

## PROPERTY, PLANNING AND CONSTRUCTION



Russia's ageing infrastructure needs investment, offering many opportunities to private sector players. **Ted Matheny, Xavier Poulet-Mathis and Andras Haragovitch** chart Russia's progress along the PPP highway

# IN THE FAST LANE

Russia's need for rapid improvement in its infrastructure has seen a concerted move to embrace public-private partnerships (PPPs) and, with investors looking for 'established' methods of entering emerging markets to shelter from the credit crunch, PPP presents an attractive option. But how will Russia integrate a capitalist idea into a post-communist, overheated economy?

To date, relatively few PPPs have been implemented in emerging markets, due to the nascent state of the legal and practical framework for PPPs. Indeed, although PPPs have certain advantages over conventional forms of public procurement, their complexity nevertheless presents a number of practical, legal and financial challenges in any market.

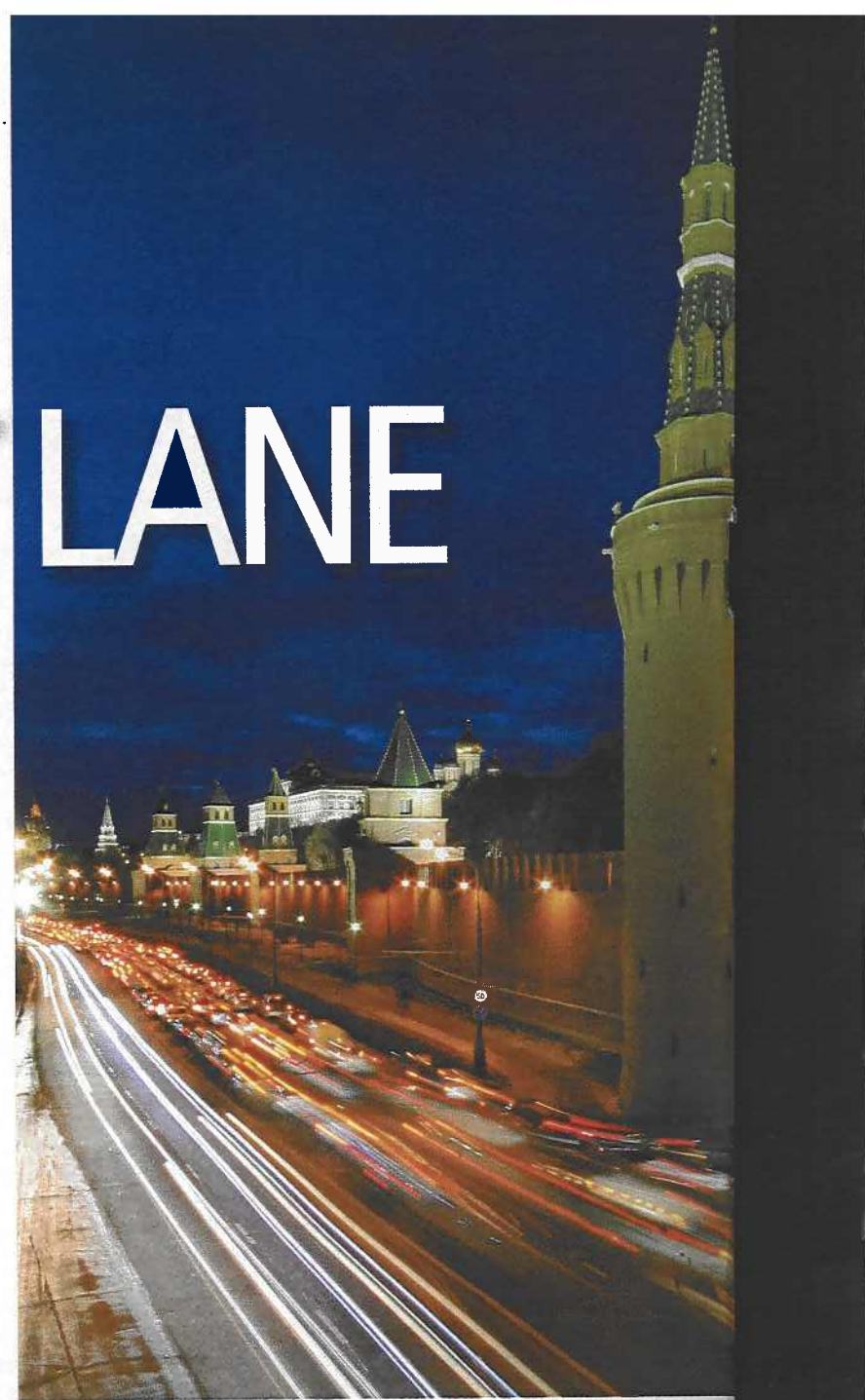
Although the Russian government has announced plans to spend \$1trn (£514bn) over the next 10 years on improving infrastructure, it has also made clear that most of this investment will be in the form of PPPs, in order to benefit from the leverage provided by the efficiency, competition and investment of the private sector. As a result of this drive to replace and modernise

an ageing, decrepit (and in some cases non-existent) infrastructure, a series of high-profile PPP projects are currently advancing through the tender process in Russia. These include major road, rail and air transport projects such as the Western High Speed Diameter (WHSD) Motorway, the Orlovski Tunnel, the Nadzemnyi Express and Pulkovo Airport projects in St Petersburg, and the Moscow to St Petersburg and the Moscow to Belarus toll roads. These public tenders, launched in 2007-08, are the first real test for legislation such as the Concession Law of 2005. The Concession Law, together with a series of model concession agreements for different types of infrastructure, established the basic legal framework and foundation for PPPs in Russia, and in some cases were supplemented by ancillary legislation adopted at lower government levels (eg. the December 2006 'Law on the Participation of St Petersburg in Public-Private Partnerships').

Despite the fact that none of the high-profile tenders have yet reached the award phase, it is already clear that both the general Russian legislative frame-

work, as well as the tender documentation for specific projects, contain a number of shortcomings. Transparency of legislative frameworks and tender processes is a key factor in attracting high-calibre applicants to bid on tenders. The existing Concession Law in Russia has a number of drawbacks:

- The absence of affirmative support for international arbitration as a means of dispute resolution. Current Russian policy favours Russian court jurisdiction in disputes. The absence of a truly independent forum for dispute resolution places considerable constraints on potential bidders and also creates uncertainty and increases risk for lenders.
- Restricted ability of the concession holder to pledge the project assets or rights under the concession agreement. Since such pledges are a common form of security for finance obtained through bank loans, finding lenders and structuring the security package becomes more difficult.
- Real estate objects built under the concession agreement are owned by the grantor upon their completion, with the concessionaire being granted only a long-



term lease and concession rights. Such a provision effectively excludes all PPP models that incorporate ownership of assets by private sponsors (for example, Build-Own-Operate-Transfer (BOOT)) and also reduces the range of PPP models that may be used to implement a project.

At a documentation level for specific projects, governments need to propose tender procedures which align to international practice based on past PPP experience and which international consortia sought to bid on such projects would see as a required minimum. The first version of the tender documentation published for the WHSD motorway did not allow bidders to submit a markup of the concession agreement with its bid. Instead, bidders were obliged to sign the version of the concession agreement published with the initial tender package. Bid procedures have since been modified to allow bidder markups and to facilitate post-tender negotiation of key terms but bidders are still bound to the published version of the concession agreement and exposed to potential liability if unwilling to sign it in its published form, with very limited carve-outs.

The Russian government's stance towards concessionaires remains somewhat unusual in the area of construction design and development. One of the advantages of PPPs over traditional procurement is that in a PPP, private sponsors have a large financial stake in the project for its entire duration. Consequently, such sponsors have an incentive to design the object of the concession in a manner that minimises long-term maintenance and operation costs. PPPs should allow private sponsors to bring their experience, know-how and capacity for innovation to a project and make it as cost-effective to the public, the gov-

ernment and themselves. However, the extent to which this advantage of PPPs can be exploited depends considerably on the latitude given to private sponsors to vary the original design and to innovate. The current approach in Russia — perhaps as a result of the influence of having a centrally-planned economy for 70 years — tends to be very input-oriented, where engineering specifications are specified very precisely in the tender documentation, with little room for bidding consortia to implement their know-how, evaluate the project and optimise costs through 'value-engineering'. An approach oriented towards identifying desired service levels instead of over-specifying inputs would allow private sponsors to benefit from one of the main advantages of PPPs over conventional procurement.

### **DESPITE THE FACT THAT NONE OF THE HIGH-PROFILE TENDERS HAVE REACHED THE AWARD PHASE, IT IS ALREADY CLEAR THAT THE GENERAL RUSSIAN LEGISLATIVE FRAMEWORK CONTAINS A NUMBER OF SHORTCOMINGS**

Another key principle for successful PPPs is that an assignment or a risk is to be borne by the party best able to manage and assess such assignment or risk. With the backdrop of an overheated Russian economy, a shortage of skilled workers and a lack of key construction materials on the world market, an unusually significant portion of risk is currently placed on the concessionaire, under a list of special events defined in the tender documentation. Since the construction period of major projects is likely to be several years, the resulting escalation in costs is borne solely by the concessionaire and its subcontractors.

Dialogue is needed to discuss reasonable sharing of such cost risks between the grantor and the sponsors, particularly through the implementation of appropriate price indexation mechanisms.

Up to now, the Russian government has demonstrated a pragmatic approach to such legal hurdles and in order to gain feedback on key legislation (such as the Concession Law), it recently organised a series of informal roundtables with the main participants in PPP projects. Draft amendments to concession and other relevant legislation addressing some of the above points are currently under discussion in the Duma. This shows a growing understanding of PPPs in Russia (due to their complex nature, PPPs need to be adapted to the specifics of individual projects, competitive environments and market conditions, and are very much an exercise in trial and error). If legislation does not sufficiently accommodate the interests of both government and private sponsor, action must be taken in order to realise the benefits of PPP. Having said this, governments need to manage their expectations. PPPs are not a panacea for a nation's entire infrastructure development, and transferring all risk onto private sponsors or imposing restrictions and conditions that make commercially-viable projects impossible to structure will not attract the right kind of investors to make such ambitions a reality. If the discussions currently underway lead to partnerships being formed and to the much-needed development of Russian infrastructure, then this could pave a path for other emerging markets to follow in the future. ■

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