THE POTENTIAL FOR PUBLIC PRIVATE PARTNERSHIPS FOR INFRASTRUCTURE PROCUREMENT IN ESTONIA

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ABSTRACT: Public Private Partnership (PPP) arrangements are purported to offer benefits including the accelerated provision of infrastructure, improved budgetary certainty and greater value for money. Since their introduction two decades ago, PPPs have become an increasingly popular infrastructure procurement option throughout Europe. Though the majority of PPP projects are yet to be completed, numerous initial assessments have been made and considerable experience has been gained which is reflected in a growing body of literature.

To date, Estonia has little experience of PPP projects but, by drawing on that of other countries, the changes relative to current procurement practices that would accompany the adoption of PPPs may be inferred.

This paper describes the qualitative differences in procurement inputs, processes and outputs between PPP approaches and traditional forms of procurement as derived from a review of the literature. On the basis of these differences, a set of procurement parameters is identified with which current procurement arrangements may be described in order to allow assessment of the potential impacts of PPPs. This informs the development of data collection requirements and a methodology for assessing the potential for PPP arrangements in Estonia.

Keywords - Estonia, Infrastructure Procurement, Public Private Partnerships.

1. INTRODUCTION

A Public Private Partnership (PPP) is a long-term contractual arrangement between a public authority and a private sector entity. Under a typical PPP contract, the private sector partner finances, designs, constructs and operates an infrastructure asset in order to provide public services that have been defined by the public sector partner who has a long-term commitment to purchase them. All risks associated with the project are allocated to whichever party is best able to manage them.

In this context, the term “infrastructure” is considered to include transport, energy and water networks and systems as well as social facilities such as schools, hospitals, prisons, public buildings, etc.

PPPs have become an increasingly popular procurement model in much of Europe. In Estonia, however, little progress has been made towards employing PPPs so that, currently, only the experiences of PPP projects recorded from other countries can be drawn on to provide insight into the impacts which the adoption of PPP approaches might have on procurement performance in Estonia. This paper considers the possibility for estimating these impacts and proposes a methodology for doing so.

2. PPP DEVELOPMENTS IN ESTONIA

The concept of privately financed infrastructure projects and certain forms of contract, for example concession contracts, which are generally considered to constitute PPP arrangements, have been in existence for considerable time. Government programmes to promote the use of private finance in the delivery of public infrastructure and services, however, emerged as part of wider privatisation strategies (notably in Chile in the 1970s (Estache, 2005) and the United Kingdom in the 1980s (Sadka, 2006)) and, by the late 1990s
had become an established means of securing private capital and management expertise in infrastructure investment (International Monetary Fund, 2004) and an increasingly popular procurement option globally and particularly within the European Union.

The European Commission itself has begun to embrace the PPP concept and, since 1999, there has been a clear policy to increase the level of private funding in infrastructure procurement. (European Investment Bank, 2005) In March 2003 it published “Guidelines for Successful Public-Private Partnerships” (European Commission, 2003) in particular response to the benefits it perceived that the PPP approach could offer the then Accession Countries with their requirements for improved infrastructure. This was followed up with further practical guidance in the form of the “Resource Book on PPP Case Studies” (European Commission, 2004) in June 2004. In the same year a “Green Paper on Public-Private Partnerships and Community Law on Public Contracts and Concessions” (Commission of the European Communities, 2004) was issued which, in turn, was followed by consultation on its contents with stakeholders from member states which concluded in May 2005. (Commission of the European Communities, 2005)

Within this context, Estonia has been relatively slow to adopt PPPs. Central government interest in the PPP concept is, however, apparent in that steps are being taken to establish institutions to provide guidance for PPP projects. In contrast to the state’s rather cautious approach, local governments have shown both interest and initiative to engage in PPPs. To date, two substantial PPP projects have been arranged, both by the municipal authorities in Tallinn and both in the form of lease agreements:

1. A project to develop and maintain 650 apartments over a 30 year period in exchange for an annual service payment and a municipal land transaction. (Approximate value €25 million)
2. The renovation and maintenance of 10 secondary school buildings in return for an annual service payment. (Approximate value €33 million). (European Bank for Reconstruction and Development, 2006)

In the view of Price Waterhouse Coopers (2005) Estonia’s adoption of the PPP model may remain slow, particularly in the transport sector, while concentration is focused on the EU Cohesion Fund rather than the need to develop alternative infrastructure financing arrangements.

3. THEORETICAL APPROACH

To assess the potential impact of adopting a PPP rather than a traditional model for infrastructure procurement, it is proposed to consider the current (traditional) procurement environment and the changes to it that PPP arrangements would be anticipated to bring about. To achieve this, an analysis of the differences between PPPs and traditional procurement drawing on both theoretical advantages and disadvantages as well as the practical experience of PPP projects gained in other countries is required to identify a set of parameters which vary according to which procurement arrangement is employed. A baseline data set reflecting the current procurement environment in Estonia may then be established on the basis of these parameters and potential impacts associated with the hypothetical use of PPP arrangements may be inferred.
4. DIFFERENCES BETWEEN PPP ARRANGEMENTS AND TRADITIONAL FORMS OF PROCUREMENT

The general, fundamental difference between PPPs and traditional public sector procurement is that under a traditional model the public sector contracts with private sector companies to construct an infrastructure asset which is funded by government borrowing. The central feature of PPPs is that the private sector finances and builds the asset and it is the flow of services from the asset which is sold to the public sector. (Grout, 1997)

Specific differences may be conveniently grouped into three categories:
1. Differences in input requirements;
2. Procurement process differences; and,
3. Output differences

4.1 Differences in Input Requirements

Input requirements for PPPs will tend to be additional to those for existing procurement models as the latter will continue to be employed in the majority of cases with PPP projects merely complimenting the overall infrastructure investment portfolio. These requirements relate to:

- **Political and governance environment** – PPPs require major investment on the part of participating private sector companies and a stable, enabling political environment is essential to provide assurance of the public sector’s commitment to forming and maintaining such partnerships with the private sector. In particular, the public sector must be seen to be fair in its dealings, have clear channels of responsibility and accountability for the government involvement in PPPs and be free of corruption. (International Monetary Fund, 2004)

- **Legal and regulatory framework** – The European Commission (2003) suggests that reforms to the legal and regulatory framework might include:
  - the removal of impediments to private sector participation
  - the restructuring of current operators ahead of a PPP
  - the introduction of sector specific regulation making private sector participation possible and effective

- **Institutional capacity** – PPP arrangements call for particular capabilities and skills in both the public and private sectors. Public sector authorities (at both central and local government levels) must have or be able to develop the full range of skills necessary to manage a PPP programme. (International Monetary Fund, 2004) These include the capacity to determine when a PPP approach is an appropriate procurement strategy, to formulate suitable specifications to obtain the desired public services from a PPP deal and to ensure that the PPP contract awarded represents better value for money than would be achieved under a public procurement alternative. In practice, the considerable institutional changes required for PPP development have lead many European Union member states to establish PPP units or taskforces within government to focus on enabling requirements, lesson learning and dissemination of best practice. (European Commission, 2003)

Private sector contractors are required of adequate size and expertise to finance, construct and operate substantial infrastructure assets and to do so more efficiently than the public sector. Suitable contractors must also be sufficiently numerous to allow for effective competition. (Price Waterhouse Coopers, 2005) While the market for private sector contractors is Europe-wide and, therefore, relatively unconstrained,
a lack of suitable local contractors might well influence the political acceptability of PPPs.

- **Funding** – Traditionally, public funds and/or public debt are drawn on to finance infrastructure projects - capital costs being incurred at the construction phase and operating costs spread over the assets’ life. Under a PPP, some or all of the capital cost is provided by the private sector partner and the public sector pays when services are delivered. Consequently, where government budgets are constrained and limitations imposed on borrowing, PPP arrangements can allow projects to be undertaken which otherwise could not be sanctioned.(Price Waterhouse Coopers, 2005)

4.2 **Procurement Process Differences**

- **Scheme preparation** – The decision to adopt a PPP model for any particular project will normally be driven by a desire to achieve best value for money.(European Commission, 2003) This may be determined by comparing the cost of a PPP to that of a hypothetical publicly procured equivalent project.(Hurst, 2004), (European Commission, 2004) A second major difference in PPP scheme preparation is the tendency to specify output requirements (in terms of desired services) (Price Waterhouse Coopers, 2005) leaving greater design flexibility for the private sector partner whereas a traditional procurement scenario would normally rely on a detailed input specification and a preliminary or detailed design being provided by the public sector. Public sector authorities often buy in advisory services to help in PPP scheme preparation.

- **Competitive tender** – The competitive tender for the award of a PPP follows a similar process to that for traditionally procured projects, however, since PPP projects are considerably more complex, bid costs for the potential private sector contractors are far higher than for traditional projects and the evaluation effort and thus cost to the public sector is similarly increased.(Allen, 2001)

- **Negotiation** – Once a preferred bidder is selected, complex negotiations to determine the precise details of the PPP agreement and its financial structure commence. These are lengthy (typically taking a year or more) and expensive for all parties. Specialist consultants are often heavily relied upon by all parties during these negotiations.(Partnerships UK, 2006), (European Commission, 2004)

- **Risk allocation** – An underlying principle of successful PPP arrangements is that risk should be borne by the party best able to manage it. The precise allocation of risk for any project is determined on a case by case basis and usually involves substantially more risk being allocated to the private sector partner than is the case with traditional procurement models.(International Monetary Fund, 2004), (European Commission, 2004), (Commission of the European Communities, 2004)

- **Construction phase** – A survey of the construction phases of PPP projects in the United Kingdom showed that 89% were completed on time or early in comparison with a figure of 30% for publicly procured major construction projects.(HM Treasury, 2003) Construction risk tends to be fully borne by the private sector which provides powerful incentives for the construction phase to be completed on time and within budget(European Commission, 2003) and this has been largely reflected in practice.(Deloitte, 2005)

- **Whole life cycle consideration** – A theoretical synergy exists where the design, construction and operation of an asset are contracted as a single package resulting
from consideration of the whole life cycle of the asset. For example, appropriate design decisions may lead to reduced maintenance costs and overall savings.(Price Waterhouse Coopers, 2005)

4.3 Output Differences

- **Quality of procured facilities** – Since infrastructure assets procured through PPP models are often specified indirectly in terms of the services that are required to be delivered through their operation, their quality may differ from that of comparable assets procured in a traditional manner. An example of adverse quality outcomes associated with PPP projects in the United Kingdom is the finding from a survey of some of the first schools built under the Private Finance Initiative (PFI) that the technical quality of the buildings was significantly worse in the PFI schools than in a comparable sample of traditionally procured schools.(Audit Commission, 2003) Theoretically, however, asset quality may equally be higher under a PPP model if this is considered to bring about whole life cycle savings.

- **Technologies and working practices employed** – PPPs are expected to draw benefits from the private sector’s access to the latest technology and working practices.(Reagan, 2005), (United Kingdom Government, 2000)

- **Public sector management roles** – Publicly procured projects require the public sector to project manage the preparation, design, procurement and construction phases before handing over the project to operational staff to deliver services. PPP projects require the project management of the development of more complex projects requiring additional expertise until contract award. Thereafter, contract management is exercised to ensure that services are delivered.(European Commission, 2003)

- **Revenue generation possibilities** – Under a PPP arrangement, all commercial opportunities associated with the project would be considered for exploitation by the private sector partner. Revenues arising from these opportunities may offset service costs or public sector subventions.(European Commission, 2003)

- **Public response to direct user charges** – Where PPP projects rely on direct user charges, for example tolls for roads, fares for transport and tariffs for utilities, the public may object to their magnitude or to paying them at all particularly when similar services have been previously indirectly paid for through general taxes.

- **Long-term commitments to use and pay for facilities** – With PPP projects the public sector is bound to accept and pay for services delivered from a particular infrastructure asset by a long term commitment (of usually 20 – 40 years). This offers both the benefit of budgetary certainty and the drawback of inflexibility.

- **Investment opportunities** – The adoption of a PPP programme opens new investment opportunities for the private sector often in areas from which they were previously excluded.(International Monetary Fund, 2004)

5. DEFINING APPROPRIATE PROCUREMENT PARAMETERS

From the differences identified and described above, parameters which reflect the characteristics of the current procurement environment and which are anticipated to undergo variation when a PPP procurement model is employed may be derived as follows:
<table>
<thead>
<tr>
<th>Identified Difference</th>
<th>Parameter</th>
<th>Further Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Political and governance</td>
<td>Political support for private sector participation in infrastructure provision and operation</td>
<td>as reflected in infrastructure procurement policies and long-term sector strategies</td>
</tr>
<tr>
<td>environment</td>
<td>Arrangement of roles and responsibilities for infrastructure provision and operation</td>
<td>within the public sector</td>
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<td></td>
<td>Accountability and transparency of public sector contract awards and management</td>
<td>as perceived by the private sector</td>
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<tr>
<td></td>
<td>Arrangement of roles and responsibilities for infrastructure provision and operation</td>
<td>within the public sector</td>
</tr>
<tr>
<td></td>
<td>Accountability and transparency of public sector contract awards and management</td>
<td>as perceived by the private sector</td>
</tr>
<tr>
<td>Legal and regulatory framework</td>
<td>Legal and regulatory constraints to private sector participation in infrastructure provision and operation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Skills and expertise availability in the public sector</td>
<td>including the capacity to develop and manage PPPs as well as current capacity constraints to spending particularly with regard to operating infrastructure and facilities management of suitable size and experience</td>
</tr>
<tr>
<td></td>
<td>Skills and expertise availability in the private sector</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Availability of private sector contractors</td>
<td>e.g. a PPP task force or PPP unit(s) within a relevant government department(s)</td>
</tr>
<tr>
<td></td>
<td>Development of PPP institutions</td>
<td></td>
</tr>
<tr>
<td>Institutional capacity</td>
<td>Public budget constraints</td>
<td>with consideration of any backlogs in infrastructure investment</td>
</tr>
<tr>
<td></td>
<td>Private sector access to finance</td>
<td>including the forms of financing available in the local and the European markets</td>
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</tbody>
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### Table 2: Parameters arising from Procurement Process Differences

<table>
<thead>
<tr>
<th>Identified Difference</th>
<th>Parameter</th>
<th>Further Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scheme preparation</td>
<td>New project development process</td>
<td>including scheme development, evaluation and appraisal of project proposals, use of external consultancy services including the degree to which the public sector determines the design of assets</td>
</tr>
<tr>
<td></td>
<td>Specification of requirements</td>
<td></td>
</tr>
<tr>
<td>Competitive tender</td>
<td>Private sector bid costs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Public sector tender evaluation procedures</td>
<td>including their duration and cost</td>
</tr>
<tr>
<td>Negotiation</td>
<td>Contract negotiations</td>
<td>their duration, cost and the use of external advisory / consultancy services</td>
</tr>
<tr>
<td>Risk allocation</td>
<td>Allocation of risk between public sector authority and private sector contractor</td>
<td>including political, legal / regulatory, demand, design, construction, financial, operation and residual value risks</td>
</tr>
<tr>
<td>Construction phase</td>
<td>Construction costs</td>
<td>with respect to budgets</td>
</tr>
<tr>
<td></td>
<td>Construction durations</td>
<td>with respect to time schedules</td>
</tr>
<tr>
<td>Whole life cycle</td>
<td>Infrastructure asset whole life cycle consideration</td>
<td></td>
</tr>
</tbody>
</table>
### Table 3: Parameters arising from Output Differences

<table>
<thead>
<tr>
<th>Identified Difference</th>
<th>Parameter</th>
<th>Further Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quality of procured facilities</td>
<td>Infrastructure asset quality</td>
<td></td>
</tr>
<tr>
<td>Technologies and working practices employed</td>
<td>Efficiency of employed technologies</td>
<td>of procured facilities</td>
</tr>
<tr>
<td></td>
<td>Efficiency of operational practices</td>
<td></td>
</tr>
<tr>
<td>Public sector management roles</td>
<td>Public sector management functions</td>
<td></td>
</tr>
<tr>
<td>Revenue generation possibilities</td>
<td>Exploitation of revenue generation opportunities</td>
<td>associated with particular infrastructure assets</td>
</tr>
<tr>
<td>Public response to direct user charges</td>
<td>User charges</td>
<td>for access to infrastructure or services arising from its operation</td>
</tr>
<tr>
<td>Long-term commitments to use and pay for facilities</td>
<td>Budgetary certainty</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Flexibility to make changes</td>
<td>to services delivered or to facilities themselves</td>
</tr>
<tr>
<td>Investment opportunities</td>
<td>Private sector investment opportunities in infrastructure</td>
<td></td>
</tr>
</tbody>
</table>

### 6. DEVELOPMENT OF A METHODOLOGY TO DESCRIBE THE CURRENT INFRASTRUCTURE PROCUREMENT BASELINE

A description of the current infrastructure procurement baseline relies on ‘values’ being ascribed to the parameters identified above to reflect current procurement practice. These ‘values’ should be solicited from suitably knowledgeable personnel and / or appropriate documentation from institutions engaged in the current infrastructure procurement process.

A proposed methodology should thus provide a basis on which to identify potential sources of procurement information and a means of accessing the information sought.

#### 6.1 Identification of Potential Sources of Public Sector Procurement Information

Estonian infrastructure procurement is undertaken at state, county and municipal government levels. Departments and agencies engaged with procurement within these levels of government can be identified by a search of the relevant governments’ internet websites. A second information source on procuring departments is the Official Journal of the European Commission (OJEC) since notices of all major public procurement projects are published in it.

An internet-based search of information openly available to the public reveals that a general understanding of Estonian public sector organisations, their roles and responsibilities and initial identification of appropriate contact persons from whom to request further infrastructure procurement data are attainable.
Procurement details beyond this tend to be limited to the annual accounts of the public sector entities and these do not reveal detailed information which could be used to assess procurement processes or their efficiency.

All the information identified as required to describe the proposed baseline may therefore only be obtained through contacting the respective authorities.

Private sector contractors engaged in the provision of public infrastructure must also be identified and contacted to complete an evaluation of the parameters. Similarly, publicly available information tends to be limited to confirmation that a contracting organisation is engaged in infrastructure provision and contact details for the further information sought.

6.2 Accessing Data from Infrastructure Procurement Practitioners

Since detailed information is required to sufficiently describe the parameters identified above and the parameters themselves are wide-ranging and cannot be accurately defined in the absence of a thorough understanding of current procurement procedures, a structured interview appears the most appropriate means with which to obtain the necessary data from procurement practitioners. The format of the structured interviews being based on a set of questions designed to solicit answers which would provide adequate illustration for each parameter.

For example, the parameter: “Public budget constraints” may give rise to questions of the following nature:

- Do your department / agency have access to sufficient finances to maintain and replace existing infrastructure as required?
- Is there a backlog of investment in infrastructure?
- Have further sources of financing been identified and, if so, what sources are these and what are the constraints to accessing them?

With the question set being continuously refined with each interview as a more comprehensive understanding of current procurement practices and issues emerges.

7. EXTRAPOLATION FROM THE BASELINE TO ASSESS THE POTENTIAL FOR A PPP APPROACH

The baseline data set describing current public sector infrastructure procurement practice in Estonia in terms of parameters subject to variation under a PPP procurement model provides a datum. Against this datum, impacts of the adoption of PPP approaches as observed from the experiences of other countries and reported in the literature can be considered.

For example, PPP projects have tended to complete infrastructure asset construction on time. (Deloitte, 2005) If the baseline reflects that under current public procurement, infrastructure asset construction also tends to be completed on time, it may be concluded that the PPP model is unlikely to provide an observable benefit in relation to the ‘construction durations’ parameter. Conversely, if the baseline reflects that few infrastructure construction projects are completed on time then it may be seen that the PPP approach would be likely to improve the situation in terms of the ‘construction durations’ parameter.

By consideration of all the identified parameters the relative advantages and disadvantages of a PPP approach in comparison to the current procurement model may be determined and conclusions may then be drawn as to the potential for PPP arrangements in Estonia.
8. SUMMARY AND CONCLUSIONS

Estonia has been relatively slow to employ the PPP model in infrastructure procurement. This provides an opportunity to draw on the experience gained from the adoption of the PPP approach in other countries in order to assess the potential for PPP approaches in Estonia.

Considerable literature relating to PPP experience in other countries is available and from it the parameters of procurement which are likely to change under a PPP procurement model may be drawn. These parameters provide an efficient basis with which to describe the current procurement environment in such a way as to enable direct comparison with PPP procurement.

Defining the current procurement environment, or baseline, in terms of these parameters requires a survey to be undertaken and it is considered that this is best achieved through interviewing procurement practitioners. The interview questions being derived from the identified parameters. With the current procurement baseline established, the PPP experiences literature will provide anticipated values for each of the parameters under a PPP model enabling the possible impacts on procurement of PPP adoption to be evaluated and the potential for PPPs in Estonia to be assessed.

The proposed research will provide an evaluation of current public sector infrastructure procurement in Estonia from a novel perspective – that of comparison with PPP procurement approaches. The achievement of the research objective, to assess the potential for PPPs for infrastructure procurement in Estonia, will contribute to existing knowledge as no similar, independent assessment has been made.

It is envisaged that the proposed research outputs will benefit stakeholders by providing a reference for policy decisions concerning PPP adoption and, additionally, through the independent assessment of current public sector procurement performance.

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