

**Russian Experience in Concessions and
Other Forms of PPP:
Prospects for Investors and
Government within the New Legal
Framework**

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FRESHFIELDS BRUCKHAUS DERINGER

- Experience and development trends of PPP in Russia
- Opportunities and limitations of the new law

IMPLEMENTING PPPs IN RUSSIA BEFORE THE CONCESSION LAW

Over the last decade there has been a significant development of PPPs in Russia

Areas in which projects have been implemented

- **Water infrastructure:**
 - Drinking water purification plants
 - Potable water supply
 - Wastewater treatment
 - Sludge processing
- Waste incineration infrastructure
- Energy infrastructure
- Other municipal construction
- Transport infrastructure (rare cases)

Key aspects

- *Previously, the projects structured mainly as BOOT models*
- *A large number of the project-related risks undertaken by the state*
- *In many cases investments paid back by the government at almost no-risk basis following completion*
- *Degree of private sector involvement: providing upfront funding*
- *PPP projects developed mainly on the regional level*



GROWTH OF PPP IN RUSSIA: EXISTING PRACTICE AND TRENDS

Gradual development of PPP from simple turnkey contracts to comprehensive concession schemes. More fair and balanced risk allocation between public and private sectors has been the main trend in recent years

Existing PPP models in Russia

Payback options associated with specific models in Russia

BOOT/ROOT

The government (relevant state-owned enterprise) reimburses investment costs and assumes direct obligations as a form of security

Turnkey contract

Public sector pays a fixed fee to the private contractor

O&M

The private party maintains a facility and receives income, as a rule, solely from its operation, pays lease fees for using the facility and in most cases bears the project risks

BOO/ROO

Project risks lie on the sponsor. Public sector commitments are generally limited to guaranteeing of raw materials supply, and/or purchase of products, and/or fixed tariffs

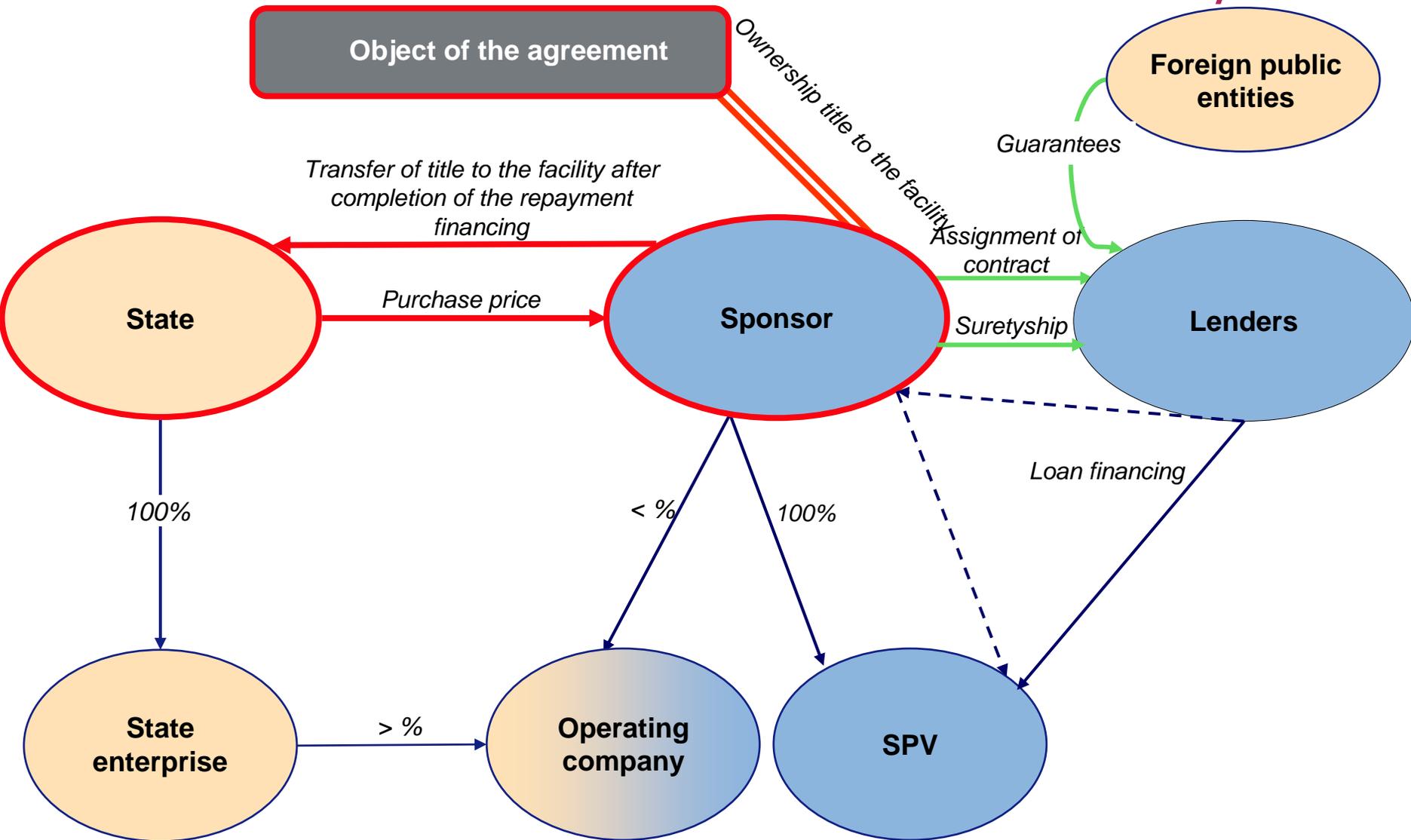
Concession

The risk allocation depends on the influence that each party has over the possible risk factors. Grantor may provide revenue guarantee, or make availability payments and/or other types of compensations



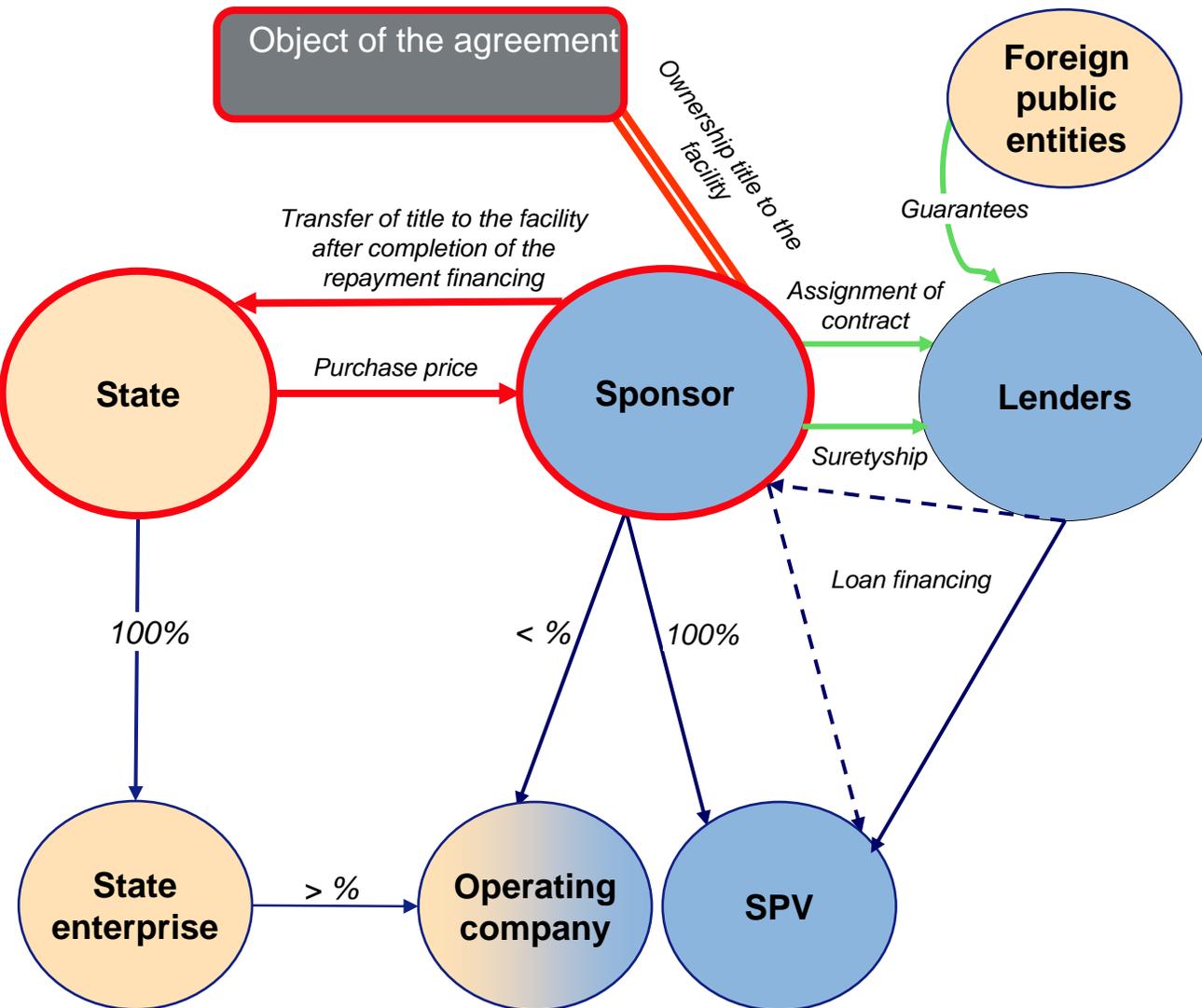
GROWTH OF PPP IN RUSSIA: EXISTING PRACTICE AND TRENDS (continued)

BOOT/ROOT



GROWTH OF PPP IN RUSSIA: EXISTING PRACTICE AND TRENDS (continued)

BOOT/ROOT



Examples of our experience



Water Purification Plant in South Butovo (Moscow, 1997)



Water Purification Plant in Zelenograd (1998)

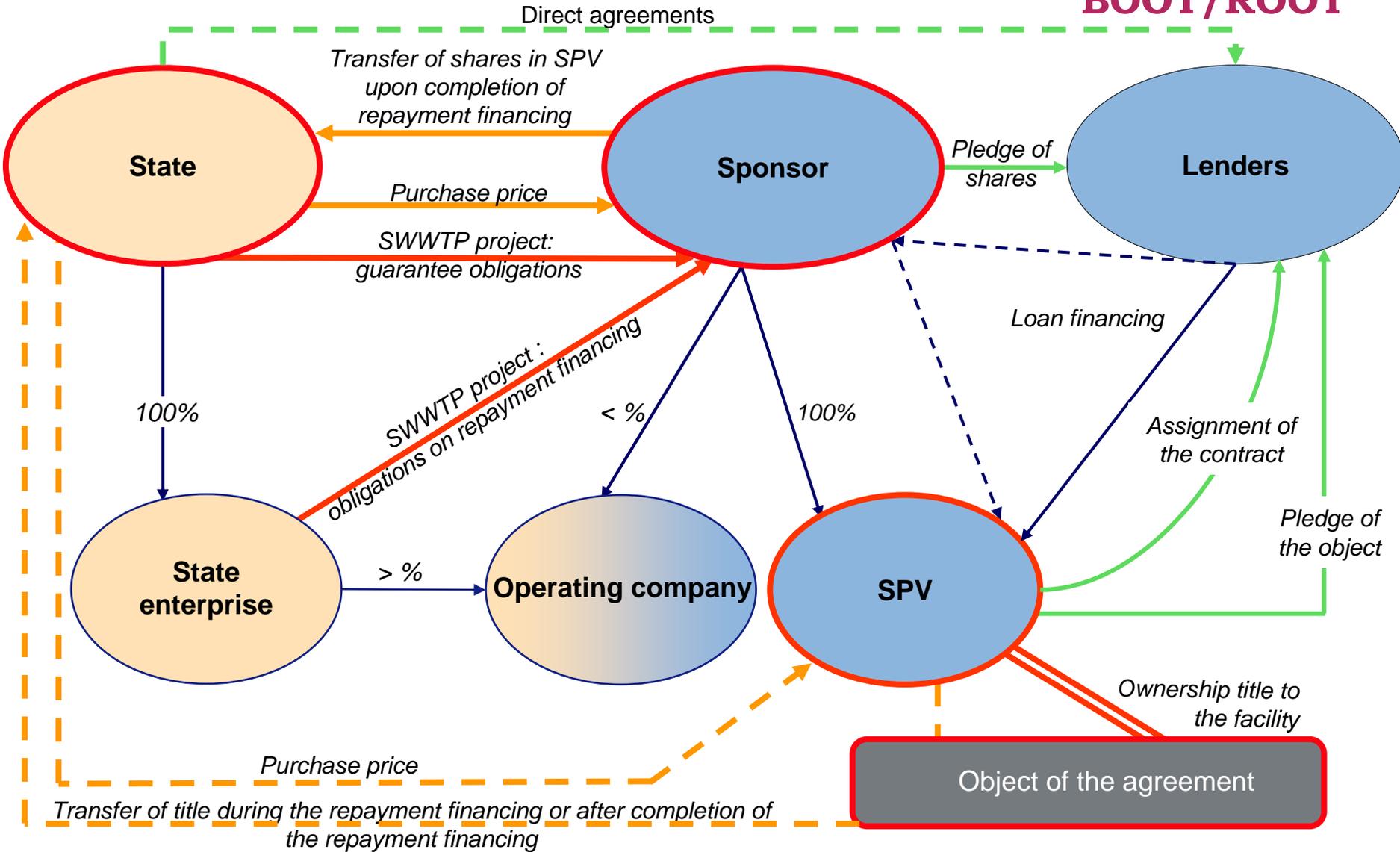


Facility to treat silt deposits in Moscow (2000)



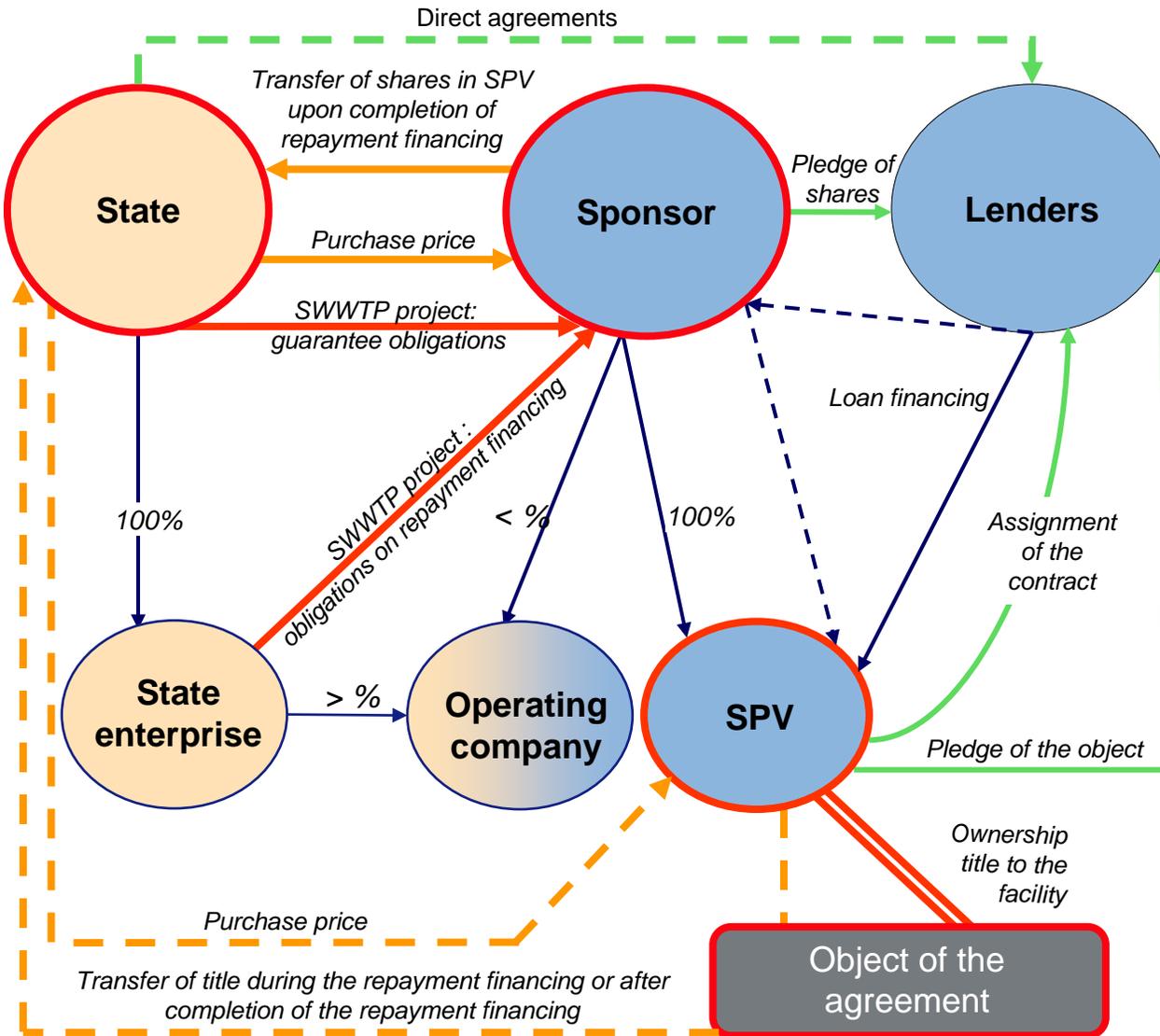
GROWTH OF PPP IN RUSSIA: EXISTING PRACTICE AND TRENDS (continued)

BOOT/ROOT



GROWTH OF PPP IN RUSSIA: EXISTING PRACTICE AND TRENDS (continued)

BOOT/ROOT



Examples of our experience



South West Wastewater Treatment Plant (SWWTP) in St. Petersburg (2002)



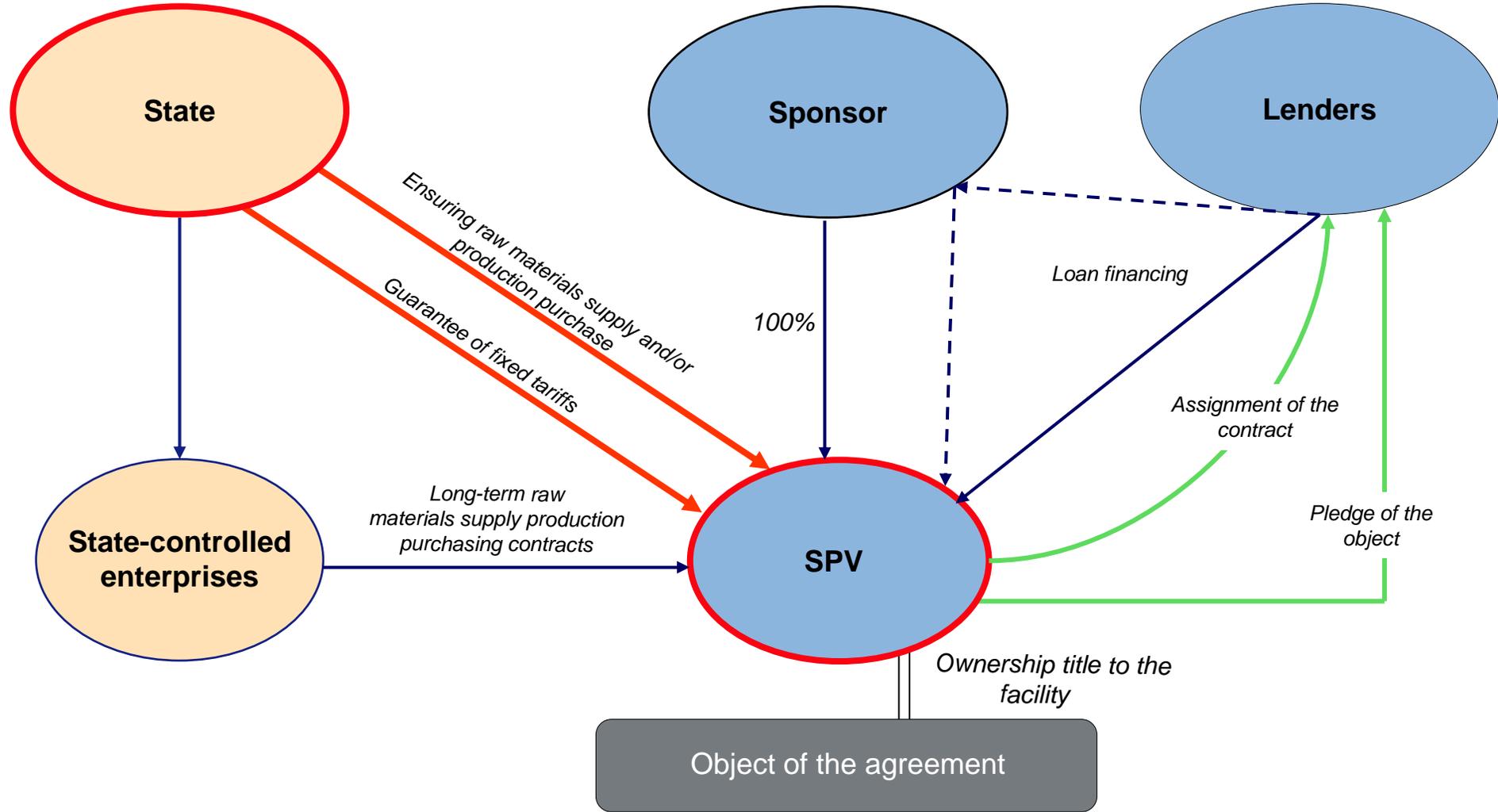
South West Water Purification Plant in Moscow (2004)



Waste Incineration Plant No.3 in Moscow (2005)

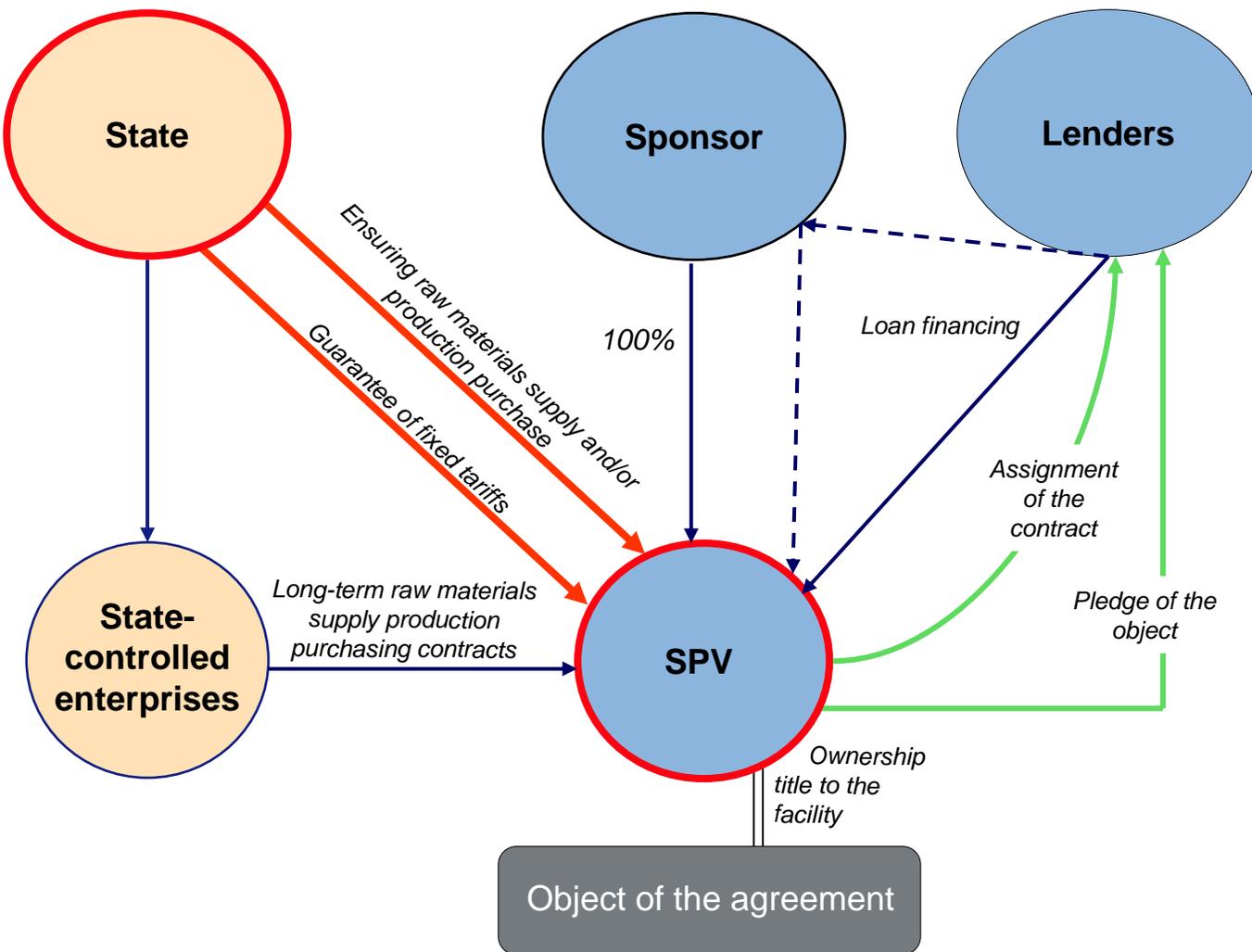


GROWTH OF PPP IN RUSSIA: EXISTING PRACTICE AND TRENDS (continued) **BOO/ROO**



GROWTH OF PPP IN RUSSIA: EXISTING PRACTICE AND TRENDS (continued)

BOO/ROO



Examples of our experience (initial stages)



*Municipal facilities,
including power plants
in Moscow*



GROWTH OF PPP IN RUSSIA: EXISTING PRACTICE AND TRENDS *(conclusion)*

-  Gradual movement towards conventional project finance schemes with a more balanced risk allocation
-  Use of PPP at the federal and municipal level
-  Most projects are still financed through loans. Possibility of issuing bonds for a project depends largely on legislative development
-  Possibilities for advancement of the role of special state participant – involvement in repayment financing at the operation stage
-  Adoption of new concession legislation
-  Participation of the public sector in re(construction) – providing capital grants
-  Developing special mechanisms for the state to co-finance infrastructure projects (in particular, the investment fund)

CONTENTS

- Experience and development trends of PPP in Russia
- **Opportunities and limitations of the new law**



DEVELOPING LEGAL FRAMEWORK

General legislation

- Civil code
- Legislation on foreign investments
- Town-planning code
- Anti-monopoly legislation
- Tariff setting and regulation

Special legislation

- Budget code
- Government Resolution On the Russian Federation Investment Fund
- Sector-specific legislation, including:
 - ✓ Federal Law on Management and Disposition of Railway Transport Assets (2003)
 - ✓ Government Resolution on Circulation-Restricted Property of OAO Russian Railways (2004)
 - ✓ Government Resolution on Toll Roads (1999)
 - ✓ Government Resolution on Classification of Motorways in the Russian Federation (1991)
 - ✓ Draft law on toll roads
 - ✓ Draft law on trunk pipelines

Typical forms of PPP

BOOT
/ROO
T

BOO/
ROO

O&M/
S&M

Turnkey
contract

Federal Law dated 21 July 2005 No. 94-FZ on
Procuring Public Contracts

Concessio
n

Federal Law dated 21 July 2005 No.
115-FZ on Concession
Agreements (Concession Law)



NEW LEGAL FRAMEWORK FOR PPP: OVERVIEW OF CONCESSIONS

Legal Framework

- Concession Law, adopted by the Russian parliament to establish a special legal framework for large infrastructure projects, including in the transport sector, which came into force in August 2005

Concession

- Project under which a concessionaire builds or renovates real property, which is or will be owned by the grantor, and operates such property for a term defined in the concession agreement (Article 1(2) of the Concession Law)

Nature of Concession Agreement

- Specific, complex and mixed-type contract for (re)construction and operation of real property belonging to the state, regulated by civil law provisions, which apply to the separate types of contracts constituting the concession agreement, to the extent that this does not contradict the terms and the essence of the concession agreement

Parties to the Concession Agreement

- Public sector
 - ✓ The Russian Federation represented by the federal government or an authorised executive agency
 - ✓ Constituent entity of the Russian Federation
 - ✓ Municipality
- Private sector
 - ✓ Individual entrepreneur
 - ✓ Legal entity (Russian or Foreign)
 - ✓ Two or more legal entities acting on the basis of joint venture or partnership agreement



NEW LEGAL FRAMEWORK FOR PPP: ALLOWED TARGETS FOR CONCESSION

Transport infrastructure

- Motorways and other engineering assets of the transport infrastructure
- Railroad transport facilities
- Pipeline transport facilities
- Airfields, buildings and structures for take-offs, landings, parking of aircrafts
- Production and engineering systems of airports
- Facilities of the unified air traffic control system
- Underground train systems and other public transport facilities
- Sea and river ports and vessels

Public utilities

- Hydro-engineering facilities
- The infrastructure and communal facilities including water, gas, sewage systems, waste water purification systems and domestic waste processing

Other infrastructure

- Sanatorium and medical facilities, recreation and tourist facilities
- Health, educational, cultural, sports and other social purpose facilities (entertainment, sports etc.)

Energy

- Facilities for production, transmission and distribution of electricity and heat energy

- **The list of the facilities available for concession provided by the Concession Law (Article 4) is exhaustive**
- **All the targets are subject to open tender unless they involve a state secret or have strategic importance for state security**



NEW LEGAL FRAMEWORK FOR PPP: MAIN CHARACTERISTICS OF CONCESSION

- Concession Law is rather flexible in terms of structuring particular projects
- Facilities remain the state's property, but the concessionaire gets the contractual right to hold and operate the facility on post-completion
- Unity of the obligations of the concessionaire: it is not possible to split construction and operation risks between two legal entities
- Collecting tolls from the end user (depending on the area and chosen PPP model):
 - ✓ Where there is a statutory obligation on the state to finance the provision of the respective public services, the concessionaire shall not collect tolls (Article 10(3) of the Concession Law)
 - ✓ In other areas the concessionaire may be allowed to collect tolls from the end users
- Restrictions in relation to some types of security
- Detailed regulation of procurement



NEW LEGAL FRAMEWORK FOR PPP: STANDARD CONCESSION AGREEMENT

Article 10 of the Concession Law provides that an agreement for a particular project must be concluded in accordance with the standard concession agreement. Government Resolution №319 of 27 May 2006 approved a standard agreement for toll roads, tunnels and other road infrastructure. Other standard agreements are being developed

Main problems with the existing approach to standard agreements:

- Mandatory nature of standard agreements
- Unified approach to all the concession projects, few provisions for alternative regulation
- Certain restrictive provisions of the current variant of concession agreements in respect of security, liability and termination

What should be done

- Establish a non-mandatory character of standard agreements
- Provide for an individual approach in structuring each agreement
- Ensure that it is possible to take account of international experience in structuring concessions in order to meet the expectations of potential sponsors and lenders

The draft law providing for permissive rather than mandatory application of standard agreements was recently originated in the Russian parliament



ALTERNATIVE FORMS OF PPPs IN RUSSIA: OWNERSHIP-BASED STRUCTURES

Ownership-based structures imply ownership of the assets during operation by the SPV. Such agreements are based on the general norms of the Civil Code and to some extent of the Law on state contracts. Such structures as BOOT or ROOT, have been tested in a number of projects developed in Russia. It is expected that such models will continue to develop in certain areas of infrastructure

Advantages as compared to concessions

- +** More contractual freedom in structuring the agreement
- +** Broader list of available securities
 - Facilities can be mortgaged for the benefit of banks and/or the government
 - No restrictions on security assignments of rights out of the project documentation
- +** Construction and operation risks can be effectively separated (contractually or through using another SPV for operation)
- +** Third parties, (e.g state-controlled entities responsible for particular industries), may become party to the project agreement

Disadvantages as compared to concessions

- Although the principle of contractual freedom still applies, there is a risk, that the mandatory rules in respect of specific types of law provided for by the civil law may be applied to the project irrespective of the parties' agreement to the contrary
- Less flexible rules in respect of procurement
- Not applicable for the projects where the property must remain under state control



NEW LEGAL FRAMEWORK FOR PPP: OVERVIEW OF INVESTMENT FUND

The first recipients of investment fund money were announced in summer 2006. Among them are pilot concessions in transport infrastructure and other prospective PPPs

Brief characteristics

- Special instrument designed by the Russian Government to co-fund the development and implementation of national projects
- Established within the Russian federal budget => therefore, performance of the obligations is backed by the entire budget
- Budget funding from investment fund to be provided for a maximum of 5 years

Volume of the investment fund

- Annual volume of the investment fund to be calculated on the basis of
 - ✓ Increase in the oil price and
 - ✓ Savings on interest by early repayments of external state debt
- The volume for 2006 is Euro 2 billion

Eligible projects

- Infrastructure, institutional and innovative projects of national importance
- Project aggregate investment costs to be not less than approximately Euro 150 million
- At least 25% of the financing to be provided by the private sector

Project initiators

- Russian Federation
- Regions (Constituent Entities of the RF)
- Municipalities
- Private investors



NEW LEGAL FRAMEWORK FOR PPP : OVERVIEW OF INVESTMENT FUND (continued)

- Important source for state financing of national infrastructure projects
- Important political indication that Russia welcomes the concept of PPP's
- Long-term planning for financing the development of infrastructure facilities

- Does not solve problems of the budget legislation, e.g. those of permitted expenses and project incomes payable to the state
- Relations between the tender for investment fund money and concession tender remain unclear and will have to be resolved in practice

BUT



OTHER ASPECTS OF PPP STRUCTURING: GENERAL BUDGET LAW

LIMITATIONS

Problems

- Instability of state financing: dependence on annual budgetary planning
- Exclusion of state revenues from cash received from implementing the project: the principle of making budget income anonymous
- Limited list of permitted forms of budget expenditures allowing to make compensation payments

Possible structuring mechanisms

- Using special purpose programmes – providing cash funds through subsidies, subventions, state loans or budget investment
- Providing payments under a state contract if a PPP contract is recognized as a state contract for the budgeting purposes
- Providing SPV with funds through a third party – a state participant (in the form of open joint stock company)
- State guarantees: (1) to guarantee performance of state participant; (2) to guarantee SPV's performance
- Assuming compensatory contractual obligations before the SPV
- Using Investment Fund to provide partial financing for the project



OTHER ASPECTS OF PPP STRUCTURING: ISSUES OF SECURITY

Regulation of security under Russian law is rather complicated and inflexible. In addition the Concession Law contains some further limitations in respect of security. Available forms of security depend on the type of PPP project

General restrictions

- Property encumbered by a mortgage or pledge may only be sold at a public auction
- The mortgage of uncompleted facilities is permitted, but in practice is difficult to accomplish (problems with evaluation, registering rights, connection with the lease of land)
- Restrictions on the amount, term of and a complicated procedure for receiving and maintaining state guarantees
- Assignment of future claims faces a risk of invalidation as the court practice has been inconsistent in respect thereof

Available security under PPP contract

- Pledge of assets
- State guarantees
- Assignment of future monetary claims
- Pledge of SPV's shares
- Direct and regulated by the foreign law commitments to creditors
- Assignment of rights under project agreement
- Suretyship of the sponsors
- The right to change SPV's subcontractors
- Pledge of rights under the bank account
- Insurances



Limitations of the Concession Law

- The Concession Law expressly precludes the concessionaire from pledging the object of the concession agreement (Article 3(6) of the Concession Law)
- The Concession Law expressly precludes the pledge of rights by the concessionaire under the concession agreement (Article 5(2) of the Concession Law)
- Assignment of the agreement is allowed, subject to grantor's consent, from the date of putting the object of the concession agreement into operation (Article 5(2) of the concession Law)

Most risks can be mitigated by proper structuring and drafting of project and financing agreements

Problems with tariff regulation

- In a number of areas the state has the exclusive right to set tariffs (oil transportation, railway transportation, port and airport services, etc.)
- The state has the right to establish exemptions and restrictions, aimed at ensuring the social protection of individual groups of the population
- Complicated procedure for changing tariffs

Possible solutions

- Obligations of the state to provide guarantees and compensation
- State obligation not to establish additional exemptions or restrictions, in addition to those that were in effect at the time of concluding the agreement
- Risks may be significantly lowered by choosing the relevant repayment financing model depending on the type of project

Problems with tax legislation

- The absence of a special tax regime for complex project financing structures creates uncertainty around the following issues:
 - ✓ Set-off of input VAT for the SPV's contractor
 - ✓ Taxation of state compensation payments

Possible solutions

- Detailed legal and tax structuring within the framework of existing tax regimes.
- Financing of the project through contributions to the SPV's charter capital
- The sale of shares in the SPV to the state (in schemes which include the right to provide ownership of the facility)

OTHER ASPECTS OF PPP STRUCTURING: PROVISION OF LAND

Problems of land law

- Shortcomings in the procedure for reserving and withdrawing land for constructing transport infrastructure
- An excessive role for local government authorities in the area of disposing land plots in relation to land prior to demarcating state ownership thereto
- No possibility to conclude a lease agreement directly by a counter-agent where the subject of the lease is land for which state ownership has not been determined
- A series of problems arise in relation to the application of the Federal Law On Concession Agreements, including the relative impossibility of concluding a land plot lease agreement within the term established by the Law on Concession Agreements (60 days)

Possible solutions

- Before taking a decision on disposing land on which the object of capital construction is to be situated pursuant to Russian Federation planning documents, oblige local government authorities to receive approval from the relevant federal executive authorities
- Provide for the opportunity to establish a different term for concluding land lease agreements upon the consent of the parties
- Provide for the opportunity for an entity to apply to choose the land plot for the purposes of developing that land plot and subsequently providing it to another entity that is not determined at that point



Possible difficulties

- The procedure for registering rights to a number of infrastructure facilities is not established in legislation and has not been developed in practice
- The legal effectiveness of arbitration in relation to disputes over immovable property within Russia is doubtful
- The issue of state immunity is unresolved in Russian law (exception: the Law on Production-Sharing Agreements)
- The body authorised to conclude agreements under PPP projects on behalf of the state has not been determined

The majority of problems related to implementing PPP projects may be resolved with appropriate legal structuring

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