How to make PPP work in Russia

2012 Overview

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Contents

Introduction 1
Research methodology 2
Principal conclusions 3
Advantages for the state 4
Industry appeal 6
Regulatory framework 8
Quality of preparation of PPP projects 10
State policy on PPPs 11
Terms of financing 12
Allocation of risks 13
Role of development institutions 16
Contacts 17
Introduction

In this overview, we present the findings of a survey that Ernst & Young did this year of players on the Russian PPP (public-private partnership) market.

The survey's objective was to gauge the opinion of public officials, private investors, credit institutions and development institutions on the opportunities and advantages of PPP mechanisms for the state, society and business, as well as key factors affecting the rates of growth of this approach to infrastructure projects in Russia.

We have summarized the respondents’ opinions on a variety of legal, financial and commercial issues relating to PPP projects.

While the public and private sectors give different assessments of the advantages and opportunities of PPP projects in Russia, they agree that legislation must be improved and they underline the importance of a clear state policy on PPPs. An appropriate allocation of liability for risks in PPP projects between the state and the private sector is paramount.

We thank all the respondents for taking part in our study and trust that its findings will promote a better understanding of the prospects for PPP development in Russia.
We surveyed Russian federal and regional state officials who deal with PPP issues, as well as strategic and financial private investors, banks, credit institutions and development institutions that are active on the market.

Both Russian and foreign organizations took part in the survey.

The survey was conducted by means of questionnaires over the Internet. Most of the twenty questions we asked were multiple-choice. In some cases, free-form answers and/or comments were allowed. The questions were largely evaluative in nature and did not concern specific projects.

One of the tasks we set was to study the opinion of various groups of PPP project participants and compare their points of view and evaluations for a more detailed analysis of the prospects for PPP development in Russia.

We believe that the PPP experience accumulated by our respondents makes the survey findings a valuable source of information deserving serious analysis.

Figure 1. Respondents’ organizations by economic sector

- Development institution 16%
- Private investor 48%
- Credit institution 9%
- State body 27%

Figure 2. Respondents’ organizations by country of origin

- Foreign organization 23%
- Russian organization 77%
### Principal conclusions

<table>
<thead>
<tr>
<th>The public and private sectors give different assessments of the advantages and opportunities of the practical implementation of PPP mechanisms.</th>
<th>Public officials regard off-budget financing as the key task of PPPs. They count on transferring liability for key project risks to the private sector and expect a low cost of private capital. The private sector is prepared to provide optimal value for money, but in return expects state support and guarantees as well as an adequate return on investments.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market players agree that certain sectors, with the exception of social infrastructure, are relatively promising.</td>
<td>Transport and utilities are the industries that show the most promise for PPP mechanisms in the next five to ten years. The state needs PPP projects in the social sphere, but has not as yet created the conditions for projects in this sector.</td>
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<td>For the further development of PPPs, legislation must be improved.</td>
<td>Federal and regional PPP legislation should be flexible and coordinated, and a number of related issues need to be resolved in the areas of tariff formation, access to land, taxation, budget formation, etc.</td>
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<td>But it's no less important to eliminate other obstacles as well.</td>
<td>The quality of project preparation remains low. State bodies lack experience. State institutions for the support and development of PPPs are insufficiently developed at the federal and regional levels. Investors are also concerned about the low creditworthiness of Russian regions.</td>
</tr>
<tr>
<td>There are opportunities to make projects more financially attractive.</td>
<td>Projects may be made more attractive by means of state guarantees, the accumulation of experience with PPPs and an appropriate allocation of liability for risks.</td>
</tr>
<tr>
<td>A clear state policy on PPPs is of key importance for all market players.</td>
<td>Most market players do not understand current state policy on PPPs. The state should more clearly formulate its requirements. Development institutions can and should assist in project preparation and delivery.</td>
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</table>
Advantages for the state

When survey participants were asked about the key advantages of PPP mechanisms for the Russian state, the most frequent answers were:

- Elimination of problems in connection with insufficient budget funds
- Use of private investors’ experience in introducing technical innovations
- Improved quality of public services

Opinions on the potential of PPPs for making state expenditures more cost-effective differ between the public and private sectors and between Russian and foreign companies. Representatives of foreign (as opposed to Russian) companies regard the following as key advantages of PPPs:

- Budget savings
- Use of private investors’ experience in project delivery

Note also that foreigners are less inclined to assume project risks than their Russian colleagues.

Figure 3. Opinion on the key advantages of PPPs for the Russian state
Public officials attach greater importance to off-budget financing and the transfer of liability for risks to a private partner than they do to such PPP opportunities as budget savings and new technologies.

By contrast, private investors and financial companies, especially foreign, believe that PPP mechanisms promote budget savings by means of:

- Effective work of a private investor and improved cost-effectiveness for the state
- A flexible and balanced allocation of risks between parties to a PPP agreement
- A partial transfer of costs to consumers

It can be concluded that market players view the effectiveness of PPPs more broadly than do public officials and base their evaluation on value-for-money criteria.

Note that representatives of the private sector are far less inclined to assume risks than the state expects. Banks take the most conservative position (which is natural, inasmuch as their chief task has traditionally been the preservation of capital).
Industry appeal

Survey participants regard transport and utilities as the Russian industries that show the most promise for PPP mechanisms in the next five to ten years.

Respondents named the Russian power industry as the least promising for PPPs. This may have to do with the comparatively low return on investments in conditions of tariff regulation.

Public officials differed with other respondents in their evaluation of the prospects for PPPs in social infrastructure (Figure 8). Our findings indicate that, while there is a need to update and develop social infrastructure, there are no well-developed approaches or schemes for attracting private investors to such projects.

Despite the fact that one of the most frequently mentioned advantages of PPPs is the advanced technology introduced by private investors, the survey participants believe that the regions need conventional, standard infrastructure projects with well-developed means of implementation more than they need high-tech projects. This likely reflects a desire by respondents to try out PPPs at the regional level in relatively simple, reproducible projects before moving on to more complex projects.
Chief obstacles

The respondents were unanimous in believing that the chief obstacles in the way of wider use of PPPs in Russia are:

- The failure of federal laws to satisfy modern requirements
- The low quality of preparation of PPP projects
- An insufficient level of state readiness to put PPP projects into practice

Note that it was public officials who pointed to the lack of a unified state policy on PPPs, the underdevelopment of public institutions and their low level of readiness to undertake such projects as being among the most serious obstacles.

Representatives of development institutions are more concerned than other respondents about the paucity of PPP projects that are well developed and in demand and the consequent low level of competition on the market.

Figure 10. Assessment of the significance of the chief obstacles in the way of wider use of PPPs in Russia

![Bar chart showing the assessment of the significance of the chief obstacles in the way of wider use of PPPs in Russia. The chart includes bars for incomplete/imperfect legislative framework, lack of thoroughly elaborated projects that are attractive to investors, no executive bodies responsible for initiating and delivering PPP projects, unwillingness of public officials to give up traditional budget purchases, high cost of financing, low creditworthiness of Russian regions, and insufficient number of market players to ensure competition. Each category is represented by bars indicating the percentage of Development institution, Credit institution, State body, and Private investor.]
Regulatory framework

Seventy-five percent of those surveyed think that Russian law must be substantially revised to meet the current needs of PPP projects.

The list of proposals is extensive:

- Revision of Law 115-FZ “On Concessions Agreements”
- A greater number of possible types of PPP under federal law
- Amendments to the Budget Code to make it possible for long-term liabilities relating to PPP projects to be included in the budget
- Amendments to the Tax Code to eliminate adverse tax implications of contractual PPP schemes
- Amendments to the Land Code to eliminate ambiguities in the legal regulation of land relations in connection with PPP projects
- Amendments to the procedure for forming tariffs as well as the possibility of setting fixed tariffs for the long term
- Development of specialized sectoral legislation on PPPs
- Legal and regulatory support making it possible to accelerate the initiation and preparation of PPP projects
- Wider powers for constituent entities of the Russian Federation, allowing them to independently regulate regional PPP projects
- The possibility of using resources of the Investment Fund of the Russian Federation for infrastructure projects carried out under regional PPP laws
- Federal guarantees that regional PPP projects will be protected against discriminatory amendments to federal laws

Figure 11. Evaluation of the regulatory framework

The existing regulatory framework is a major hindrance to project realization and requires fundamental transformation

Existing laws must be amended substantially, or certain new regulatory acts must be passed

Minor amendments to existing laws are needed

Other

0% 5% 10% 15% 20% 25% 30% 35% 40% 45%

40% 35% 25% 3%
Not a single respondent thought that the rights of investors and creditors were adequately protected in Russia. The current mechanisms for protecting the rights of investors and creditors are rated lower by foreign companies than by their Russian colleagues.

In their comments on this issue, representatives of credit institutions indicated a need for law enforcement practice in connection with Russian PPP projects (including judicial decisions in favor of private investors). This could help to improve the investment climate and increase private investors’ confidence in the legal protection offered to them.

**Figure 12. Assessment of mechanisms for protecting investors’ rights**

- Existing legal mechanisms do not adequately protect the rights of investors and creditors, seriously inhibiting growth in investments
  - Foreign organization: 56%
  - Russian organization: 38%

- Certain risks entail a comparatively higher cost of financing
  - Foreign organization: 44%
  - Russian organization: 62%

- Existing law and practice adequately protect the rights of investors and creditors

0% 10% 20% 30% 40% 50% 60% 70%
Quality of preparation of PPP projects

Respondents agree that the quality of preparation of Russian PPP projects remains low.

Survey participants are also unanimous in their belief that the best way to improve quality and ensure the transfer of experience is to engage outside experts. The respondents also indicated that they would like to see a unified center at the federal level for the dissemination of best PPP practices as well as receive assistance from state officials who have positive experience in realizing such projects in other regions or industries.

Figure 13. What is your assessment of the quality of preparation of Russian PPP projects that you’re familiar with? (respondents’ average assessment on a scale of 0 to 3, where 0 is very low quality, and 3 is high quality)

Figure 14. How, in your opinion, should experience with PPP projects be shared between state bodies?
State policy on PPPs

Only 8% of surveyed public officials indicated that they fully understood and supported current state policy on PPPs (while in other groups there were no respondents who indicated this).

Current policy received the lowest evaluation from representatives of credit institutions and private investors.

Here are a few opinions of survey participants:

• “The state needs to determine its priorities.” – a representative of a foreign private investor
• “PPPs are still a political rather than an economic decision. When state bodies act on the basis of long-term project economy, there will be financing for project preparation as well as transparent tenders and appropriate results.” – a public official
• “The actions taken by federal ministries to develop PPP mechanisms are not coordinated; no state agency has been made responsible for formulating PPP policy.” – a representative of a development institution
• “[We need] to get away from the universal practice of state orders and use and develop PPPs as an alternative approach to infrastructure projects ...” – a representative of a Russian private investor
• “Unified approaches and terminology [are required].” – a representative of a development institution
• “We need a comprehensive program that, in addition to the fine tuning of legislation, will include the upgrading of state and municipal officials, methodological support for the regions, the development of standard projects, etc.” – a public official.
• “Structure and transparency at all levels of government: federal, regional and municipal. Organization of institutions responsible for developing and improving unitary rules, legislative initiative, preparation of public officials to manage the investment climate and projects, development of judicial practice in connection with PPP cases, development of relations with foreign institutions that export investments, functions involving guarantees that the rules of the game will be followed.” – a public official.

Figure 15. What is your opinion of current state policy on PPPs

<table>
<thead>
<tr>
<th>Institution</th>
<th>Clear and supported by the respondent</th>
<th>Clear but has weaknesses and needs revision</th>
<th>There is no unified state policy on PPPs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development institution</td>
<td>43%</td>
<td>57%</td>
<td></td>
</tr>
<tr>
<td>Credit institution</td>
<td>100%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>State body</td>
<td>8%</td>
<td>25%</td>
<td>67%</td>
</tr>
<tr>
<td>Private investor</td>
<td>14%</td>
<td>86%</td>
<td></td>
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</tbody>
</table>
Terms of financing

There is a wide gap between the opinions of representatives of the public and private sectors as to the optimum scope of a pilot regional project and the acceptable level of return on equity in PPP projects.

Figure 16 shows that representatives of credit institutions completely disagree with public officials on the acceptable level of return on equity in the current environment. While state bodies believe that 20% p.a. in rubles is an acceptable ceiling, credit institutions regard this as the bottom limit.

In assessing various ways of enhancing the bankability of projects, respondents from the public and non-public sectors express somewhat different opinions.

As demonstrated in Figure 17, infrastructure investors from the non-public sector believe that state guarantees of return on investments play an important role in achieving a successful financial close.

By contrast, public officials are confident that the development of PPP practices, an increasing level of knowledge and expertise, a more thorough elaboration of projects and, consequently, higher competition among investors are crucial for raising capital.

Representatives of development institutions share both views and regard these groups of measures as equally important.

Respondents from the non-public sector have concerns about the low creditworthiness of the Russian regions. The investment community would like to see more support from the federal government in implementing regional infrastructure projects (as shown in Figure 10 in the Chief Obstacles section).

Figure 16. Size and profitability of pilot PPP projects in Russia

Figure 17. Assessment of measures to enhance bankability (overall and broken down by respondent groups)
Allocation of risks

Balanced allocation of risks between the private and public sectors plays a key role in enhancing bankability.

The survey showed a lack of consensus between domestic market players on the optimal way of allocating key commercial and financial risks in PPP projects. Generally, the state's expectations are much higher than what the market can offer, especially considering that foreign investors and credit institutions view Russia as a risky investment destination.

Demand risk

Other market players do not share the optimism of state bodies regarding the transfer of demand risk to a private partner.

Only 6% of surveyed private investors are prepared to assume the entire demand risk, and just 39% agree to partially assume this risk. Projects with an availability payment mechanism are therefore still perceived by investors as preferable.

Risk of regulated prices/tariffs

All market players agree that the risk of regulated prices/tariffs should be borne by the state.

Russian law does not envisage any mechanisms that would allow regional authorities and industry regulators to keep tariffs at an attractive level for the duration of PPP agreements.

The surveyed investors are generally ready to collect project revenues directly from users, provided that they are able to enforce penalties for non-payment and have the respective guarantees from the state.

Figure 19. How should liability for the risk of regulated prices/tariffs be allocated between the public and private sectors?

<table>
<thead>
<tr>
<th>Development institution</th>
<th>Credit institution</th>
<th>State body</th>
<th>Private investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private partner</td>
<td>Joint liability</td>
<td>State</td>
<td>Private partner</td>
</tr>
<tr>
<td>14%</td>
<td>100%</td>
<td>9%</td>
<td>5%</td>
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<tr>
<td>86%</td>
<td>100%</td>
<td>91%</td>
<td>95%</td>
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Figure 18. How should liability for the demand risk be allocated between the public and private sectors?
Risk of cost inflation and currency risk

Equity and debt investors are more willing to assume the risk of cost inflation during the investment stage than the state would expect them to be.

State bodies, however, are too optimistic about the ability of market players to manage the inflation risk in the long term.

Figure 20. How should liability for the risk of cost inflation at the investment stage be allocated between the public and private sectors?

Interest rate risk and refinancing risk

The majority of surveyed Russian market players believe it appropriate to transfer the interest rate risk (whether before or after the project’s financial close) to the private partner. The respondents had mixed views on refinancing risk (where the borrower is unable to raise debt financing for a term commensurate with that of the project). The prevailing view, however, is that this risk should be shared between the private sector and the state.
Perception of risks by foreign investors

The survey revealed that foreign investors are highly sensitive to commercial and financial risks. This factor should not be overlooked by state bodies if they want to expand the list of potential participants in PPP projects and spur competition, primarily by providing wider access for major international PPP players.

Figure 25. How should liability for key risks be shared between the public and private sectors? (comparison of opinions expressed by Russian and foreign respondents)
Survey respondents believe that the role of development institutions in PPP projects is fundamentally different from that of commercial banks. According to respondents, the following functions of development institutions are most in demand:

- Disseminating experience in the area of the preparation and delivery of PPP projects and providing advice to state bodies
- Financing the preparation of PPP projects
- Providing various forms of “credit support,” including financing on favorable terms, guarantees, etc.

Respondents think that the possibility of raising financing from development institutions on market terms is less important than other factors.
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