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PUBLIC-PRIVATE PARTNERSHIP

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PPP DEVELOPMENT IN RUSSIA

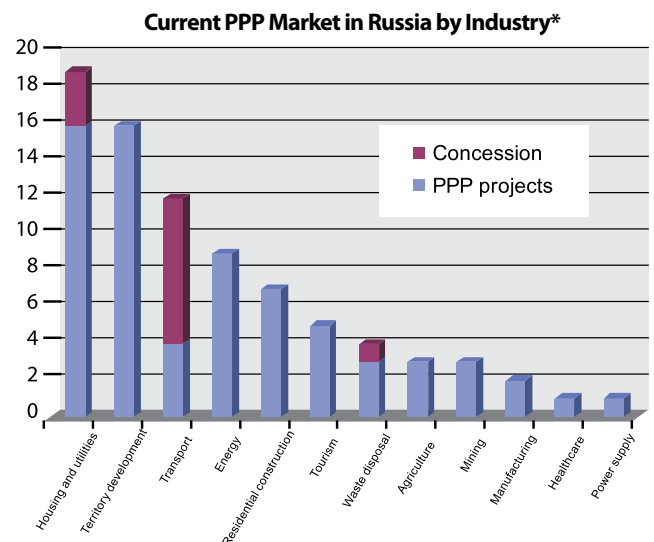
Public-private partnership (PPP), a growing trend in Russia in recent years, is becoming one of the most popular and commonly used forms of cooperation between business and government. Notwithstanding certain difficulties related not only to the financial, economic and political situation, but also to the insufficiency of federal legislation regulating PPP, Russia is gradually accumulating experience in preparing and implementing various projects based, in one form or another, on a PPP structure.

MARKET OUTLOOK

Current status. The PPP structure is being used in Russia in both large-scale and technically complex infrastructure projects that require major long-term investment (mainly from federal budget funds) and the latest technology, as well as in mid-size and small, socially significant projects (generally at a regional level and funded by local budgets). According to statistics and market overviews, there are more than eighty (80) projects of various types currently underway in Russia that are structured as one form of PPP or another, and that number is increasing every year. These PPP projects include *inter alia* arrangements for construction, development and operation of transport infrastructure (airports, high-speed (toll) roads, railways, tunnels, bridges); renovation and modernization of residential utility systems (e.g., water supply, sewage, heating infrastructure); construction of waste treatment plants and other environmental (recycling) facilities; construction (reconstruction) of public schools, kindergartens, and other educational institutions; development of tourism and recreation facilities.

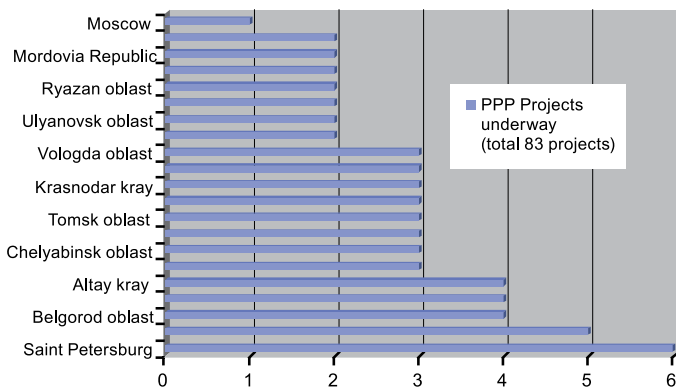
Practice shows that the Russian authorities (both federal and local) have a strong interest in PPP projects, since the PPP model can significantly increase long-term investment in infrastructure during a budget deficit, with private companies both sharing the financial burden and introducing the new technology Russia needs so much. PPP allows the state to pass to private parties the responsibility, cost and risk of designing, constructing, operating and maintaining public assets, thereby increasing the state's ability to develop, operate and maintain needed infrastructure

with reduced public financing requirements and reduced allocation of state technical and human resources, and increased/improved service levels to end users. It is clear that developing the PPP framework is one of the priorities for the Russian authorities today. The development of PPP projects in Russia will also be determined by the need to implement a number of international mega-projects in the near future, such as the 2018 FIFA World Cup.



* according to data of www.pppi.ru as at December 15, 2011

Current PPP Project Market in Russia by Region**



** according to data of www.pppi.ru as at December 15, 2011

PPP centers in Russia. International practice shows that PPP is a very complex tool. A PPP project may become a “working tool” only if it has been carefully structured (from the legal, financial and technical perspectives) and is based on a balanced risk matrix. To achieve this goal it is necessary to study international experience and train our own skilled professionals, primarily in the federal and regional authorities.

With this understanding, the federal executive and legislative authorities have set up PPP expert councils which are currently operating. The most active and influential in shaping PPP policies is the Expert Council on PPP Legislation of the Committee for Economic Policy and Business of the State Duma created in October of 2008. The Expert Council is a consultative body. The Expert Council includes deputies, federal and regional government officials, representatives of leading Russian and international financial institutions (including from the World Bank, the EBRD, the Eurasian Development Bank, Vnesheconombank, VTB), law professors, representatives of international law firms, and others. Among the Expert Council’s main achievements are the drafting of a model regional law for Russian Federation constituent subject participation in PPP projects, and active involvement in drafting and lobbying for amendments to federal concessions legislation.

Also, various political parties and business institutes are creating specialized PPP development centers. We should note in particular Vnesheconombank’s PPP Center, created in June of 2008¹, the chief goal of which is to provide qualified training, organization and support of PPP projects to implement industry-specific, regional and municipal development strategies, and also to provide support to municipal and state administrative authorities in improving PPP tools. At this time Vnesheconombank’s PPP Center is playing a very active role in shaping the Russian PPP market as an organizer and coordinator of an entire range of important regional PPP projects in various sectors of the economy. With Vnesheconombank’s participation, a PPP department has also been created in the Russian Government’s Financial University in order to train experts in the field.

Interest and support of financial institutions. It is also of no little importance that PPP projects in Russia are of interest to international financial organizations (such as EBRD, IFC, EIB, NIB), export credit agencies and major foreign and Russian banks.

From project to project Russian authorities are becoming familiar with the basic requirements of international financial organizations for the structuring of PPP projects and the documentation to ensure bankability. As practice shows, local and international financial organizations are willing to provide from 70% to 90% of the project financing for a term of 10 to 15 years for PPP projects in Russia (provided they have a clear and transparent financial structure for generating income on the project

1 According to Russian Federation Government Order No. 1372-r of August 17, 2010, Vnesheconombank is the sole provider of investment consulting services for state needs of Russian Federation constituent subjects for creating investment projects implemented on PPP terms.

and acceptable guarantees of return on investment). Recently it has been common for project organizers and coordinators to already have official letters of interest in project financing from two or three reputable financial organizations at the stage of preparing a Russian PPP project and presenting it to potential investors (at the road show stage).

We also see a new trend where in some cases it is mostly local financial institutions that consider equity participation and participate in the bid for a PPP project as a part of the consortium together with the foreign and/or local suppliers, contractors, and/or operators.

New trends. We see that there is now a strong demand from the public side for development of various sport facilities (stadiums, sport centers, etc.) on the basis of the PPP concept. As noted above, this is primarily connected with preparations for the 2018 FIFA World Cup.

It is anticipated that in the near future the PPP structure will be more actively applied in medicine and healthcare thanks to recent amendments to federal legislation. For example, Federal Law No. 323-FZ “On the Fundamentals of Health Protection in the Russian Federation” adopted on November 21, 2011 expressly provided among the powers of federal state authorities for “establishing a procedure for engaging in medical activities on PPP principles in the sphere of health protection.” The procedure hasn’t yet been established, but providing a legislative framework for the PPP structure in the primary federal law on medicine and healthcare has important practical significance in the process of “denationalizing” the medical field and providing access to private investors; to date this process has been very slow.

Similarly, we should note new Federal Law No. 416-FZ “On Water Supply and Removal” which was adopted on December 7, 2011 and will enter into force on January 1, 2013 (except for certain provisions). This law is designed *inter alia* to substantially stimulate long-term private investment in that sector of housing and utilities primarily on the basis of concessions.

BASIC LEGISLATIVE FRAMEWORK

PPP definition. Despite the rapid development of the PPP structure in Russia in general, there is still no clear definition of a PPP found in federal or regional Russian legislation, nor is there a unified understanding of the legal grounds and working principles of the respective mechanisms. As is stated in an analysis from the Audit Chamber of the Russian Federation entitled “Analysis of the effectiveness of implementing large-scale projects and programs in Russian Federation constituent subjects on the basis of a public-private partnership” (2009-2010): “On the federal level, the concept of a PPP has not been legally defined, even though the concept is widely used in various regulatory acts... and a number of federal target programs. An analysis of the context in which the term PPP is used shows that in its most general meaning, PPP means any form of cooperation between the state and private business. This in itself is a concept, a complex phenomenon, of an economic, social, and, to a significant extent, political nature.”

It is worth mentioning that international practice also has no unified legal concept of a PPP, and there are many definitions of PPP depending on the country’s level of development and its experience with joint state and private projects. In international practice generally, a PPP project means a project to commission private investors to perform works and render services that, as a rule, are related to the responsibility of public authorities, and the distribution of risk between the state and the private participants in the project. From this standpoint, the European PPP model can be split into two types: (1) the first type includes projects in which the entire implementation of the project, to a certain extent, is the private investor’s responsibility: organizing the financing, construction, and operation;² and (2) the second type of projects has investor’s functions limited to operation of existing facilities (service contracts, management contracts, etc.).

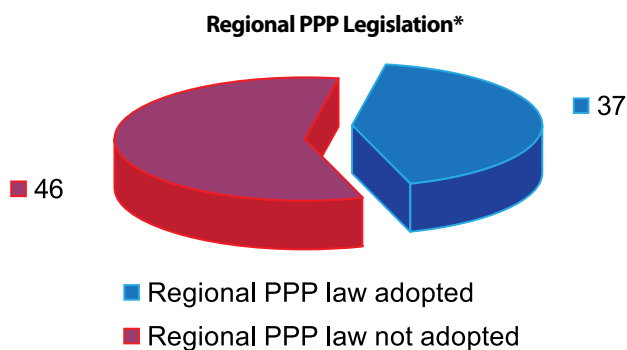
2 These models are known by various acronyms: BOT, BTO, BLT, BOLT, BOO, BOOOT, DBFO, DBFOOT, DBFOM, etc. They differ, for the most part, in their division of various elements of the project’s implementation between the parties and the legal structure of the ownership and possession of the PPP facility.

Federal legislation. In Russia, the PPP model is *de facto* determined by the level of ownership of the PPP facility. Federal Law No. 115-FZ “On Concession Agreements”, dated July 21, 2005 (as amended) directly sets forth the “concession” model, which provides the state or municipality with title to a facility under construction (concession object).³ Substantial amendments have already been made to the law on seven occasions; six of the amendments had to do with concessions in the transport sector, and one concerned housing and utilities. A new (eighth) set of amendments is expected to be adopted in early 2012 to support PPPs in the transport sector, mainly for the planned federal mega PPP project for construction and operation of the high-speed rail between the “two capitals”, Moscow and St. Petersburg. The planned amendments will be vital to investors. They are aimed at *inter alia* clarifying availability payment models and relevant contractual arrangements, solving the issues of participation of unitary enterprises, which usually hold the title to state facilities for which concessions are granted, in concession projects, providing additional regulation of direct agreements, authorizing life cycle contracts, and legalizing negotiations over draft concession agreements. It is also expected that the assignment of a concession agreement would be allowed.

The other basic models for “state participation” in federal and regional projects expressly provided for by the applicable federal laws are the use of funds of federal target programs of the Investment Fund of Russia or state corporations and joint stock companies with the state participation (e.g., Vnesheconombank, Rusnano, Russian Railways) and the use of mechanisms operating in special economic zones in accordance with Federal Law No. 116-FZ “On Special Economic Zones in the Russian Federation” dated July 22, 2005 (as amended). In practice, such models are sometimes also considered PPP projects.

Regional legislation. If we speak of classic PPP models, then all other PPP models (except concession), including those in which the investor owns the property under construction, are implemented on the basis of regional legislation governing PPP.

A number of Russian regions have already adopted, or are in the process of adopting, specialized regional PPP legislation to provide the requisite legal regulation of the relations between public authorities and private investors in the implementation of various PPP projects. As of November 1, 2011 there were thirty-seven (37) regions that had adopted a regional PPP law.



* according to data of www.pppi.ru as at November 1, 2011

Special regional laws on PPP are adopted to provide the minimum necessary legal framework for development and implementation of possible forms of various PPP projects for social-economic development (which is to take into account international practice as well). It should be noted, however, that the respective legal acts of Russian Federation constituent subjects regulating legal relations in the PPP sphere are not unified in their structure and content, and the conditions of a local government’s participation in a PPP vary quite significantly from region to region.

³ This model corresponds to the European acronyms BFOT or DBFOT.

Investors are very appreciative of the efforts of Russian regional authorities to create legal instruments regulating PPP development.

However, the most pertinent issue with respect to the structuring and implementing of PPP projects on the basis of regional legislation is their relationship with the federal legislation, including constitutional, civil, budgetary, procurement, land, tariff, and anti-monopoly legislation. For example, in a number of cases the provisions of regional PPP laws providing for the extension of additional guarantees to investors in connection with the implementation of PPP projects and/or compensation to investors of expenses and losses at certain stages of PPP projects using budget funds may enter into certain conflicts with the norms of federal legislation. The professional and careful legal structuring of a regional PPP project is therefore a key condition for attracting investors and financing organizations, whose first move is to assess the risk of the contractual structure of the project being deemed invalid or void due to it contradicting federal law.

It is evident, however, that regional PPP laws should not fully replace or supplant the appropriate federal legislation, and investors are expecting the Russian authorities to take further steps soon for the adoption and implementation of adequate and up-to-date federal legislation, or amendments to the above-mentioned special legislation which will govern PPP and its basic structuring and implementation principles (mechanisms).

PRACTICAL EXPERIENCE

Currently, it is for the most part large-scale and strategically significant transportation projects that are being implemented on the federal level as PPP on a “concession” basis. The Investment Fund of Russia plays an important role in co-financing such projects, raising a significant amount of the necessary funds.

Some typical examples of federal PPP projects are:

- Construction of a highway between Moscow and St. Petersburg. Completion of the 684 kilometer road is planned for 2018. The volume of private investment is approximately 36.5 billion Rubles, and funding from the Investment Fund constitutes about 29.5 billion Rubles.
- Construction of a new junction between the Moscow ring road and the Moscow-Minsk federal highway. Private investment is approximately 10.5 billion Rubles, while the Investment Fund contributes about 13 billion Rubles.

Both projects have reportedly completed the financial close stage.

The Investment Fund of Russia also invests in regional PPP projects. For example, there is an integrated program for construction and reconstruction of water supply and water removal facilities in Rostov-on-Don, the total investment in which is approximately 37.1 billion Rubles, in which the Investment Fund is investing about 6.7 billion Rubles, a private investor is raising 24.5 billion Rubles where 19.7 billion Rubles are coming from its own funds, and 4.8 billion Rubles are borrowed funds, and 5.9 billion Rubles are being allocated from the regional and municipal budgetary funds.

The city of St. Petersburg is a good example of how the PPP structure can be successfully implemented in Russian constituent subjects based on the relevant regional legislation. The city was first to adopt a special regional PPP law,⁴ which is already being applied to a number of major projects, such as:

⁴ The first regional PPP law was St. Petersburg Law No. 627-100 “On Participation of St. Petersburg in Public-Private Partnerships” dated December 25, 2006 (as amended). The Expert Council on PPP Legislation of the Committee for Economic Policy and Business of the State Duma later drafted on its basis the Model Law “On Participation of a Russian Federation Constituent Subject/Municipality in Public-Private Partnerships” which was recommended for adoption in other regions.

Project name	CAPEX	Private investor	Status
Western High Speed Diameter	30 billion Euro	Highways of Northern Capital (consortium of GPB Infrastructure, VTB, Gazprombank, Astaldi, Mega Yapi)	PPP agreement signed in November 2011
Construction (reconstruction) of the Pulkovo Airport	1.2 billion Euro	Northern Capital Gateway (consortium of VTB, Fraport AG, Copelouzos Group)	PPP agreement signed in October 2009, financial close - in April 2010
Construction of a waste treatment plant (facility)	300 million Euro	Consortium of Helektor S.A., Aktor Concessions S.A., Actor S.A.	PPP agreement signed in May 2011
Construction of education facilities in the Pushkinsky district of St. Petersburg	55 million Euro	Baltros (Russian developer)	PPP agreement signed in April 2011; the first school has been completed in November 2011

Potential participants in Russian PPP projects (private investors) include well-known international companies such as Vinci, Porr, Strabag, Veolia, Suez Group, Bouygues, etc. Russian companies (including regional ones) are also expressing interest in PPP projects, especially companies with experience in design and construction of particularly complex facilities. Consortiums or special purpose companies organized by international market leaders together with Russian partners participate in many large or mid-scale PPP projects.

The Russian authorities have already accumulated significant experience in the preparation and implementation of PPP projects (although certain regions may significantly differ in their level of experience in structuring and implementing PPP projects). They allocate significant funds at the initial stage for development of the project's concept, its legal structuring and business model, and for drafting tender documentation, including the PPP agreement. For these purposes the Russian authorities select for each project at tender professional and experienced technical, financial, and legal advisors (usually these are international companies with an office in Russia). All of this helps to achieve quite a high level of PPP project preparation and aids the public partner and tender organizer in effectively maintaining an open dialog with investors and financial organizations.

PPP tenders in Russia now have a high level of transparency. The necessary information is supplied to potential investors and their advisors in electronic form and regular seminars and working meetings are organized with investors. Public officials are generally open to discussion of PPP projects and willing to accept reasonable suggestions from investors concerning project timetables, revisions to tender documentation, and even amendment of the conditions of agreements on the implementation of projects.

PRACTICAL AND LEGAL PROBLEMS

Initial practice of preparing and implementing Russian PPP projects is not extensive; however, taking into account such practice and the comments of investors and financial organizations which took part in the first PPP tenders, we could identify the following main issues which are the fundamental problems facing PPP projects today:

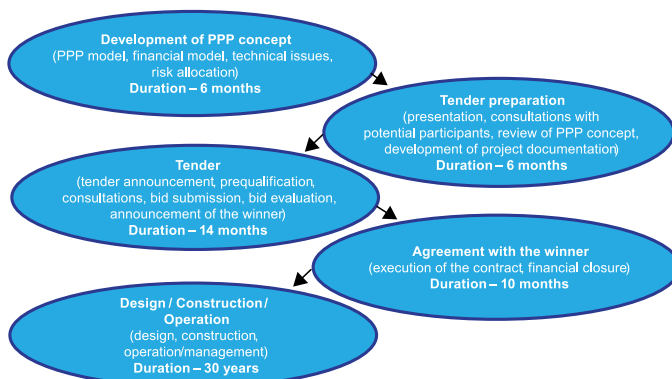
- **Political risks.** In Russia, PPP projects are still highly political and depend on the political will and position of a specific leader. It is worth mentioning that in St. Petersburg the project for construction of the Palace of Arts (CAPEX of 250 million Euros) was recently "cancelled" (the PPP agreement signed between the Government of St. Petersburg and the foreign investor in July of 2011). The project for construction of the Orlovsky Tunnel under the Neva River (CAPEX of 1 billion Euros), the PPP agreement for which was signed in June of 2010, was also suspended and will be either reorganized or cancelled.

Some connect these changes with the replacement of the governor of St. Petersburg in the fall of 2011.

- **Legislation and PPP mechanisms.** Federal legislation provides for only one form of working "classical" PPP mechanism: concession (or BFOT / DBFOT according to the European classification). Concession is mainly applied in practice in major federal transport projects and the housing and utilities sector, but has not been widely practiced in other sectors (see the table on page 2). The lack of popularity of concession on the industry or regional levels is caused primarily by the fact that concession is less attractive from the perspective of project financing (a) because the concession object, which continues to be owned by the state or municipality, is generally excluded from the security package, and (b) due to excessive regulation of concession relationships by federal legislation, which diminishes the parties' flexibility in determining project terms. The regions are "fixing" this problem by structuring and implementing PPP projects on the basis of regional PPP legislation; however, the legal validity of such "local" initiatives has not been tested by the judicial authorities.

- **Preparation of PPP facilities and land plots** for transfer to investors should be accomplished by the public partner in such a way that investors are able to ensure during project implementation proper and timely compliance with all of the numerous requirements of applicable town-planning, land and environmental legislation. For example, the public partner should be responsible for bringing utilities to land plots and ensuring that the infrastructure needed for project implementation both exists and is accessible. Also, existing deficiencies or encumbrances of land plots (including third-party rights, environmental pollution and the siting of architectural objects) which were not discovered and eliminated at the earliest stages of project preparation by the public partner should also be the public partner's responsibility. Yet, in practice, the public partner is unwilling to accept such responsibility. Unfortunately, we often see in practice facilities and land plots whose preparation is of "poor quality" or does not provide sufficient information on the permitted use, existing encumbrances and deficiencies, sanitary buffer zone, etc. This makes it necessary for the investor to conduct its own legal and technical due diligence and incur extra costs at the stage of preparing the business proposal.

- **Having realistic terms and timeframes for holding tenders, for preparing and executing PPP project implementation agreements, and also "financial close"** are important aspects.



In practice, the initial timeframes are extended more than once. Potential investors (especially international companies) generally need a lot of time to study all of the available material and the PPP facility (to conduct due diligence), assess the risks and take an informed decision. This is particularly true when tender organizers for PPP projects specify (which we have seen in practice in St. Petersburg) that they do not give any representations or warranties as to the completeness and accuracy of information and documents provided to investors,

and are not liable for the possible inaccuracy or incompleteness of data and materials on projects. In addition, as practice shows, tender organizers cannot always respond in a timely manner to investors' truly complex questions, which require comprehensive expert analysis or clarification of the positions of various competent state authorities (for example, tariff and anti-monopoly regulation), or such additional information which requires interaction with third parties to obtain (for example, private owners of land plots or public utility operators).

• **Distribution of risks between the public authority and the private investor** should be more balanced. According to international practice, the following principle should lie at the basis of risk distribution (risk matrix): a specific risk should be borne by the party that is closest to that risk and can more effectively manage the risk and minimize the consequences of that risk ensuing. The most vivid illustration of this principle in action is the risk of legislative changes. The public partner in a PPP project is clearly "closer" to this risk than the private partner. If legislative changes negatively affect the private partner's performance of its obligations, the course of project implementation and its economy, then the PPP agreement should include balanced mechanisms for modifying the project and the private partner's obligations, and for excluding its liability. Nevertheless, in practice this issue continues to be the subject of dispute and debate between private and public partners.

• **Provision of long-term guarantees of demand, tariffs and budget financing from the public authorities.** It is worth mentioning in this regard that the public authorities in a number of PPP projects (in particular, those connected with development of utilities infrastructure) take on the obligation to ensure a certain minimum profitability

of projects and, if necessary, even to compensate investors' expenses or shortfalls (including in cases where receipts from set tariffs do not cover investors' related costs). From the formal perspective, when applying such provisions of PPP agreements certain contradictions or inconsistencies may arise with imperative rules of budget and tariff legislation, the planning horizon for which is one to three years, or five years at most (for tariffs in certain cases). Such an approach negatively impacts the "bankability" of PPP projects and requires improvement (amendment) of federal legislation.

In conclusion we would like to note that Russian PPP projects are extremely complex from the legal perspective, since they include elements of various branches of legislation and law (e.g., civil, budget, anti-monopoly, tariff, land, town-planning, environmental). Furthermore, the provisions of special legislation (e.g., in the spheres of power engineering and housing and utilities), the appropriate regional legislation, and sometimes highly specific issues of legal regulation (e.g., legislation on state secrets) need to be taken into consideration and correctly applied. For this reason it is extremely important to involve in the project professional legal advisers possessing the necessary Russian experience at its earliest (preparatory) stage.

On the whole, regardless of the fact that PPP projects at the moment seem to have good prospects in Russia, how actively they will develop depends on a number of different macroeconomic factors. One is the debt crisis in Europe, which will suck up liquidity all over the world which may affect the large-scale PPP projects in Russia requiring significant equity and debt financing. Other factors are the current Russian political crisis, which means, among other things, that Russia may need to pay more for financing to cover that risk, the high cost of infrastructure, still high level of corruption and lack of competition in Russia. ■



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