

Tools for the job?

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Over the next decade planned investment in new and existing infrastructure in Russia is expected to exceed \$1 trillion (of which state funding is to compose only one-fifth). In the transport sector alone the federal programme for development through to 2015 provides for investment of nearly Rb13.5 trillion (\$570 billion), of which up to Rb7.2 trillion will be financed from non-budgetary sources.

PPP projects boom

While PPP projects based on variations of BOOT/BOO, design and build, operation and maintenance structures have been used predominantly in the utilities sector since the mid-1990s, the last two-and-a-half years have seen the launch of several large-scale PPPs in the transport sector.

These PPPs include the toll road and tunnel projects in St. Petersburg and Moscow regions such as the Western High-Speed Diameter, Orlovsky Tunnel, Odintsovo Bypass, and sections of the Moscow-St Petersburg Highway, each of which are based on the concession scheme envisaged under the Federal Law on Concession Agreements of July 2005 (the Concession Law). In addition there are the Nadex light rail and the Pulkovo airport expansion projects, which have been conceived as the first PPPs to rely, for the most part, on purely regional PPP legislation, in this case, enacted in St. Petersburg.

However, despite the increase in interest, only the Western-High Speed Diameter has so far reached the concession award stage. With three other pre-qualified consortia declining to submit their bids, the concession, with a total value of Rb212.7 billion has been granted to the only remaining bidder – a project consortium led by Basic Element (with consortium participants including Strabag A.G., Bouygues Travaux Publics, Hochtief PPP Solutions, Egis Projects and JSC Mostotryad No. 19).

Developing the legal framework

The recent boom in potential PPP projects has been largely facilitated by the development of the legal framework in the course of the last three years.

The Concession Law became operational when the forms of most of the requisite model concession agreements were approved by the Russian Government in 2006 and early 2007. Under the Concession Law, title to the concession object vests with the public sector grantor (the Russian Federation, its constituent member or municipality) and the concessionaire is expressly prohibited from mortgaging the concession object or pledging its rights under the concession agreement. An assignment of the concessionaire's rights and transfer of obligations under the concession agreement is only possible after the completion of the concession object. The Concession Law also introduced detailed rules requiring the grantor in most cases to hold an open two-stage tender for granting the concession agreement.

A comprehensive set of amendments to the Concession Law and certain related legislation was finally adopted in June 2008. The amendments are intended to address certain practical issues that have been highlighted in the course of implementing the pilot concession projects.

Among others, these amendments include the relaxation of the requirements with respect to concession fees payable by the concessionaire (which now become optional in certain cases), clearer rules on allocation, accounting and taxation of movable and immovable property created or acquired by the concessionaire under the project and the streamlining of the tender procedures.

In particular, to facilitate assessment of technical proposals, the amendments to the Concession Law propose a dual envelope submission procedure. The amendments confirm the principle that concession agreements may deviate from the forms of the model concession agreements approved by the Government by supplementing them with additional provisions, provided these comply with the terms of the tender documentation and Russian law.

Pursuant to the amendments to the Concession Law, the obligation of the grantor with respect to providing to the concessionaire land, forest and subsoil plots and water objects required for the project may now be deemed discharged to the extent that the grantor is able provide any permitted legal right (such as servitude) (and not only leasehold title) to such plots or objects to the concessionaire.

There are also other relevant laws to be considered:

The construction or reconstruction of toll roads under concession agreements was recently detailed in the Federal Law on Motorways and Road Activities of November 2007 (the Law on Motorways). Among other things, the Law on Motorways has expressly confirmed the possibility for the grantor to provide compensation to the concessionaire for insufficient traffic.

Traditional public procurement contracts are currently regulated by the Federal Law on State Procurement of July 2005 (State Procurement Law), which applies to capital construction and reconstruction works for state or municipal needs and requires such contracts to be awarded pursuant to public tenders or auctions. The State Procurement Law contains an express prohibition on negotiations during the tender process, failing which the tender may be invalidated.

A recent trend in developing the regulation of PPPs is the emergence of regional PPP laws in several Russian regions, most notably, the St Petersburg PPP Law (the SPb PPP Law) purporting to create a more flexible legal framework for non-federal PPPs.

In particular, the SPb PPP Law is conceived to allow ownership-based PPP structures (such as BOOTs and BOOs), thus potentially expanding the options for structuring the security packages in respect of both the objects constructed/reconstructed under the project and rights under the relevant PPP agreement. The SPb PPP Law also elaborates on the options of St Petersburg's financial participation in regional PPP projects, allowing for tariff subsidies, availability payments, minimum revenue guarantees and termination payments. The SPb PPP Law intends to introduce more flexible tender rules as compared to those envisaged under the federal Concession Law, which allow tenders to be conducted in several stages.

As far as other Russian regions are concerned, a law, very much resembling the SPb PPP Law, has recently been adopted in Dagestan, while in several other regions (such as republic of Altai and Tomsk region) more generic regional PPP legislation has been put in place.

State financing tools

The development of the regulatory framework for granting and performing under PPP agreements has also been enhanced by expansion of the state financing options available to investors.

Generally, under the Russian Budget Code, direct state financing may be provided in the form of (i) subsidies to compensate costs or make up for insufficient revenues in rendering particular services; and (ii) budget investments. Budget investments can take the form of capital grants for the construction or reconstruction of state or municipal property (including facilities built or reconstructed pursuant to concession agreements) or investments granted to legal entities (other than state (municipal) institutions or unitary enterprises) in exchange for transfer of equivalent equity stakes in such entities into state or municipal ownership.

Aside from the above, Russia has earmarked the budget funds of the Investment Fund of the Russian Federation specifically for PPPs. The regulation of the Investment Fund (which was originally created in 2005) has been significantly revamped as recently as March 2008. Projects eligible to compete for the funding from the Investment Fund include key PPP (including concession-based) projects with a value of not less than Rb5 billion.

Generally, direct public sector funding from the Investment Fund may be provided for a period of up to five years in the form of budget investments into capital construction (including for preparation of design and tender documentation and site preparation) or equity investment. The private sector is required to put up at least 25% of the costs of the project.

The Investment Fund may also provide state guarantees for up to 60% of the principal amount of the bank loans attracted by the private actor for a period of up to five years.

Importantly, funds from the Investment Fund in a particular financial year may not be combined with other forms of federal budget funding.

Another form of state financial backing of PPP projects is expected to be extended by State Corporation Bank for Development and Foreign Economic Affairs (Vnesheconombank) which was created in May 2007. With its special status exempting Vnesheconombank from compliance with prudential ratios requirements applicable to conventional commercial banks, Vnesheconombank promises to offer longer tenors than the Russian lending market has seen so far. Vnesheconombank has also reported to be lobbying for the creation of a national PPP unit similar to Partnerships UK.

Some obstacles remain with new issues on the horizon despite the bright big picture, certain regulatory issues continue to cloud the skies for PPP projects in Russia and should be considered when assessing the optimal PPP structure. A few of these are outlined below.

Potential issues for regional non-concession based projects

The uncertainties with respect to the correlation of the regional PPP laws with the federal legislation, with federal laws having either exclusive jurisdiction or prevailing force in matters such as civil, land and administrative legislation, may be seen to leave room for re-classification and invalidation risks in respect of projects that are purported to be structured around the federal laws on concessions, state procurement or privatisation.

Unlike concession-based projects, certain forms of state financing (including funds of the Investment Fund) may not be available for PPPs based on regional PPP laws. For example, budget investments in the form of capital grants may not be provided to construct facilities which do not or cannot comprise federal, regional or municipal property.

Also, while concession-based projects are generally seen to be grandfathered against adverse changes of federal, regional and municipal laws and regulations, to the extent such changes deprive the concessionaire of the benefits it was expecting to obtain at the time of entry into the concession agreement, regional projects would be grandfathered against changes of regional laws only. (Notably, certain types of eligible investment projects (whether concession-based or not) could also enjoy protection under the general stabilisation provisions of the 1999 Foreign Investments Law).

Land allocation issues

Practitioners have noted inconsistencies between the provisions of the Concession Law requiring the grantor to provide the requisite rights to land plots to be used by the concessionaire in connection with the project and the procedures for land allocation envisaged under the Russian Land Code which may lead to practical difficulties respect of proper and timely provision of land rights to the winning bidder.

Restrictions applicable to strategic companies

A new range of issues that can potentially adversely affect the attractiveness and bankability of certain PPPs for foreign investors is posed by Federal Law on Foreign Investments in Companies of Strategic Significance for State Defence and Security (the Strategic Companies Law) of April 2008.

The Strategic Companies Law requires a preliminary consent from a special Government commission for the consummation of certain transactions resulting in the creation of control by a foreign investor (or a group of persons) over companies which are qualified as "strategic". Currently, certain natural monopolies, including those providing services in transport terminals, ports, airports, railway transportation and in connection with the use of inland waterways, may fall within the ambit of the Strategic Companies Law. The definition of transactions relating to creation

of control is widely drafted to include direct and indirect acquisitions of shares in, and the ability to determine the terms of business activities of, strategic companies. The Strategic Companies Law imposes severe sanctions for consummation of transactions in the absence of the requisite governmental approval: such transactions may be deemed void and require to be unwound. Where the unwinding of the relevant transactions is not possible, the foreign investor may be disqualified from voting at the shareholders' meeting of the relevant strategic company.

The restrictions introduced by the Strategic Companies Law could necessitate additional governmental approval for a foreign controlling investor to be able to participate in certain infrastructure PPPs whether directly or indirectly, through a Russian project company wholly owned by an offshore holding vehicle (which to date has been the most popular structure for PPP consortiums). The restrictions could also apply to transfers of shares in the offshore holding company between the consortium members or transfers to third parties conferring control over the Russian project company.

Similar concerns may arise upon enforcement of security over the shares of the Russian project company and/or the holding company, which are seen as critical elements of conventional security packages for Russian PPP projects.

In addition, given the broad language of the Strategic Companies Law, it is not entirely clear, whether negative control obtained by the financiers under standard investor protection provisions of the financing documents (including for example restrictions on disposal of assets, changes of charter capital and material investments) could also trigger the requirement to obtain a governmental consent by the financiers of the project.

While as early as one month after its adoption senior governmental officials have voiced an intention to relax the restrictions introduced by the Strategic Companies Law, these promises remain to be put into practise.

What next?

Despite the number of legal and commercial issues remaining to be addressed for PPPs to become a driving force of infrastructure development, the outlook for PPPs in Russia appears positive.

This seems to be in part because of the level of political support and the continued evolvement of the regulatory framework, coupled with the market's continued appetite for Russian transactions which is based on a sound level of awareness of the inherent Russian commercial and financing risks that has been accumulated by investors, both domestic and foreign.

With growing competition between the various projects for private sector funding, proper structuring and optimal risk allocation will play an increasingly important role. And it may be the case that this 'dash for cash' by the various projects will drive evolution of this sector as much as regulatory changes.

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