Public-Private Partnerships in Russia
October 2008
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
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

- Government Authority
- [3rd Party Revenue Contract]
- Project Agreement
- Finance Parties (see next slide)
- [3rd Parties]
- Construction Firm
  - Design & Construction Contract
  - Surety
  - Guarantee
- Hard Facilities Management Firm
  - Co-operation Agreement
  - Guarantee
- Soft Facilities Management Firm
  - Co-operation Agreement
  - Guarantee
- Project Company (PPPCo)
  - Hard FM Contract
- Soft FM Contract
- Insurance Company
- Construction Parent
- Hard FM Parent
- Soft FM Parent
PPP Financing Structure

MRIF Equity

Shareholders Agreement

Holding Company (HoldCo)

Project Company (PPPCo)

Debt Parties (any of those listed)

- Sub Debt
- Senior Bank Debt
- Mezzanine Bank Debt
- Bonds
- RPI Swaps
- Interest Rate Swaps
- GIC
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.
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
Cash outflow: 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.
Consistent cash outflow

PPP procurement brings cash outflow to a steady and even state

PPP procurement

Payment profile for the public sector

<table>
<thead>
<tr>
<th>Years</th>
<th>Construction phase</th>
<th>Operation phase</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>No payments until facilities ready</td>
<td>Payment based on usage</td>
</tr>
<tr>
<td>10</td>
<td></td>
<td>Payment based on availability</td>
</tr>
<tr>
<td>15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td></td>
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</tr>
</tbody>
</table>

- 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
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.
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 smooths 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
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
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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Size</th>
<th>Progress</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moscow-Minsk M1</td>
<td>&gt; US$600 million</td>
<td>&gt; Bid due February 2009</td>
</tr>
<tr>
<td>Moscow Great Ring Road</td>
<td>&gt; US$3 billion</td>
<td>&gt; Tender expected</td>
</tr>
<tr>
<td>Moscow-St. Petersburg toll road (15-58km)</td>
<td>&gt; US$2.1bn</td>
<td>&gt; Final bid 22 Sept. 08</td>
</tr>
<tr>
<td>Western High Speed Diameter</td>
<td>&gt; US$3bn</td>
<td>&gt; Strabag/Bouygues Preferred Bidder</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Pulkovo airport</th>
<th>Nadex</th>
<th>Orlovsky Tunnel</th>
</tr>
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<tbody>
<tr>
<td><strong>Description</strong></td>
<td>&gt; Largest airport in St. Petersburg</td>
<td>&gt; 29.9km light rail route linking the metro, rail and transit networks in the southern suburbs with the city centre</td>
<td>&gt; Two deep parallel two-level 940m long circular tunnels under the river Neva in St. Petersburg</td>
</tr>
<tr>
<td><strong>Size</strong></td>
<td>&gt; US$1.2bn</td>
<td>&gt; US$2bn</td>
<td>&gt; US$1bn</td>
</tr>
<tr>
<td><strong>Progress</strong></td>
<td>&gt; Tender expected shortly</td>
<td>&gt; Final Bid 1Q 2009</td>
<td>&gt; Tender launch expected in H2 2008</td>
</tr>
</tbody>
</table>

* 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)
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
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
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