

9.7 Other public sector procurement

In 2003 the Government revised the Green Book which it uses as a guide for the procurement of goods and services throughout the public sector, apart from the special case of the PFI referred to in Section 9.6. In the Consultation Document which preceded the new Green Book, it was stated that the aim was to tackle the following deficiencies in the previous process:

- The methodology needed to be long-term and to tackle key issues, such as evaluation of benefits.
- There needed to be stronger incentives to encourage users to adopt a systematic and thorough approach to appraisal.
- There needed to be strengthened expertise in appraisal techniques within government.

The most striking change was a reduction in the discount rate used to appraise projects, from 6% to 3.5% per annum, declining to 1% per annum for projects with very long life expectancies. This has the effect of placing a greater value than previously on benefits received and costs incurred in future years, particularly in respect of more distant periods. Another change was that specific adjustments now have to be made in project appraisal to allow for 'optimism bias' – i.e. a systematic tendency observed in the past (see Appendix 12) for appraisers to be over-optimistic in assessing projects. These adjustments are based (loosely) on an analysis of past experience and make it more difficult for projects to pass the viability test on the basis of the assessed cash flows. However, if project appraisers can demonstrate that good practice has been adopted in effectively managing the downside risk areas, the adjustments may be reduced.

Whatever the merits of introducing an optimism bias may be for public sector appraisals in the UK, it is not a technique we recommend for general use

outside the public sector, as it has some major disadvantages:

- The application of optimism bias adjustments may encourage project promoters to understate costs in an uncontrolled way.
- The size of the adjustments to be made will often be based on evidence which is too scanty to establish confidence that the adjustments are of an appropriate magnitude.
- If properly prepared, the cost estimates should already include variant figures which allow for risk, so that subsequent application of an optimism bias would result in double counting. If, however, the project appraisal is being based on single 'most likely' estimates of cash flows, then the risks are not being properly studied and opportunities for risk responses which might well improve the project out-turn are being lost.
- If the project goes ahead, the optimism bias adjustment will (in effect) provide the project manager with a large contingency allowance in his budget, so that the incentive for effective cost management is reduced.

We believe that (rather than applying an optimism bias adjustment) in general it is preferable to adopt an open and unbiased approach to project appraisal, with full discussion and documentation and with checks and balances, such as independent auditing of the parameters and models used, before key decisions are made. This will tend to ensure that the analysis is based on the most realistic figures that can be obtained, including estimates which are as realistic as possible of the extent of the upside and downside variability of these figures and the likelihood of such variations occurring. Even more important, detailed analysis, as described in this handbook, will facilitate the mitigation of downside risks and the maximisation of upside potential.

RAMP is recommended in the Green Book