and final costs are refined.

In availability payment deals, the negotiations under the PDA may also provide an avenue for the parties to come up with potentially more affordable prices for the grantor, or at least prices that fall within the grantor's affordability threshold.

Uncertainty with the Progressive Model

Progressive procurements still include elements of uncertainty, including uncertainty of closing: there is no guarantee that the exclusive negotiations will result in a P3 agreement. This risk can be reduced by establishing clear parameters for the PDA phase and negotiation of the final P3 contract. The process should include certain milestones that give each party the ability to exit if a target isn't met.

Similarly, at each checkpoint during design, the two sides evaluate the changes to confirm against the budget. The risk remains that if the terms of the PDA are not precise enough, one of the parties may decide not to proceed. Another key risk is a delay in the PDA process. The progressive model should not be used by a grantor as a means of getting general advice and direction on a project. It is important instead that the grantor has clear enough goals and a well-organized process at the outset to make sure the process doesn't drag on. A fishing expedition is a sure way to turn off potential bidders, or send the unlucky chosen developer to the next off-ramp.

If the process fails, in theory the grantor owns the work product developed through the termination date, which can present the developer with concerns over disclosure of proprietary information contained in their design solutions. This can be mitigated by providing a process to protect certain information to avoid trade secrets falling into competitors' hands if the project

is retendered.

Critics say the progressive model discourages participation by purely financial investors in the procurement phase; we are not convinced that this is the case, based on interest by such players we have seen in progressive procurements to date. There is a lot of money chasing projects with good, steady returns. Financial investors who want to be on good projects from the start, without paying a completion premium in the secondary market, are interested in teaming up with industrial partners to secure an equity position in the project.

Progressive Model and Changing Economics

The progressive model may not be the perfect solution for all projects. Yet, it is a valuable tool for both grantors and investors, being especially suitable for projects where the grantor is prepared to speed the project delivery and work cooperatively with a proposer in developing a bankable project.

It seems to have particular value in social infrastructure projects, or technically complicated transportation projects, that entail vertical construction where design solutions can determine the viability and/or affordability of a project.

Moreover, we think the progressive model is especially well suited in today's economic and geopolitical conjuncture of escalating inflation and supply chain issues affecting the construction industry globally.