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Public-Private Partnerships in Russia

October 2008

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Public-private partnerships in Russia

A huge opportunity

> Underinvestment since 1991 has led to infrastructure development opportunities across the CIS region

> Ivanov: US$1 trillion of infrastructure investment needed over next 10 years
  – Up to 80% from private sector

> Public Private Partnerships are likely to be major source of funding

> Government support through the Investment Fund and the Development Bank

> Legal framework for concession contracts and Russian banking system still relatively undeveloped

> Public-private partnership will be a crucial step to fund the infrastructure funding gap

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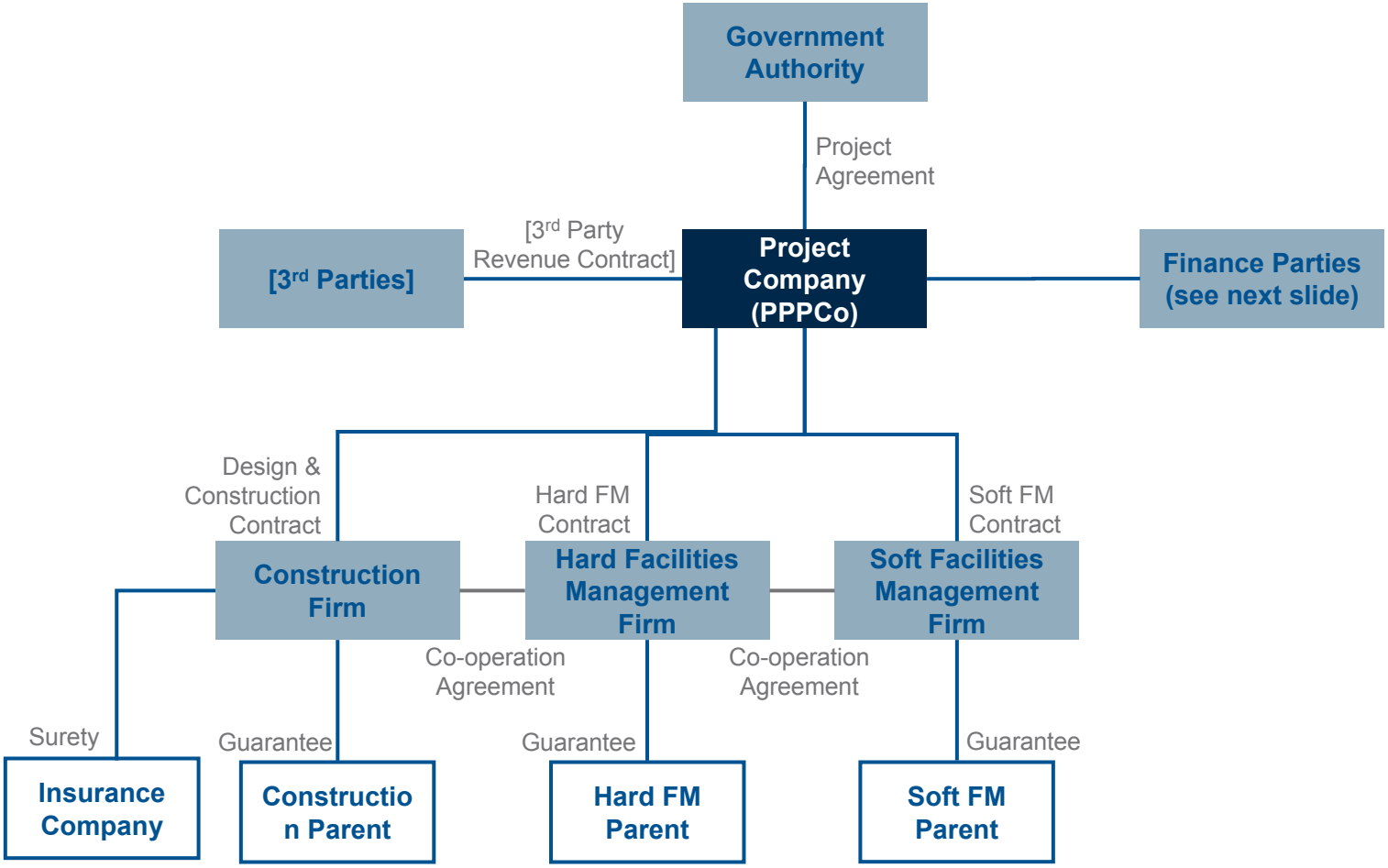
The PPP concept

How does it work?

- A private investor works in partnership with the Authority
- Own, manage and maintain an asset in partnership with the Authority through a concession agreement
- Term – typically 30 to 40 years.
- The private party assumes responsibility for:
  - Planning, design and build
  - Raising and structuring finance
  - Operating and maintaining the asset over the concession period
- The Authority makes periodic Availability Payments from the completion until the end of the concession
- The private investor subcontracts design, construction, operation and maintenance to contractors and retains the risk of price fluctuations
- Financing for the asset is raised by the private investor and repaid through availability payments

PPP Project Structure



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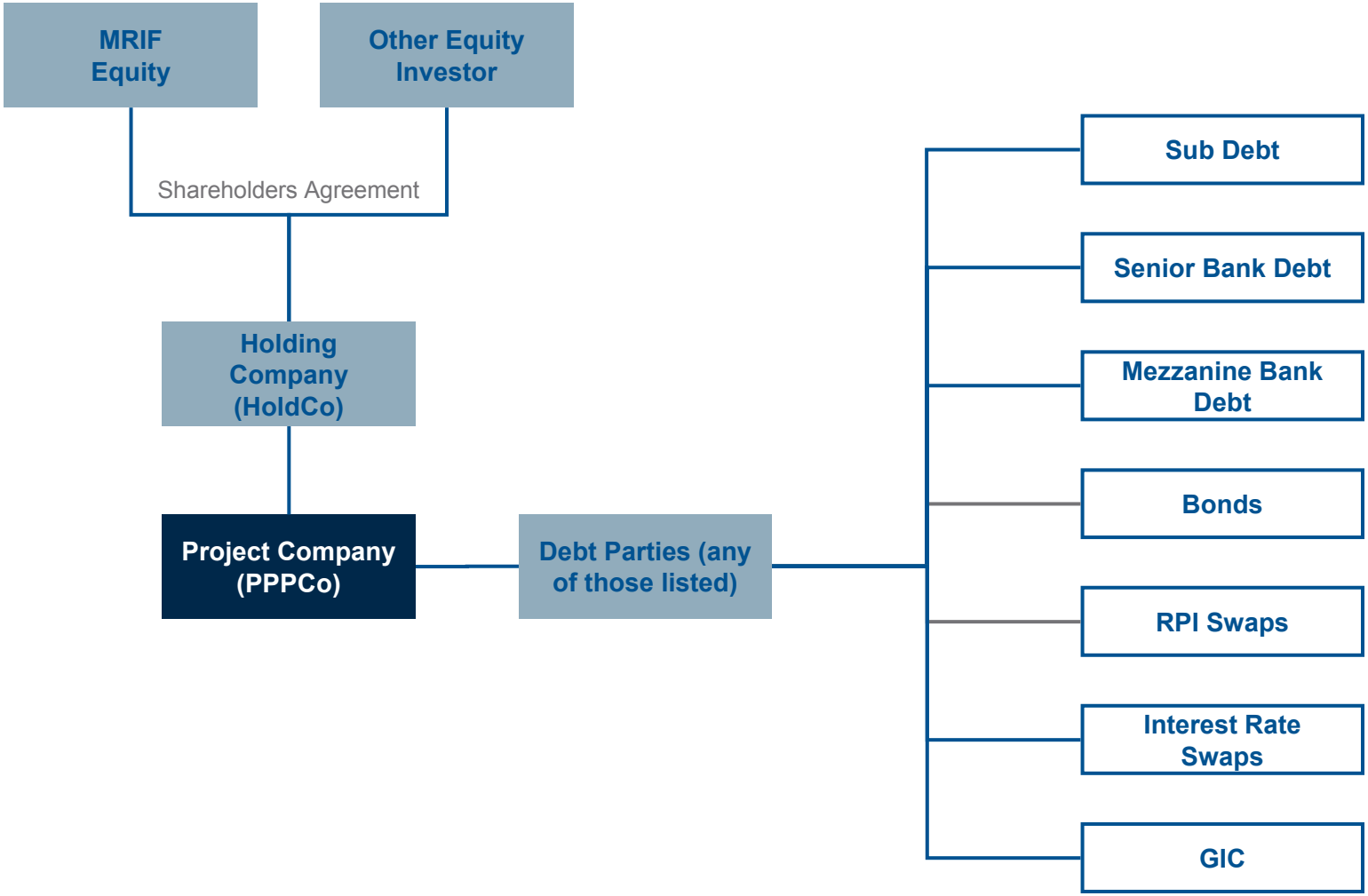
PPP Financing Structure



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The attraction of Public-Private Partnerships

Public-private partnerships (PPPs) are a way to source private sector funding and introduce discipline to the provision of a public good. Some of the benefits include:

> **Operational Efficiency**
Private investors are rewarded for increasing the efficiency of assets, either by performance penalties or direct market exposure

> **Fiscal Discipline**
PPPs are a way for governments to source capital to fund projects, thereby avoid increases in public debt

> **Faster implementation**
Limited concession period creates an incentive for private investors to make projects operational as soon as possible#

> **Equitable distribution of resources**
Auction processes ensure fair prices are being paid by the private investors and concession contracts ensure that customers are paying fair prices for services used

> **No transfer of ownership**
Governments still own assets that are being leased under a concession, in contrast to privatisation

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Simple payment mechanism

No payments until project is complete and operational

- The Authority specifies the key outputs for the investor to achieve
  - Availability Payments are only paid when those outputs are delivered
- Special Key Performance Indicators ("KPIs") are set to ensure an on-going standard of the asset
- Where these KPIs are not met, financial penalties are deducted from the monthly Availability Payment
- Hence payments from the Authority will be fixed (on a real basis) from commercial signing and deductions will occur where pre-defined performance standards have not been met
- The payment mechanism incentivises the investor to actively maintain the quality of asset throughout the concession period

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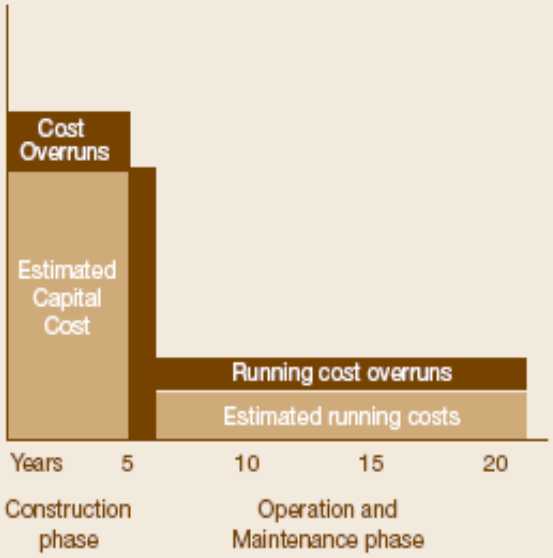
Cash outflow: Government Procurement

Traditional Government procurement

Payment profile can be depicted as follows:



- Capital and operating costs are paid for by the public sector, who take the risk of cost overruns and late delivery.

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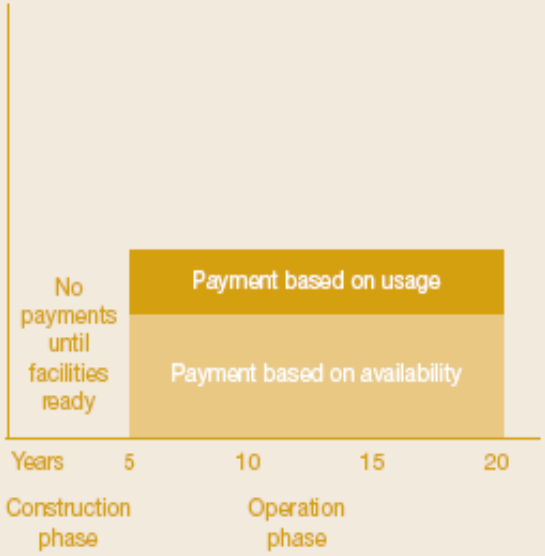
Consistent cash outflow

PPP procurement brings cash outflow to a steady and even state

PPP procurement

Payment profile for the public sector



- The public sector only pays over the long term as services are delivered. The private sector funds itself using a large portion of debt plus shareholder equity. The returns on their equity will depend on the quality of services.

Source: PricewaterhouseCoopers

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Reduced risk

Adopting PPP over traditional procurement provides other non-financial benefits to the Authority

> PPPs are an efficient transfer of risk to the party most able to manage and mitigate it

> Risk is then shared between the public sector and private partner

> Procurement risk is passed to the private investor since availability payments are only paid after construction has been completed

> As indicated in the table below, the proposed structure would clarify the responsibility of each party and makes them clearly accountable over the concession period.

RISK	PPP Model			Traditional D&B Procurement		
	Authority	Shared	Private	Authority	Shared	Private
Long-term partnership		×		n/a	n/a	n/a
Risk of failure to design to specifications			×	×		
Planning risk		×		×		
Construction contractor insolvency			×	×		
Handover/commissioning to the long-term facilities manager			×	×		
Defects post construction completion			×	×		
Operational cost risk			×	×		
Maintenance cost risk			×	×		
Availability payment	×			n/a	n/a	n/a
Archaeological event risk		×		×		
Increase in insurance premia		×		×		
Utility consumption / price risks		×		×		

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Reduced balance sheet pressure

Freedom to pursue other essential projects

- Thanks to the Payment Mechanism structure, possible to keep the value of the project off the balance sheet of the Authority
- Under a traditional D&B project, the Authority would be required to raise separate funds, occupying fiscal room that could be used for other essential projects
- The Availability Payment is a scheduled monthly expense which smoothes out the cost of the project and covers all operation and maintenance
- At the end of the concession, the Authority receives a fully operational asset at no further cost

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Local benefits

The private investor absorbs risk and strengthens local communities

> The risk is fully transferred from the Authority to the private investor

- A unique cradle-to-grave approach is taken in all design components
- Underlining the investor's role in providing whole-life costing is our absorption of all future price risk going forward
- The Authority will be able to transfer to the investor large equipment lifecycle risk to a globally recognised partner

> Long-term partnership: skills and expertise are transferred to the local community

- The partnership between the public sector and private sector allows a cross-transfer of international and industry-specific skills, knowledge and expertise
- As the project develops and matures, both the Authority and the investor would be actively monitoring and/or managing the asset
- The project therefore benefits from both the efforts of the public sector and private sector simultaneously

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The Federal Law on Concessions in Russia

In July 2005, a Federal Law on Concession* was passed, forming a basis on which individual concession contracts can be based on

- General provisions include:
  - Concessionaire undertakes to create/reconstruct a real estate object for payment
  - The grantor may partially subsidise the costs of construction and/or operation
  - No criteria for selecting the winning bidder identified in the tender documentation
  - Applicable to transportation, energy, education, health care, and utilities industries
- Law is vague with regards to the relationship between the state and the private party

Projects being carried out under the Federal concession law:

	Moscow-Minsk M1	Moscow Great Ring Road	Moscow-St. Petersburg toll road (15-58km)	Western High Speed Diameter
Description	> 19 km Link between the Moscow ring road and the M-1	> 520 km long toll-road around Moscow city	> First segment (15-58km) of the Moscow-St. Petersburg toll road	> 46.3km motorway linking St. Petersburg's trade seaport with Scandinavia
Size	> US$600 million	> US$3 billion	> US$2.1bn	> US$3bn
Progress	> Bid due February 2009	> Tender expected	> Final bid 22 Sept. 08	> Strabag/Bouygues Preferred Bidder

* Federal Law No. 115-FZ "On Concession Agreements" dated 21 July 2005

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The St. Petersburg Concession Law

The 2006 PPP Law of the City of St. Petersburg* is more specific

> Many St. Petersburg projects based on the regional St. Petersburg concession law

> More flexible in terms of structure, tender process and support from the City

- It does not discriminate Russian and foreign entities
- Project assets and rights may be pledged as security for debt funding
- The law permits the City to provide financial support through subsidies
- Offers protection in the case of changes in laws or political circumstances

Projects being carried out under the St. Petersburg concession law:

	Pulkovo airport	Nadex	Orlovsky Tunnel
Description	> Largest airport in St. Petersburg > Extension of the current airport to support rapid traffic growth	> 29.9km light rail route linking the metro, rail and transit networks in the southern suburbs with the city centre	> Two deep parallel two-level 940m long circular tunnels under the river Neva in St. Petersburg
Size	> US$1.2bn	> US$2bn	> US$1bn
Progress	> Tender expected shortly	> Final Bid 1Q 2009	> Tender launch expected in H2 2008

* Dated 25 December 2006 No 627-100

Recent developments in Russia

Western High-Speed Diameter – the first major PPP contracted under the new Federal Concession Law

- 46.3km motorway linking St. Petersburg's trade seaport with Scandinavia
- The biggest PPP deal closed in Russia so far
- One of first to receive financial support from the Investment Fund
- Practical test of the existing legal framework for Russian PPPs

Government support

- Two tailor-made state financing vehicles have been set to fund PPP transactions: the Investment Fund and the Development Bank
- The Investment Fund has so far co-financed:
  - Moscow - St. Petersburg highway (est. US$7bn)
  - Short link to the Moscow-Minsk highway (the Odintsovo bypass)
  - Orlovskiy tunnel under the Neva River in St. Petersburg (est. total value up to US$1bn)

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Potential financing issues with Russian PPPs

Raising Rouble bank debt is possible, but support from multilaterals still crucial

Availability of Rouble debt financing

- Bank debt with maturities over 10 years rare in the Russian market
- Support from multi-laterals (VEB, IFC, EBRD, EIB) and export credit agencies crucial
- Transparency, free capital flows and stable macroeconomic environment are key factors

Exchange rate risk

- Debt can be hedged on a rolling 5-year basis, but not eliminated
- Governments can help by offering:
  - Availability payments in US Dollar or Euro
  - Capital grant or annual compensation by the grantor
  - Long concession periods

Inflation risk

- Construction cost inflation poses a serious risk
- High inflation rates may ultimately lead to a weaker currency
- Concessionaires should be rewarded for taking on significant capital expenditure
  - Ideally transfer construction price risk to the grantor

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Legal issues with the Federal PPP law

The Federal Concession Law has been deemed insufficient in many respects

- No adequate definition of a concession
- No provision to protect the rights of the concessionaire
- Pledging concession assets as security for bank loans only allowed after the facilities have been commissioned
  - Requires the explicit consent of the grantor
- No provisions relating to compensation of the concessionaire, should the project fail for economic reasons:
  - Grantor can terminate the contract without obligations
  - Increases credit risk and creates adverse incentives

More practical obstacles:

- Lack of legal practice and practical experience of PPPs in Russia
- Property rights on a number of objects are not properly defined
- Tax treatment is also unclear:
  - Common or special tax treatment?
  - Taxation benefits (such as exemptions, tax credits, etc.) are not identified

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Macquarie Renaissance Infrastructure Fund

Bringing together Macquarie's infrastructure expertise with Renaissance Capital's strong deal origination and execution capabilities in Russia and other CIS countries

- The Fund is targeting total investor commitment of US$1-1.5 billion
  - The first major CIS infrastructure fund
- VEB, EDB and Kazyna intentions to invest up to US$450 million with VEB as the cornerstone investor
- The Fund will aim to acquire stakes in companies in Russia and other CIS countries with individual equity investments of US$50m to US$300m

- Investment opportunities within:
  - Toll roads
  - Airports
  - Ports
  - Utilities
  - Rail projects

- The Fund may target assets in other infrastructure sectors, including water, social and communication infrastructure

Primary focus sectors

Rail **Roads** **Airports** **Ports** **Utilities**