

# EAP Task Force

## Document 5

### **Joint Meeting of the EU Water Initiative's EECCA Working Group and the EAP Task Force Environmental Finance and Water Networks**

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### **Overview of Domestic and International Private Companies Operating in the Water Utilities Sector in Russian Federation**

*Participants are invited to take note of the document and to comment on it as appropriate.*

*ACTION REQUIRED: For information, discussion, and endorsement.*

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## Used abbreviations and acronyms

BOD	Biochemical oxygen demand
BOOT	Build-Own-Operate-Transfer
CEE	Central and Eastern Europe
CEO	Chief Executive Officer
CES	Comprehensive Energy Systems
CIS	Commonwealth of Independent States
CJSC	Closed-type Joint-stock company
EAP TF	Environmental Action Plan Task Force
EBRD	European Bank for Reconstruction and Development
EECCA	Eastern Europe, Caucasus and Central Asia (region)
EVN	Energie Vernünftig Nutzen (company)
EU	European Union
EUR	Euro
HCS	Housing and Communal Services
IBRD	International Bank for Reconstruction and Development
IFIs	International Financial Institutions
JSC	Joint-Stock Company
Ltd	Limited Liability Company
SUE/MUE	State/Municipal Unitary Enterprise
NEAP/REAP	National/Regional Environmental Action Plan
NIS	Newly Independent States
OECD	Organization of Economic Cooperation and Development
PE	Person Equivalent – in grams of BOD per day
PPP	Public-Private Partnership
PSP	Public Sector Participation
RUI	Regional Utilities Investments
RAO UES	Unified Energy System of Russia, JSC
RUS	Russian Utilities Systems
RUR	Russian rouble (1 USD = 29.2 RUR <i>as of Sept. 2004</i> )
USD	US dollar
VAT	Value-added Tax
Vodokanal	water utility
WB	The World Bank
WSS	Water supply and sanitation
WW	Wastewater
WWPS	Wastewater pumping station
WWTP	Wastewater Treatment Plant

## ***Preface***

In 2000, the participants of the Ministerial Consultation between Economic/Finance and Environment Ministers of the Newly Independent States (NIS), held in Almaty, Kazakhstan, adopted the “*Guiding Principles for Reform of the Urban Water Supply and Sanitation Sector in the NIS*”. The document, *inter alia*, admitted that “*participation of **the private sector** may facilitate the mobilisation of funds, efficiency improvements, and the introduction of new technologies in the work of vodokanals.*”<sup>1</sup>

Recently, several big private companies entered the market for communal/utility services in Russia. And this document represents *the first ever* attempt of comprehensive profiles of the strategies and specific projects of domestic and international private companies operating in urban water supply and sanitation (WSS) sector in Russia.

In June 2004 in the course of preparation of the World Bank – OECD conference on private sector participation in urban WSS in Europe, Caucasus and Central Asia to be held in Sept. 2004 in Moscow it was decided to overview the precedents of private companies becoming involved in providing water supply and sanitation services in Russia. For the purposes of this Overview, a special questionnaire (see Annex 3) was prepared and mailed to several domestic and international private operators already doing business in urban water sector or intending to start it soon.

In addition to general information about the companies, their founders, business strategies and achievements so far, this Overview profiles some of their ongoing projects. Moreover, in our study we have succeeded in identifying the holdbacks and problems preventing broader, more involved partnering between the private sector and public authorities in Russia, or at least those problems that have been already met and/or identified by private companies themselves.

Participation in the study was voluntary, and every company was given full discretion in its choice of projects and the level of detail of the information it was willing to disclose. We were pleasantly surprised by the participants’ openness, their honest account of the problems they face, and their commitment to building sustainable partnerships with public authorities.

The Overview was undertaken in the framework of programme for urban water sector reform implemented by the OECD Environmental Action Plan Task Force (EAP TF).

### **Purpose of this Document**

This Overview is intended to present the current state of affairs in involving private-sector entities in managing urban water supply and sanitation utilities and operating urban WSS infrastructure, and identify challenges confronting the implementation of the *Almaty Guiding Principles* along the path of fostering successful public/private partnerships.

The Overview also aims to facilitate greater transparency and help forge better mutual trust between key players, consumers, the government, and investors involved with the utilities sector.

### **Targeted Audience**

We hope that this Overview will prove helpful for:

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<sup>1</sup> OECD (2001) Water Management and Investments in the Newly Independent States. *Materials of the Ministerial Consultation between Economic/Finance and Environment Ministers, October 16-17, 2000, Almaty, Kazakhstan.*

- Policy- and decision-makers at the national, regional and local level;
- Managers and specialists at water companies, local public authorities and non-governmental organizations (NGOs) involved in water-related projects aiming at improving the level of services and enhancing the transparency of decision-making processes and financing operations;
- Russian and international financial institutions, donors and other prospective investors sizing up investment opportunities in water supply and sanitation infrastructure in Russia;
- Private-sector players: both those mentioned in this Overview and those about to enter the marketplace.

It is our hope that the contents of this Overview will shed enough light on the problems impeding greater involvement of private operators in Russia's water utilities, and will help acquire a better insight into the concept and phenomena of Public-Private Partnerships in the utilities sector.

## Structure

**Analytical Summary** presents main findings and conclusions derived from the analysis of the Overview results.

**Chapter One** of this report profiles several domestic private players operating in urban water supply and sanitation sector in Russia.

**Chapter Two** lets the companies featured in this report share their experience in implementing specific projects in water supply and sanitation. The information includes general project background and results achieved so far, as well as impediments and problems encountered in the process of implementation. The fact that companies operating in WSS sector use different approaches to resolve the problems they face make the study even more interesting.

Along with domestic private operators, the present Overview features WTE Wassertechnik GmbH – a German company which carries out several BOOT projects in Moscow City and region. The editors also deemed appropriate to include *CES-Multienergetika company*, whose business is in heat, electric power and gas supply, in order to make two points: (1) that problems in other utility areas differ very little from those in water supply and sanitation; and (2) that there exist alternative options for private sector involvement in utility sector, and these options are already practiced in certain Russian municipalities.

## Acknowledgements

The survey formed the groundwork of the present document, prepared by Roman Martusevich and edited by Peter Börkey. The publication of this document was made possible through a concerted effort and participation of the companies it represents, EAP TF, and some eminent EECCA experts. The editors are very grateful to the CEOs and staff of the companies interviewed, that had kindly replied to the questionnaire and provided information that was included in this report. We would like to thank each and everyone of them: Patricia Wachtmeister (WTE Wassertechnik), Vladimir Gefer (RUS), Xenia Kamenskikh (Novogor-Prikamye), Vladimir Kiriukhin (EuroSibEnerg), Vitaliy Kuznetsov (Rosvodokanal), Igor Medvedev (Rosvodokanal), Mikhail Nikolsky (Novogor-Prikamye), Denis Pozdnyakov (RUI), Yulia Sirota (CES), Mikhail Slobodin (CES), Alexander Sotnikov (Syzranvodokanal), Andrei Khokhlov (Syzranvodokanal), Dr. Reinhard Schröder (WTE Wassertechnik), and Sergei Yashechkin (RUS). We also thank Sergei Sivaev (Institute for Urban Economics), Sergei Karpov and Alexei Popov (Syzran City Administration) for their cooperation.

# Analytical Summary

## *1. Problems of the industry and private sector involvement*

The problems of Russia's utility sector are well known and largely shared by all developing economies. They include excessive wear of fixed assets combined with tough budget constraints on replacing and upgrading them, as well as plummeting service levels and inefficient service delivery, not to mention the financial difficulties of municipal or state-owned utility companies.<sup>2</sup>

The widespread view is that many of the problems can be addressed by engaging private-sector entities under delegated management contracts. In the “**Guiding Principles** for Reform of the Urban Water Supply and Sanitation Sector in the NIS”, the participants of the Ministerial Consultation between Economic/Finance and Environment Ministers of the Newly Independent States (NIS), held in Almaty, Kazakhstan, in 2000, noted that “*participation of the private sector may facilitate the mobilisation of funds, efficiency improvements, and the introduction of new technologies in the work of vodokanals.*”<sup>3</sup>

However, the past few years have seen precedents of how in a number of countries where private companies become involved in utility services provision, *the outcome is apt to be well below the expectations*. The result is that while tariff rates rise considerably, the industry has little to show in the way of improvement, garnering an avalanche of criticism, usually levelled against the private operators themselves.<sup>4</sup>

Private finance and industry groups in Russia began setting sights on the utilities market about a year ago. In this light, it is important to find out whether the arrival of private players has promoted positive change in the industry, what problems and holdbacks are facing these companies in Russia, and what stands in the way of the utilities business overall.

To answer these and other questions, we have polled **7** major and well-known private companies engaged in the utilities business in Russia. The majority of our interviewees gave sufficiently detailed and honest answers (see Chapters 1 and 2 of this Overview). This section briefly reviews and summarises our survey findings.

The **key factors** motivating their entry into the utility services market were cited by companies as being the large volume of the market (over RUR 877 billion, equivalent of USD 30.2 billion) and the presence of guaranteed sales, along with the sector's opportunities for significant increases in efficiency and cost reductions.

Among the seven companies that responded to our questionnaire, there is a notable predominance of two legal forms – the *limited liability company* (Ltd.) and the *open joint-stock company* (JSC). The Charter capital of the companies in our sample varies within a very wide range, from 10,000 to 1 billion roubles. Four of the companies have a Charter capital of over 1 million US dollars (in USD equivalent).

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<sup>2</sup> The problems facing the urban water supply and sanitation sector are reviewed in the 2001 OECD compilation, *Water Management and Investments in the Newly Independent States. Materials of the Ministerial Consultation between Economic/Finance and Environment Ministers, October 16-17, 2000, Almaty, Kazakhstan*. Water supply and sanitation agendas are also described in *Reform and Modernisation of Housing & Utilities in the Russian Federation*, a subprogramme of the Federal Housing programme for the years 2002-2010.

<sup>3</sup> OECD (2001) *Water Management and Investments in the Newly Independent States. Materials of the Ministerial Consultation between Economic/Finance and Environment Ministers, October 16-17, 2000, Almaty, Kazakhstan*.

<sup>4</sup> Cf. e.g. Lobina E., Hall D. (2003), *Problems with Private Water Concessions: a Review of Experience*. PSIRU.

All the companies express a wish to carry out business **on the basis of long-term delegated management contracts combined with the undertaking of significant investment commitments**. Four of the seven companies declared that the planned amount of their capital investment over the next five years ranges from 50 million to 500 million US dollars. In addition, all companies confirmed that they are ready to participate in competitive tenders for such contracts.

Three of the seven companies that we questioned specialise in water supply and sanitation, while the other four companies intend to operate in this as well as other utility sectors, including electricity, gas and heating supply, and municipal waste management.

On the whole, there are at least nine large and medium-sized private companies currently in operation in the urban water supply and sanitation sector of the Russian Federation.

According to available statistics, private water supply and sanitation enterprises currently operate on the territory of 38 municipal entities in Russia (they offer services, take part in tenders or negotiate direct agreements with the local authorities). Thus, we can predict that in the near future the private sector will be providing water supply and sanitation services in cities with a total population of 17.7 million, which amounts to around **16.6%** of the entire urban population of the Russian Federation.

Our survey has shown that *at least 15 contracts for the delegated management of major WSS assets have already been concluded* in Russia. The population of municipal entities in question is 8.7 million people, amounting to about 8.2% of the total urban population of the Russian Federation.

The most widespread form through which the private sector operates in water supply and sanitation is the *short-term lease agreement*, which is usually concluded for an 11-month period. There are also long-term lease agreements, agreements on trust management and package of agreements substituting BOOT-type contracts which are not currently backed up by appropriate legislation. Five of the seven companies represented in our survey have concluded agreements without having to participate in competitive bidding procedures.

\* \* \*

It is important to realise that attraction of profit-oriented private businesses (private initiative and private capital) is a tool local authorities may use to their ends, but this tool requires skills and a proper operating environment to be used successfully.

Where the involvement of private players in public utilities has failed, the likely cause may have been getting priorities wrong or choosing the wrong solution alternatives. We have reason to believe that what is often described as technical or financial “problems” in the industry are not really problems *stricto sensu*; at the same time, the true problems may lie in the industry’s erroneous institutional structure that distorts the incentives to be efficient and, more specifically, betrays numerous flaws in the contracting system, municipal property management, government funding for utility companies, industry regulation and, last but not least, tariff policy.

Ten years ago, the World Bank (WB) published its *World Development Report* entitled **Infrastructure for Development**. The report discussed how to address priority problems and challenges faced by different utility sectors, and posited guiding principles for utility sector reform. The recommendations contained in that WB Report are still relevant, calling for institutional change in the industry through commercialisation of utility services and

transforming them into joint-stock companies, by promoting competition in the sector and, most importantly, **giving utility companies managerial and financial autonomy while enforcing higher accountability and transparency**. These principles do not preclude appropriate tariff regulation or long-term programming for the utility infrastructure at the municipal and/or regional level.

Involvement of private players under management contract, lease and concession arrangements [the term *delegated management* is used as general for these arrangements – *editor*] automatically takes care of managerial autonomy and commercially viable service. Our polls have confirmed that. Many of the companies polled underlined that “if skilfully managed, any utility company can [fully] cover its operating costs with existing tariff, while at the same time maintaining or even slightly improving the current state of operated fixed assets” (**Rosvodokanal Ltd.**). Another company, **Novogor-Prikamye Ltd.**, testified that “Flaws in the legal/regulatory framework, ... and lack of government funding **have not** significantly affected [its] operations” (see Chapter 2).

These statements seem paradoxical in that a flawed tariff policy and insufficient government coverage of the so-called “missed revenues” [due to preferential/discounted tariff rates which by legislation utilities have to grant to some categories of households - *editor*] have been viewed as major instability factors in the utilities sector in Russia for the last 10 years.<sup>5</sup> This apparent puzzle is *partially* unveiled by the fact that, as profit-oriented players, all these companies **view the tariffs imposed on their services as strict budget constraints**.<sup>6</sup>

International experience shows that partnering with private players is a job requiring solid skills from local authorities. The more responsibilities are proposed to be delegated to a private player, the more difficult it becomes to run competitive bidding, monitor compliance, and regulate tariffs. But most of all, partnering with the private sector requires that local authorities have an insight into the essence and main principles of building of sustainable Public-Private Partnerships (PPP) in utilities sector.

It is a known fact that the majority of Russian local public authorities lack **qualified** specialists, and will continue to be so for a long time. The companies interviewed mentioned this as a major impediment. But while top local officials’ lack of familiarity with market economics as such, not to mention the subtleties of PPP, is definitely a problem, it is not their fault.

As a result, when private players do obtain contracts to deliver utility services, it is in most cases a political decision motivated by a number of discretionary and subjective considerations. One of our interviewees noted that **authorities typically place their political agendas above economic consideration when partnering with a private investor**. This is manifested not only by the absence of competitive bidding, but also by flawed and tenuous contractual relationships between local authorities and private operators; indeed, these contracts resemble *memoranda of intent* more than full-blown delegated management agreements.

But howsoever that may be, the case studies presented in this Overview indicate that the involvement of private entities has already **produced solid improvements** in a very short time, even when their contracts with municipal authorities did not vest the private player with considerable powers or responsibilities.

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<sup>5</sup> Cf. e.g. OECD (2002), Key Issues of Tariff Reform in the Water Sector in the EECCA.

<sup>6</sup> The puzzle can also be partly explained by the fact that the tariffs on the services of both these companies have never been revised yet, while they themselves operate under one-year lease contracts and **have not, to date, made any major investment commitments to the local authorities**.

Of particular note are the achievements of **Novogor-Prikamye Ltd.** and **Rosvodokanal Ltd.**, who have succeeded in ensuring the smooth, uninterrupted operation of water supply and sanitation systems, and have superseded reactive troubleshooting/emergency excavation and repairs with routine **preventative maintenance** and replacements of worn pipes and equipment. The local water company in the city of Syzran has successfully restored 24-hour water supply, a commendable improvement on the former system when water would sometimes be available for a limited number of hours in summer. All these achievements had required substantial managerial effort and financial investment. The arrival of a private player has improved the financial health of local water companies.

The experience of a German company **WTE Wassertechnik GmbH** shows that, if the conditions are appropriate, the existing legal framework allows sizable **foreign (!)** investments to flow into the urban water supply and sanitation sector, at least in cities with strong public budgets and relatively high household incomes.

It is also important to note that private utility players have a vested economic interest in improving the existing institutions in the industry. Improvements are inevitable and, in fact, critical to sustainable development in local self-governed areas. As a priority, appropriate contractual arrangements must be set straight between utilities themselves, and between utility operators on the one hand, and their consumers and local authorities (utility infrastructure owners), on the other hand, while responsibilities and risks should be allocated accordingly.

At the same time, major private utility players may have a stake in improving federal legislation and helping foster the common, fair “rules of the game.” At a conference in Vladimir in June 2004, government officials and numerous utility companies, including the majority of our interviewees, signed a *Declaration of Guiding Principles for Cooperation between Public Authorities, Private Businesses, and Consumers of Utility Services* (see Annex 1).

We are thus witnessing the emergence of formalised, more transparent relationships in the industry as the room for high-handed politically motivated interference dwindles and, consequently, new incentives arise to be efficient, and conditions are put into place for sustainable growth in the industry.

## ***2. Barriers for private-sector involvement***

The table in Chapter One of this Overview lists the barriers that Russian private operators **have already encountered** in the course of their projects in different municipalities of Russia. Notably, most of these barriers are not directly linked to the arrival of private players in the utilities sector, but ***reflect the industry’s deep-rooted and yet unresolved problems***, awaiting urgent resolution. Of the answers we received, the following appear to be typical for most EECCA countries:

1. High political risk, a tendency to manipulate the subject of utilities to political ends and, accordingly, reluctance to accept economically justified tariffs;
2. Non-transparent tariff regulations;
3. Lack of access to long-term credit facilities;
4. Gaps in the legal framework for long-term investment;
5. Lack of qualified specialists;
6. Problems associated with the evaluation [market value assessment – *editor*] and public registration of property delegated into the operational custody of private players.

As the extent of this analysis does not allow us to dwell on each of these issues in all detail, we will focus on those that appear to be the most important for the industry.

## 2.1 Political risk associated with early contract termination or violations

As we have noted above, in Russia when municipalities contract private operators to manage water utilities, this usually results from a **politically motivated decision**, but there are grounds to assume that this may not be something endemic to Russia; indeed, nearly all instances of PPP in water utilities are to an extent politically motivated. In fact, it is commonly believed that “*a firm political commitment to project implementation is a condition sine qua non for a Public-Private Partnership.*”<sup>7</sup>

One of the greatest risks – and one that Russian private operators have already come to grips with along the way – is associated with obtaining a credible answer to the question of how, if at all, the local authorities intend to participate in the sector’s operation. **Are they going to abide by their commitments? Are they going to change their agenda? Are they going to sever the contract prematurely?**

Regrettably, local governments in Russia are still **prone to short-sighted planning and decision-making**. Therefore, one can never be fully assured that, whether the government is replaced or the same government that had contracted the private investor remains in office, it will retain its “firm political commitment” to fulfilling its contractual obligations.

There are some illuminating lessons to be learned from international case studies. When a **new governor**, who had negative attitude to “privatisation” of local water utility company in Tucuman, Argentina, took office he reneged on the government’s standing concession arrangement with the private operator.<sup>8</sup> The province accused the private operator, **Vivendi**, of substandard service, default, failure to complete a project, failure to meet service level targets and reduce tariff rates as promised according to an agreed schedule. For its turn, the company sued the government to the tune of US \$100 million<sup>9</sup>.

Therefore, political risks are linked not only to tariff policy. As the owner of the utility infrastructure, the local authority may **default on its investment commitments**, fail to finance infrastructure upgrades (this is a particular threat when the infrastructure is leased by a private operator), or fail to fully reimburse the company for “missed revenues” incurred in granting preferential/discounted tariffs on utility services to entitled families.

Note, that high political risk was among the factors named by many western private operators as reasons for their decision to stay away from Russia’s utility services market.<sup>10</sup> An exception featured in this report is the **WTE Wassertechnik** case. To minimise political risk for its investors, this company had secured financial guarantees from the North-Rhine Westphalia Land, and took care of investment risks by sealing an investment agreement with the Moscow Government instead of a standard BOOT agreement, which stipulates that investment costs would be reimbursed by the Moscow Government rather than with tariff revenue streams generated by sanitation service consumers (see Chapter 2 of the Overview for more details).

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<sup>7</sup> Perrot J.-Y., Chatelus G. (2000), *Financement des Infrastructures et des services collectifs. Le recours au partenariat public-privé*. Presses de l’école nationale des Ponts et Chaussées, Paris. P. 346

<sup>8</sup> OECD (2000), *Global Trends in Urban Water Supply and Waste Water Financing and Management: Changing Roles for the Public and Private Sectors*.

<sup>9</sup> Ibid.

<sup>10</sup> National Foundation for Housing Reform/Gosstroy/World Bank (2003), *Local Authority Handbook on Housing and Utilities Reform. The international operators polled named low WSS tariffs, risk of contract break of, macroeconomic risks, and political interference risk as the highest risk factors in Central and Eastern Europe and the NIS countries*.

**Political risks faced by private operators are significantly exacerbated by the absence of competitive bidding.<sup>11</sup>**

Where a *delegated management* contract was signed without competitive bidding, a new government elect can always renounce its predecessor's arrangement with the private operator as invalid, or accuse the former government of corruption, and so on. In this sense, the absence of competitive bidding is fraught with many legal and financial problems for private operators.

Another equally important point is that the additional political risk resulting from a contract obtained without competitive bidding discourages domestic and **international financial institutions (IFI)** from lending to such a project. Notably, only IFIs are able to grant critical long-term loans direly needed in Russia. At the aforementioned conference in Vladimir, an EBRD official clearly stated that the EBRD will consider a loan application from a private company operating in utility sector *only if the contract was awarded to it in a tender*.

In a more general sense, competitive bidding is the only way to secure the best offer in a competitive market environment. Firstly, contracts awarded in a tender usually ensure lower costs, a better choice of operator and higher transparency. Secondly, tenders enable bidders to better scope up (specify) the subject-matter of the prospective deal, better assess and even minimise risks, and thus avoid many unpleasant contractual snags in the future.

Competitive bidding not only helps make a more unbiased choice of private operator, but also **legitimises the deal in voters' eyes** and helps win public confidence. This is particularly relevant when a long-term concession-type arrangement is signed between the local authority and a private operator.

Our poll revealed that the majority of delegated management arrangements targeting utility infrastructure were signed **without competitive bidding**. But while one year ago officials could rightfully cite lack of competition, this argument no longer stands, at least in major cities. Indeed, four major Russian private operators immediately showed an interest as soon as only **rumours (!) appeared of an upcoming tender** to run water utilities in Nizhny Novgorod.<sup>12</sup> While some companies claim this or that obstacle preventing competitive tenders to run utilities in Russian municipalities, such as a lack of funds, expertise or specialists in municipalities, the examples of Syzran and Moscow, cited in this Overview, indicate that **this is not necessarily the case**.

The draft Federal Law *On Investment Agreements in Utilities Sector*, which has recently passed its first reading at the State Duma of the Russian Federation, mandates obligatory competitive bidding prior to signing an investment agreement.<sup>13</sup> But unfortunately, even after this Law takes effect, loopholes will remain to lease or place municipal property in trust without competitive bidding.

Competitive bidding will of course help prevent unjustified early termination of contracts, though will not fully mitigate all political risks. And in any case, if the government is genuinely committed to improving the utilities and making them more accessible, it will be compelled to reshuffle the relevant institutional system in such a way as to restrict its own chances of non-performance or *opportunistic behaviour* vis-à-vis private investors and operators.

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<sup>11</sup> Yet another political risk factor of major relevance is the **excessive expectations** regarding private sector involvement on the part of both local authorities and citizens.

<sup>12</sup> Cf. VEDOMOSTI newspaper of February 4, 2004 and February 10, 2004.

<sup>13</sup> The draft Law also defines a closed list of cases when competitive bidding may be waived prior to signing an investment agreement.

**2.2 Unregistered property.** Years of economic chaos are to blame for a state of affairs where local governments are not only unaware of the physical condition of their fixed assets, but, in some cases, lack appropriate instruments to formally certify their property title. But by law, before municipal property can be delegated under a **long-term** management deal, it needs to be evaluated (market value assessment) and recorded in a public register. The former Russian Committee of Construction (*Gosstroy*) estimates that this effort would take from 18 months to 3 years<sup>14</sup> to accomplish and, therefore, should be regarded as a major, albeit temporary, obstacle to long-term arrangements between local governments and private operators. So far, the majority of Russian private operators featured in our Overview have had to choose the path of **short-term** leases on municipal property, which require no public registration of either the lease contract or the property being leased.

**2.3 Flawed tariff regulation.** The dual mission of tariff regulation is to supply the regulated utility with a revenue stream that would be requisite and sufficient for its sustainable operations, and not to let that company abuse its monopoly status by extracting a monopoly rent. However, the fact that water supply and sanitation services are vitally important to the entire population (life-support services), and the majority of consumers are prospective voters, frequently makes tariff-setting the subject of a political interference.

Russian and international experience unequivocally proves that a Regulator pursuing a political agenda and eager to appease the electorate is liable to deny a water company – whether private, state-run or municipal – a higher tariff, although such a request may be fully justified by price hikes in the economy, resulting in higher costs for the water company.

To a great extent, this is a consequence of the absence of a statutory framework methodology for tariff-setting in tariff regulation. To make matters worse, in many municipalities WSS tariff rates for population require the **approval** of an elected representative authority, e.g. the municipal Duma (parliament) in Syzran.

The draft Federal Law *On the General Principles of Tariff Regulation in Utilities Sector*, which has recently passed its first reading at the Russian State Duma, provides a formalised tariff regulation procedures and methodologies as the groundwork of a more transparent tariff-setting system with the aim of purging it of political content, and placing it wholly into the domain of finance and economics.<sup>15</sup>

Having said that, we have to admit that ultimately, the political slant of tariff-setting in Russia is driven by low household incomes, dictating caps on tariff growth. Therefore, it is often impossible to recoup all investments exclusively with tariff revenues. We will discuss this issue again in the next section, but in the meantime, suffice it to say that the problem is only aggravated by the extreme scarcity of funds for long-term lending in Russia's capital markets.

**2.4 Lack of funds for long-term landing.** Vesting responsibility for fixed assets investment in a private operator raises the *critical question* of whether creditors/investors can be found who would be willing and able to commit their funds for long-term capital investments.

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<sup>14</sup> Dronov, A.A. (2004) Concept for Private Business Entry into Municipal Housing and Utilities Sectors//*Zhilishchnoe pravo*, No. 1, p. 37.

<sup>15</sup> However, as long as regulatory bodies responsible for tariff-setting remain a part of executive or legislative authorities, the temptation and levers will be there to 'play' with tariffs towards political ends. Some experts have suggested that tariff regulators or members of their staff should be granted the status of a judicial authority or judges. The idea is that the Regulator should be as independent and impartial as a judicial authority.

However in Russia, private companies operating in utility sector are facing a dire shortage of long-term credit. For example, **pension funds** are not available for investment. Being largely unable to source loans internationally, companies have only their own funds and funds of their owners (shareholders) to count on when planning their investment.<sup>16</sup> In this arrangement, there is always the risk of a shareholder defaulting on its investment commitments, ruining the operator's chances of meeting its own investment pledges.<sup>17</sup>

Combined with the problem of unregistered municipal assets, the unavailability of long-term financing facilities for investments in WSS infrastructure hampers the opportunities for long-term delegated management arrangements in Russia. It is important to find out why this is so.

“There is plenty of funds, but not enough well-prepared deals.” One can often hear this from many international private investors, who would otherwise be willing to invest in Russia's urban utility infrastructure.<sup>18</sup> Some of the frequently named reasons are: (1) lack of transparency in the industry; (2) high political risk; and (3) applicants lack prior history of success in similar projects. When it comes to international lending, these factors are augmented by currency and country risks. But there are other reasons as well, which we will discuss in the next section.

One way to address this would be for prospective investors to become involved in public-private negotiations at the earliest stage. Obviously, the key partners in any investment project are banks and other financial institutions, which put up the venture capital. International experience shows that the involvement of stakeholders at the earliest project stage is critical to success. Although early involvement implies extra costs and somewhat complicates the whole process, it really pays off later on in the project.

The problems and obstacles already facing Russian private operators and named in their poll answers, largely stem from a backlog of unresolved problems in the industry. Following the same logic, further barriers and associated risks may be identified that await any private utility company wishing to broaden its involvement, e. g. assume investment risks.

### ***3. Issues not mentioned by the interviewees***

It is to be assumed that private companies operating in Russia are well aware of the industry's challenges and their own business risks. We can also assume that a company launching a new line of business or a project understands and accepts the rules of the game<sup>19</sup> and knows how to minimise/mitigate or hedge their risks. However, some companies admit that as recently as two years ago few of them had any experience in water supply and sanitation sector.<sup>20</sup>

One way or another, the companies surveyed overlooked a number of important threats and risks when replying to our questions, although it is precisely these threats and risks that may cost them serious financial loss in the near future. First of all, we should mention lack of knowledge about operating condition of the fixed assets private operators receive into their custody and risks

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<sup>16</sup> Here we mean both the operators' own equity, and loans granted by their owners (shareholders).

<sup>17</sup> When a majority shareholder in **RUS JSC** reneged on its promise to issue a US \$25 million loan for three years at 6% p.a., this sparked a serious conflict within the company's top management (see VEDOMOSTI of August 12, 2004).

<sup>18</sup> See the opinion of **WTE Wassertechnik GmbH** on this in Chapter 2 of the Overview.

<sup>19</sup> It is quite another matter that reputable financial institutions are generally reluctant to “play the game” in the first place due to their unwillingness to accept greater risks.

<sup>20</sup> At the June 2004 conference in Vladimir, a spokesman for one of the companies surveyed admitted that, as their previous operating year had shown, that company had known little of the problems awaiting it as it arrived in the water utility sector, and its expertise in other (competitive) markets had proved insufficient.

associated with weak and poorly balanced local budgets. On the socio-economic side, low household incomes naturally deter WSS tariff hikes.

Yet another problem or, rather, a *priority task* is **to build appropriate contractual relations with service consumers**. When it comes to hot and potable water supply, sanitation, and heat supply, user contracting threatens to present one of the most formidable challenges in store for private utility operators in the near future, especially in view of a whole host of issues arising when switching from billing based on the so-called “consumption norms” to billing based on meter readings.

### **3.1 Weak and poorly balanced local budgets**

It is relevant to note that when local authorities default on their obligations, this may not necessarily be a consequence of what is commonly described as “*opportunistic behaviour*” vis-à-vis private investors, but may be caused by their weak and poorly balanced local public budgets, inaccuracy of long-term revenue forecasting due to an unreliable revenue base, changeable tax legislation, and flaws in inter-budgetary relations in Russia.

Insufficient government funding, in addition to failure to compensate the utility operator for the revenues it misses due to discounted tariffs and subsidies provided to entitled families,<sup>21</sup> may imply failure to uphold government guarantees granted for a loan agreement between the operator and its bank, when the government undertook to repay the loan should the borrower fully or partially default.

A weak and imbalanced local budget may also be a major reason for local government’s default with respect to its commitment to invest in WSS infrastructure rehabilitation and development. This is a tremendous threat especially for a lease agreement. In this case, if the government fails to come up with sufficient investment in upgrading the infrastructure, promised by the municipal government as the owner of the leased assets, the private operator may find its operating costs much exceeding the anticipated/planned level.

The risk here is that lack of government funding may either result in much lower than expected operator’s profitability, or render the operator completely unable to remain in the business in the long run.

### **3.2 The risk of underestimating investment needs**

This is a risk associated with uncertainty about the state of the urban water supply and sanitation infrastructure, its replacement value, and the costs of reaching the contractual service targets. Many relevant precedents can be found in the developing economies, where concessions were typically granted amidst a great deal of uncertainty about the condition and reinstatement costs of fixed assets.<sup>22</sup>

Where a private operator contracts with the local government to take responsibility for the safe and reliable operation of the water supply system, and covenants to bring it up to a certain service level, the operator will definitely want to know how much this is going to cost. But what do you do if the system’s condition turns out to be worse than expected, and the extra costs are

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<sup>21</sup> The private companies polled name this as a serious impediment to their work. Specifically, **Rosvodokanal Ltd.** complained that the government at all levels “fails to guarantee funding to compensate for discounted tariffs and subsidies [provided to households]”.

<sup>22</sup> Savedoff W.D., Spiller P.T. (1999), *Spilled Water: Institutional Commitment in the Provision of Water Services*. Inter-American Development Bank.

not covered by the revenues? While the local authority declines to revise the tariff rates? In this scenario, **the operator will either fail to achieve its profit targets or will not fully fulfil its obligations with respect to service targets, prompting the government to terminate the contract early and thus aggravate the loss.**

On the other hand, if the new (higher) tariff rates are set to cover the extra cost, the new rates may be too high, unaffordable for some households, thus resulting in lower revenue collection. Moreover, authorities and citizens are likely to suspect foul play and accuse the operator of trying to abuse its monopoly status to extract a monopoly rent.

Fundraising to finance unforeseen capital investment may prove a hapless exercise. Extra financial needs may prove too enormous for even resource-rich private operators to handle.

One solution would be to minimise uncertainty **before** a concession-type agreement is signed. In many Russian cities, the situation evokes the plight of Buenos Aires before a private operator stepped in. The costs of fixed asset repairs and maintenance proved exorbitant there, and, initially, little was known about the true condition of the water infrastructure and how much it would cost to upgrade and develop<sup>23</sup>. However, the government did its best and committed substantial resources towards minimising uncertainty.<sup>24</sup> An entire army of experienced foreign consultants was hired. Overall, US \$4 million worth of preparatory work was completed **before** the concession deal was sealed.<sup>25</sup>

Obviously, not all Russian regions can afford a preparatory effort of such magnitude. In Syzran, for instance, neither the private operator nor local government could put up the money to even register the property placed in trust management. Incidentally, Syzran is a good example how far the danger can stretch. In Syzran, the management company had not taken the trouble to figure out how much it would cost it to meet the contractual targets promised to the municipal government, before sealing the contract. As a result during three years of its operations the operator has to invest almost all its Chartered capital in maintaining the operated infrastructure (in the meantime its Charter capital has been increased from 3 to 30 million roubles).

Eventually, unless this risk is properly managed, the burden of unforeseen and overwhelming additional outlays may simply drive the operator out of business.<sup>26</sup> Yet another danger is that, in their increasingly fierce fight for new markets, Russian private operators may loosen their risk safeguards, resulting in one of the above scenarios. The bigger the city, the heavier might be the loss. Implementation of Napoleon's principle "*First get in a fight, then think*" in utility sector is associated with extremely high risks. Obviously, very few lenders would be willing to provide loans for implementing such adventure projects.

On another plane, the bankruptcy of a utility company involving suspension of service will entail disastrous social consequences, as utilities services are vital, while some of them e.g. water have no substitutes. Not to mention that failures of this kind may discredit the whole idea of private sector involvement in utility services provision.

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<sup>23</sup> Lee T.R., Jouravlev A. (1997), Private Participation in the Provision of Water Services. Alternative means for private participation in the provision of water services // Serie Medio Ambiente Y Desarrollo №2

<sup>24</sup> The standard tools for minimizing uncertainty include: recovery of the original technical and design documentation, detailed technical auditing, thorough assessment of rehabilitation and upgrade costs, and so on.

<sup>25</sup> Ibid.

<sup>26</sup> The same can happen when the new market entrant lacks industry-specific experience in the utilities sector.

Therefore, in order to bring private investors into the utilities sector and not miss the opportunity to improve water supply and sanitation services, the government needs to devise mechanisms that would bind the utility company, even if it declares insolvency, to continue to deliver the service until the infrastructure passes to a new operator.

### ***3.3 Low household incomes and affordability issue***

The critical question asked by private utility companies worldwide is how better service level is going to affect the tariff rates. Or, in other words, is it possible to pay for improvements merely out of savings generated through higher efficiency (i.e. saving on costs while staying within prescribed tariff rates), and if not, will consumers be **able and willing** to pay more?

To put it differently, there is a likelihood that the tariff rate that will be sufficient to cover all justified costs incurred in the operation and maintenance of fixed assets, may prove too high due to low average income level and/or weak local public budget. This is a major issue in municipalities with per capita annual incomes lower than 30,000-40,000 roubles, i.e. small municipalities.

The essence of the problem is that, in light of the abovementioned risk factors (weak and poorly balanced local budgets, uncertainty about the state of fixed assets, etc.), the long-term **financial sustainability** of a private operator may be threatened if the sector's investment needs turn out to be substantial, which is very likely considering that no major investment has been made, and infrastructure maintenance and repair needs have been neglected for the past 10 to 15 years.

High unaffordable tariffs may result in massive non-payments, or even spark street protests.

One good example is the city of Pskov, where at the beginning of 2002, water supply and sanitation tariff rates went up by 150% for households and were doubled for other users. User charges collection rate dropped from 93% to 74%, and a backlog of unpaid bills snowballed. A slump in user charges collection rate in response to the tariff rate increase by 150% indicate that the tariff may have exceeded the limit beyond which households/population are no longer able to afford it.<sup>27</sup>

A review of the data gathered in 2001 while designing a financing strategy for the water supply and sanitation sector of the Pskov Region, showed that in order to fully cover due operational and maintenance costs of water utilities in the region, including replacement of worn fixed assets (within the depreciation rates) the bill for WSS services should amount to 6% of the average household income<sup>28</sup> But such a high average level of household spending on water supply and sanitation services is considered exorbitant and socially unacceptable by international standards. In other words, the existing household income level in the region did not allow water utilities at large to achieve financial autonomy and sustainability.

Besides low household income, another problem roots in post-soviet culture. In Russia, WSS services were always considered as "social services" which should be provided to everybody almost for free, and consumers can hardly accept to fast price hikes, especially if the quality of the service remains inferior.<sup>29</sup>

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<sup>27</sup> COWI (2002), *Affordability Assessment of a Long-Term Investment Programme in the Water Supply and Sanitation Infrastructure in Pskov City*. Analytical Report.

<sup>28</sup> OECD (2003) *OECD Global Forum on Sustainable Development - Financing Water and Environmental Infrastructure for All*. Paris, 18-19 December 2003.

<sup>29</sup> Admittedly, the very arrival of private players may form expectations of fast improvements in service level and thus mitigate negative reaction to price hikes. But there is another risk here, specifically, **the risk of excessively**

## **Conclusions**

The majority of the companies surveyed for this Overview expect to sign long-term agreements and make investment commitments soon. However, **transfer of responsibility implies transfer of risk**. But private investors are particularly sensitive to risk, and the higher the risk, the higher the cost of investment capital involved.

International experience proves that when certain risks appear to be too high, the private investor would rather refrain from committing to the related activity. It is to be assumed that the persistently and highly uncertain environment and reluctance to run into trouble with local authorities in the process of contractual performance, are the main factors *compelling private players not to be too specific* about the division of powers and obligations in their long-term contracts (especially as far as financial investment is concerned) with public authorities.

Given that infrastructure is a particularly capital-intensive industry, lower risk in the industry would enable operators not only to slash costs and tariff rates, but also to attract more financial resources to the sector.

One of the ways to mitigate *all* the risk factors mentioned above would be to have all the key stakeholders involved in the process of private players' entry into the water supply and sanitation sector, and that includes consumers, as well as prospective creditors and investors. Interaction with stakeholders may prove to be a lengthy and complicated process, but in essence, it is the process that will forge mutual trust between all the parties concerned and, ultimately, secure their backing for key decisions.

Private players like to operate in a predictable environment. Companies investing in water utilities deserve a workable, stable legal and regulatory framework that would allow their projects to pay back and generate returns on their long-term investments during the service life of the assets they create. In this sense, the draft legislation package aimed at fostering a market for affordable housing, which is currently being reviewed by the State Duma, will certainly help cut investment risks in the utilities sector.

However, chances are that even after the whole legislation package on affordable housing comes into force, private operators will most likely avoid straight-up concession arrangements, because even if this delegated management format is cemented by law, this will not protect private players from many other risks, some of which we have discussed above. So the more widespread arrangements will be municipal contracts or investment agreements for construction and/or modernisation of *specific* facilities, or framework agreements that will not specify the private operator's total investment commitments over the term of the agreement.

Coupled with cash-strapped and poorly balanced local budgets, low household incomes may keep fully-fledged concession arrangements unattainable to the majority of Russian municipalities for a very long time.

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**high expectations.** First of all, the business plans and investment programmes of private operators, especially the biggest ones, are often of declarative nature. They are quite far from sound financial projections and, in some cases, from the operator's real financial resources. And second, in any case, the arrival of private players cannot bring improvements in service level over-night.

The success and sustainability of private operators venturing into the utilities sector will be largely conditional on whether the industry's unresolved problems, which the present Overview is purported to identify, are resolved.<sup>30</sup>

If local authorities fail to give these issues the attention they deserve, this may breed mutual distrust between public and private entities, and cause the utility sectors of Russian cities and municipalities to relapse to the same precarious state from which they have had a chance to be delivered through the mechanisms of PPP, financial and managerial resources of private sector. What will happen if these problems persist? There will be no sufficient incentives for efficiency, private investment in utility infrastructure with long payback periods will continue to be fraught with high risk and, as a result, prospective long-term lenders and strategic investors will show little interest in the industry.

By way of conclusion, Russia's emerging market for utility management services has shown the following positive trend. Many of the players in this market choose to adhere to a **policy of informational transparency**. This should be encouraged in every way; indeed, lack of contractual and procedural transparency in the industry (1) creates more room for discretionary political interference; and (2) gives the key stakeholders a reason to fear that their interests may be under threat.

In a milestone development, the *Declaration of Guiding Principles for Cooperation between Public Authorities, Private Business and Consumers in Utilities Sector* (see Annex 1), adopted in Vladimir in June 2004, was *inter alia* signed by the majority of the companies polled for this Overview. Accession to this Declaration effectively means that **private companies invite public authorities and consumers to sit down and negotiate the fair "rules of the game"**, eventually marginalising those companies which choose to ignore them. This is how the arrival of private players in Russia's utilities sector is different from the precedents set by many other developing economies, and it gives us grounds for optimism.

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<sup>30</sup> This Overview is not an attempt to review all problems existing in the industry, and the list of the problems it contains could be continued. The main purpose of this Overview is to give decision-makers something to think about.

## **Chapter 1.**

# **General Information about Domestic and International Private Companies Operating in Utilities Sector in Russia**

<b>Questionnaire item</b>	<b>Company</b>	<b>Answer</b>
<b>1. Organizational form / legal status</b>	<b>Russian Utility Systems (RUS)</b>	Open joint stock company ( <b>OJSC</b> )
	<b>Regional Utility Investments (RUI)</b>	Open joint stock company
	<b>CES-Multyenergetika</b>	Closed joint stock company ( <b>CJSC</b> )
	<b>New Urban Infrastructure of Prikamye (Novogor-Prikamye)</b>	Limited liability company ( <b>Ltd.</b> )
	<b>Rosvodokanal</b>	Limited liability company
	<b>Syzranvodokanal</b>	Limited liability company
	<b>WTE Wassertechnik (WTE)</b>	<b>GmbH</b> (limited liability company)
	<b>RUS</b>	<b>Authorised capital:</b> RUR 1 billion <b>Founders:</b> Russian JSC UES ( <i>Unified Energy Systems of Russia</i> ) (25%), Gazprombank (25%), Interros (10%), Kazbassrazrezugol (10%), Renova (10%), EurasHolding (10%) and Eurofinance (10%).
	<b>RUI</b>	<b>Authorised capital:</b> RUR 500 million Bazovyi Element Holding member
	<b>CES-Multyenergetika</b>	Member of CES ( <i>Comprehensive Energy Systems</i> ) Holding
<b>2. Authorised capital and key shareholders</b>	<b>Novogor-Prikamye</b>	<b>Authorised capital:</b> RUR 10,000 <b>The only owner</b> of the company is New Urban Infrastructure ZAO (member of INTERROS Holding)
	<b>Rosvodokanal</b>	Member of Alpha-Eco Holding, whose authorised capital exceeds RUR 2 billion. <b>Majority shareholder:</b> Alpha-Eco OOO
	<b>Syzranvodokanal</b>	<b>Authorised capital:</b> RUR 30 million <b>Key founders:</b> Krista OOO, Syzran Distillery , Plastic , Kubra , Myasokombinat
	<b>WTE</b>	<b>Authorised capital:</b> EUR 6,033,244.00 <b>Sole shareholder:</b> EVN (Energie Vernünftig Nutzen) AG, Austria
<b>3. Utility sectors in which the company</b>	<b>RUS</b>	Heat, gas, electric power, water supply and sanitation
	<b>RUI</b>	Heat, electric power, water supply and sanitation, municipal solid waste (MSW)

<b>operates</b>	<b>CES-Multyenergetika</b>	Heat supply (heating and hot water supply), electric power, gas, water supply and sanitation
	<b>Novogor-Prikamye</b>	Water supply and sanitation, waste water treatment, production and distribution of thermal and electric power
	<b>Rosvodokanal</b>	Water supply & sanitation
	<b>Syzranvodokanal</b>	Water supply & sanitation
	<b>WTE</b>	Water supply & waste water treatment
<b>4. Why did the company join the industry?</b>	<b>RUS</b>	Potentially, the utilities sector offers some of the most attractive investment opportunities in all of the economy. The majority of utility companies are natural local monopolies with a guaranteed market for their services. This market totals RUR 700 billion (around US \$31.2 billion) nationwide. There are many ways to boost productivity in the industry. One would be to cut production costs, first of all, by introducing resource conservation technologies and curbing downstream loss. From both the economic and legal viewpoints, the utilities sector has all it takes to attract private players. The existing provisions of the Civil Code create a solid partnership framework for municipal authorities, private players, and consumers, who could join forces in rehabilitating the infrastructure and improving service level.
	<b>RUI</b>	<b>Bazovyi Element Holding</b> decided to establish a company focused on utilities, realizing that: <ul style="list-style-type: none"> <li>- Until very recently, there was no competition in the industry, which has resulted in poor managerial competencies and lack of access to information about more advanced technological and organizational solutions; therefore, the industry has a high cost-cutting potential, while the market is fully guaranteed;</li> <li>- Wear of facilities and equipment has reached critical levels in the industry, and municipal authorities begin to realise the need for bringing in private investors by letting them manage utilities infrastructure;</li> <li>- At the same time, private players are flocking into the industry, possibly heralding a complete market overtake in 3 to 5 years' time. But since major investment projects in utilities typically take 7 to 10 years to pay back, management contracts should be made to span comparable time periods. Therefore, once the market is divided up, new entrants will be effectively barred from it for another 10 to 15 years.</li> </ul> Utilities are among the least efficient industries at the moment, but this is precisely why the company envisions formidable opportunities for cutting and optimising production costs. <b>CES-Multyenergetika</b> carries on its utilities business in those regions where its parent holding company (CES) holds major equity stakes in energy companies, thus leveraging the synergy of business and asset management. Data is not available
	<b>CES-Multyenergetika</b>	
	<b>Novogor-Prikamye</b>	
	<b>Rosvodokanal</b>	<b>Rosvodokanal</b> was established as a successor to Rosvodokanaladka Group, founded in 1949 to build and operate water supply and sanitation utilities in Russian cities. A 55-year track record in WSS sector is a good place to start for a new company aspiring to become a national water operator. A steady and solvent consumer market.
<b>Syzranvodokanal</b>		

	<b>WTE</b>	<p>The company entered the sector directly in the capital of the Russian Federation in Moscow in 1996 as <b>WTE</b> is able to offer the high-quality products and services that were required according to the public tender specifications in a suburb of Moscow. <b>WTE</b> was awarded a contract for the design, finance, construction and operation of the sewage treatment plant. Before this <b>WTE</b> gathered experience in the Eastern parts of Germany and in Poland. <b>The Russian Federation was a step forward to the Eastern-European markets.</b></p>
<p><b>5. Mission and strategic vision of the company</b></p>	<p><b>RUS</b></p> <p><b>RUI</b></p> <p><b>CES-Multyenergetika</b></p> <p><b>Novogor-Prikamye</b></p> <p><b>Rosvodokanal</b></p> <p><b>Syzranvodokanal</b></p> <p><b>WTE</b></p>	<p><b>The company's mission</b> is to foster national standards for quality in utilities and maximise the influx of investments into Russian regional utilities.</p> <p><b>The company's objective</b> is to transform a sizable number of municipal enterprises in charge of municipal utilities infrastructure, into a transparent, efficient and open management company providing consumers with utility services conforming to a new, higher level of quality forged as a result of stiff competition between new players in the emerging utilities market.</p> <p><b>The mission of the company</b> is – to provide a comfortable living conditions for population by providing high quality and affordable communal services</p> <p><b>The company's mission</b> is to improve the quality of life for citizens of Perm by rendering quality water supply and sanitation services at affordable rates.</p> <p><b>Vision</b> – make water an affordable good and create a company which will be among top 3 leading companies in WSS sector in Russia.</p> <p><b>Mission</b> – improve quality of life in Russia by putting into place efficient and reliable water supply and sanitation systems operated based on market/commercial principles and addressing public interests</p> <p><b>The company's mission</b> is to render quality water supply and sanitation services.</p> <p><b>In Russia the company's mission</b> is to offer a complete package for the water and wastewater treatment plants in the form of BOOT-contracts.</p> <p><b>EVN group</b> intends to fulfill customer expectations and needs through a range of products and services, including water supply and sanitation services. As a result, <b>EVN</b> also contributes to the general quality of life. <b>EVN AG</b> is committed to a policy of maximum transparency and increased shareholder value and strives to ensure long-term success.</p>
<p><b>6. Strategic and medium-term goals</b></p>	<b>RUS</b>	<p><b>RUS</b> positions itself as a strategic investor focused on propagating managerial and technological competencies and introducing investment planning practices for the purpose of deriving a profit by reducing costs in the industry. As a matter of <b>priority</b>, the <b>RUS</b> management strives to reduce administrative and technology-related costs for the enterprises it oversees.</p> <p>The company is aware that it is doing business in an industry where technical problems remained unsolved for decades due to lack of funds. <b>RUS</b> analysts predict that it will take <b>between 2 and 3</b> years to restore a reliable technical base and bring equipment into good working order before the company can proceed with serious business projects.</p>

	<p><b>RUI</b></p>	<p>RUI will create a number modern and efficient companies operating in HCS sector, applying advanced process technologies, quite experienced and attractive for strategic investors and investments needed for sustainable development of the industry</p> <p><b>RUI will focus in th regions where major assets of its aprent holding company “Basiviyj Element” are located, nevertheless, major criterion for selection of regions for operations will be a constructive approach to PSP in local HCS markets demonstrated by regional and municipal public authorities.</b></p> <p>RUI co-ordinate its activities with RUS and other major private player in HCS market in Russia.</p> <p><b>Medium-term target</b> – in 3-5 years to achieve USD 1 billion annual turnover by managing municipal utility infrastructure and commissioning new fixed assets.</p> <p><b>Strategic objective</b> is to form an efficient company, operating in HSC sector and applying modern management and process technologies in heat and power generation and distribution, comprehensive use of resources to meet consumer interests in high quality and affordable heat, power and gas supply.</p> <p><b>The company’s strategic objective</b> is to elevate Perm’s water supply sector to European level in 12 to 15 years.</p> <p><b>Business development strategy:</b> consumer-oriented service and self-reengineering from a ‘manufacturing’ company to a service provider. The strategy of <b>Novogor-Prikamye</b> derives from the Administrative Reform business model, i. e. all company units are designated as regulatory, managerial, or executive ‘centres.’</p> <p><b>The medium-term goal</b> is to team up with international partners in order to launch a series of long-term reform programmes for the water supply and sanitation sector in some of major Russian cities with an aggregate population exceeding 5 million.</p> <p>Company expects and hopes that the effective Trust management contract will be extended for some more years.</p> <p><b>The mid term objectives</b> are to enter the Eastern-European market through PPP models, not only in the capital of the Russian Federation also offering our services to the other great Russian towns, which have to deal with the problematic water pollution and have to meet the EU-Standards for waste water treatment. The business development strategy based on company’s projects in Moscow. «Due to the need for extensive investment in the drinking and wastewater sectors, we anticipate sizeable growth opportunities in the years to come » (Rudolf Gruber, Chairman of the Executive Board <b>EVN AG</b>).</p> <p>Its economical and technical experience enables <b>WTE</b> to enter the drinking supply market, too. The first project in the field of water supply was won by <b>WTE</b> this year to build up a drinking water plant for more than 1 m inhabitants in the South-West of Moscow.</p>
	<p><b>RUS</b></p>	<p>The company has subsidiaries in 24 Russian regions and 52 ongoing contracts to render water, heat, gas, and electric power supply services in 16 regions.</p>
<p><b>7. Cities and regions where the company carries out or plans</b></p>	<p><b>RUI</b></p>	<p>10 municipalities in <i>Krasnodrarskij Krai</i> (region), including: Sochi, Tuapse, Anapa, Gelendgic; Kalliningradrad oblast, Barnaul City, Eisk and Novosibirsk City.</p>

<b>to start business activities in the near future.</b>	<b>CES-Multyenergetika</b>	Over 45 cities, towns and municipalities in the regions of Perm and Sverdlovsk, and Syktyvkar (Komi Republic).
	<b>Novogor-Prikamye</b>	Perm, Berezniki
	<b>Rosvodokanal</b>	Branches in 10 Russian regions; water supply and sanitation facilities on lease in Orenburg
	<b>Syzranvodokanal</b>	Syzran Municipality and Syzran district
	<b>WTE</b>	Moscow (South Butovo and South-West districts) and Moscow region: Zelenograd, Lyubertsy
<b>8. How is the company's involvement in utilities services formalised?</b>	<b>RUS</b>	<p><b>The currently prevalent format</b> are short-term (11-month) leases in cities with population ranging from 25,000 to 1 million.</p> <p><b>The main desired format of RUS'</b> involvement in managing urban utilities would be a combination of long-term infrastructure leases and municipal contracting for infrastructure rehabilitation and development. Financial recovery and infrastructure investment mobilisation agendas can only be addressed successfully under a long-term contract guaranteeing steady, sustainable cash flows for the operator. The needs are to be formulated by local authorities within municipal contracts defining the scope and qualitative parameters of required utility services. All facilities and improvements in WSS infrastructure created as part of contract performance would become municipal property.</p>
	<b>RUI</b>	<p><b>RUI</b> plans to establish regional subsidiaries who would secure operational custody on housing &amp; utilities in the regions; then the subsidiaries would establish their branches to operate the utilities. The company is currently in the process of negotiating its involvement formats.</p> <p><b>RUI</b> management believes that the prime beneficiaries of <b>RUI</b> projects would be citizens, who would benefit from both better, more reliable electric power, heat and water supply, and the new local jobs and retraining opportunities offered by <b>RUI</b>.</p>
	<b>CES-Multyenergetika</b>	<p><b>Major forms of company's participation in providing communal services are as follows:</b></p> <ul style="list-style-type: none"> <li>• Consolidation of a stake of shares which allows for full control or blocking power in regional gas distribution companies, which have been privatized recently;</li> <li>• Establishing local private companies providing electricity and heat supply as joint ventures with relevant municipalities</li> <li>• Short to medium term lease of electricity and heat supply infrastructure.</li> </ul>
	<b>Novogor-Prikamye</b>	INTERROS Holding CJSC and the Perm Region Government signed a Partnership Agreement on July 22, 2003, pledging mutual cooperation in investment projects targeting housing and utilities in the Perm Region. The company is currently operating on a short-term lease basis, but a long-term lease is in the pipeline.
	<b>Rosvodokanal</b>	<b>Rosvodokanal</b> is open to all commonly practiced partnership formats with local authorities.
<b>Syzranvodokanal</b>	Now <b>Syzranvodokanal</b> operates under 5-year Trust management agreement with fixed management fee but in near future the company would like to take more responsibility and also benefit from improved efficiency, e.g. under lease arrangement. Company is ready to bear relevant commercial risks.	

	<b>WTE</b>	Company offers a complete package for the wastewater treatment plants in the form of BOOT-contracts. So the community gets the full range from planning the plant over building the plant over financing the plant to operating the plant for a long term period of 10 up to 25 years.
<b>9. Projected investments in utilities infrastructure for the next 3 to 5 years, and desired returns on investment.</b>	<b>RUS</b>	RUS plans to <b>invest around US \$500 million</b> over the next 3 to 5 years. Pledged by the company at incorporation, this investment commitment has remained unchanged. The <b>RUS</b> project anticipates an average rate of returns of 10% to 15%.
	<b>RUI</b>	The company's investment target for the next five years is <b>US \$200 million</b> , and <b>US \$700 million</b> for the next 7 to 10 years.
	<b>CES-Multyenergetika</b>	Data is not available
	<b>Novogor-Prikamye</b>	The investment target is up to <b>US \$50 million</b> .
	<b>Rosvodokanal</b>	The company plans to invest at least <b>RUR 1 billion</b> in utilities infrastructure <b>per target city</b> over the next 3 to 5 years.
	<b>Syzranvodokanal</b>	Company will invest some 30 million rubles in coming 3 years
	<b>Wassertechnik</b>	The targeted level of investments for the nearest three years is <b>more than 200 m EUR</b> . The targeted level of capital profitability is approximately 9 %.
<b>10. Main obstacles preventing greater involvement of private players in Russian utilities sector</b>  <i>(in the opinion of the company interviewed)</i>	<b>RUS</b>	<ul style="list-style-type: none"> <li>• Non-transparent tariff regulations,</li> <li>• Financial constraints of municipal utility enterprises,</li> <li>• Huge backlog of debt owed by federal, regional and local governments to utility providers,</li> <li>• Regional and local authorities' interference in the production processes and technology matters of utility providers,</li> <li>• When partnering with a private investor, authorities tend to put political agendas above economic interests,</li> <li>• Gaps in the legal framework for long-term investment,</li> <li>• No guaranteed returns on private investment, specifically, the government will not underwrite interest on loans that private investors may need to take out,</li> <li>• No long-term credit facilities, specifically, pension funds are not available for investment in utilities infrastructure,</li> <li>• Obsolete technology and equipment,</li> <li>• Lack of qualified labour and know-how,</li> <li>• No competitive bidding.</li> </ul>

	<p><b>RUI</b></p>	<p><b>Main problems when negotiating with local authorities:</b></p> <p>a. Municipalities and the management of municipal utility enterprises are apt to say: “just give us the money; we know how to use it.” This stance misses two points: (1) that large-scale investment is impossible unless the investor has the leverage to manage the enterprise; and (2) investment will never pay back within a reasonable time span unless the management system is seriously upgraded.</p> <p>b. Some municipalities (although they may declare their willingness to cooperate and may, in fact, be genuinely willing to do so) will not allow the company to carry out an in-depth study of the utility provider singled out for investment. In a typical example, some municipalities have recently held what was described as “open tenders” for investors, where the information was more or less limited to this: “Heat supply enterprise for rent; turnover: X; employee headcount: Y. If interested, reply specifying the amount of investment you are prepared to commit to this enterprise.”</p> <p>c. Exaggerated fear of premature severance of relationship by <b>RUI</b>; failure to realise that a private investor faces an incomparably greater risk of early contract termination.</p> <p>d. Investment is sometimes viewed as some sort of non-refundable fee for the right to operate the infrastructure for a specific time period and, accordingly, some investment “opportunities” on offer may be completely <b>devoid of the whole concept of payback or returns</b>.</p> <p><b>CES-Multyenergetika</b></p> <ul style="list-style-type: none"> <li>• For all intents and purposes, the practice of competitive bidding for the right to lease utility infrastructure does not exist for two reasons: (1) local self-governments are not prepared to organise this procedure on a professional level; and (2) private operators in the utilities market lack proven “histories.”</li> <li>• Governmental tariff regulation is a solid institutionalised process, but “institutionalisation” applies more to the procedural aspect than regulating principles. This is a result of both a fast-changing regulatory and methodological framework, and the “disposition” of players in the energy market.</li> <li>• When the government regulates “caps” on tariff hikes, and as long as such regulations persist, they cater primarily to the financial appetites of major monopolies, while utility infrastructure needs are only met out of the surplus, if any. As a consequence, the production and investment plans of utility operators become secondary to the same plans of major “traditional” energy market players such as AO “Energos” of RAO UES and divisions of RAO Gazprom. It would be fair to say that this whole process is substantially “politicised.”</li> <li>• It is necessary to “synchronise” reforms in the energy sector and housing &amp; utilities sector.</li> </ul> <p><b>Novogor-Prikamye</b></p> <ul style="list-style-type: none"> <li>• The main problem facing Novogor-Prikamye is that private operators lack any utilities business experience in Russia. Consequently, the company has had to make an excessive amount of “pioneering” decisions.</li> <li>• Flaws in the legal/regulatory framework, organisational structure of the housing &amp; utilities sector, and lack of government funding have not significantly affected the operations of Novogor-Prikamye within the extent of its ongoing commitments.</li> <li>• According to this company, greater involvement of private players in Russia’s utilities sector is mainly hampered by a lack of a generally accepted policy backed by the Russian government.</li> </ul>
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	<p><b>Rosvodokanal</b></p> <ul style="list-style-type: none"> <li>- High political risk; a tendency to manipulate the subject of utilities to political ends and, accordingly, reluctance to accept economically viable tariffs;</li> <li>- Social benefits and subsidies (to the population) that have no financial backing;</li> <li>- Municipalities fail to conceptualise (possibly due to a lack of widely publicised precedents and trained specialists) the standard and more creative partnership formats between local authorities and private operators;</li> <li>- Local authorities have no understanding of the available project financing schemes and more economically sound solutions for urban infrastructure improvement;</li> <li>- Absence of a known and trusted “umpire” (e. g. a consulting firm) to evaluate investment programmes/infrastructure improvement programmes;</li> <li>- Citizens and authorities at all government levels need to be better educated about the benefits and possible formats of private sector involvement in the utilities sector; lack of such education fuels mistrust, misunderstanding, and unreasonable fear among citizens and municipal authorities alike;</li> <li>- Lack of standardised contracts for lease, management and concessions;</li> <li>- Concession law is in its infancy;</li> <li>- Cross-subsidising;</li> <li>- Local authorities’ reluctance to help organise the commercial process, including consumption accounting, billing and collection; high level of corruption;</li> <li>- Municipalities are not equipped to evaluate and register property.</li> </ul>	<ul style="list-style-type: none"> <li>• Flaws in the laws and regulations breed tariff regulation problems.</li> <li>• Flaws in the organisational structure of the housing &amp; utilities sector create contractual problems, specifically, with the heat supplier regarding hot water output volumes; they also result in protracted, complicated and ineffectual debt recovery procedures, and so on.</li> <li>• Flaws in the budget process and inter-budgetary relations cause delays in reimbursements for subsidies and rebates.</li> <li>• <b>Lack of long-term capital investment planning at municipality level</b>, in spite of the fact that a sound long-term plan for WSS infrastructure development would help resolve many existing and prevent future problems in the sector.</li> </ul> <p>Working closely with Mosvodokanal WTE was able to solve all problems in a very short period.</p>
	<p><b>Syzranvodokanal</b></p>	
	<p><b>WTE</b></p>	

Note: The table in Chapter 1 was filled with information taken from the questionnaires completed by interviewees themselves. In some cases, however, such information was supplemented with facts taken from public domain sources.

## **Chapter 2.**

### **Experience of domestic and international private companies in implementing specific projects**

In this chapter, the companies listed above cite their specific projects underway in different parts of Russia to illustrate their experience so far with Russian utilities. Some of the issues briefly mentioned in the previous chapter are dealt with in more detail. The data was provided by the companies polled.

## RUSSIAN UTILITY SYSTEMS

### 1. Cities and regions where the company operates

As of August 10, 2004, RUS had signed 37 cooperation agreements with regional governments, and established 24 subsidiaries, namely:

- |                                     |                                  |
|-------------------------------------|----------------------------------|
| 1. Altai Utility Systems            | 13. Orenburg Utility Systems     |
| 2. Amur Utility Systems             | 14. Oryol Utility Systems        |
| 3. Arkhangelsk Utility Systems      | 15. Perm Utility Systems         |
| 4. Vladivostok Utility Systems      | 16. Petrozavodsk Utility Systems |
| 5. Vladimir Utility Systems         | 17. Saratov Utility Systems      |
| 6. Volgograd Utility Systems        | 18. Sverdlovsk Utility Systems   |
| 7. Voronezh Utility Systems         | 19. Smolensk Utility Systems     |
| 8. Don Utility Systems              | 20. Tambov Utility Systems       |
| 9. Kaluga Utility Systems           | 21. Tver Utility Systems         |
| 10. Kirov Utility Systems           | 22. Tomsk Utility Systems        |
| 11. Kursk Utility Systems           | 23. Tiumen Utility Systems       |
| 12. Nizhny Novgorod Utility Systems | 24. Chuvash Utility Systems      |

All the listed daughter companies have legal status of (open) Joint-Stock Companies. As of August 10, 2004, RUS had 52 ongoing contracts to provide water, heat, gas and electric power supply services in 16 Russian regions, including:

- |           |   |
|-----------|---|
| <b>6</b>  | <b>in water supply and sanitation</b>                             |
| <b>29</b> | in heat supply  |
| <b>13</b> | in electric power supply  |
| <b>4</b>  | Leases on gas distribution networks had been signed in 4 regions. |

**RUS** provides WSS services under lease contracts in the following municipalities:

- |                           |                               |
|---------------------------|-------------------------------|
| 1. <b>Blagoveshchensk</b> | (Amur Utility Systems);       |
| 2. <b>Volgograd</b>       | (Volgograd Utility Systems)   |
| 3. <b>Kirov</b>           | (Kirov Utility Systems);      |
| 4. <b>Kachkanar</b>       | (Sverdlovsk Utility Systems); |
| 5. <b>Tambov</b>          | (Tambov Utility Systems);     |
| 6. <b>Tomsk</b>           | (Tomsk Utility Systems).      |

In August 2004, **RUS** signed a strategic partnership agreement with the Mayor's Office of **Rostov-on-Don** to manage and improve the city's water supply and sanitation systems. This agreement will serve as the groundwork for a long-term investment deal, aiming to attract RUR 1 billion in investment.

### 2. Main format of the company's involvement in utility services

The prevalent format at the moment are short-term (11-month) leases in cities with population ranging from 25,000 to 1 million. RUS has found out that cities with population up to 200,000 are the best in terms of property relations (as a rule, all utilities in such a city belong to a single owner, the municipal government), capital investment and project timeframes. In cities this size, it takes considerably less time and effort to audit the state of the utility sector and take

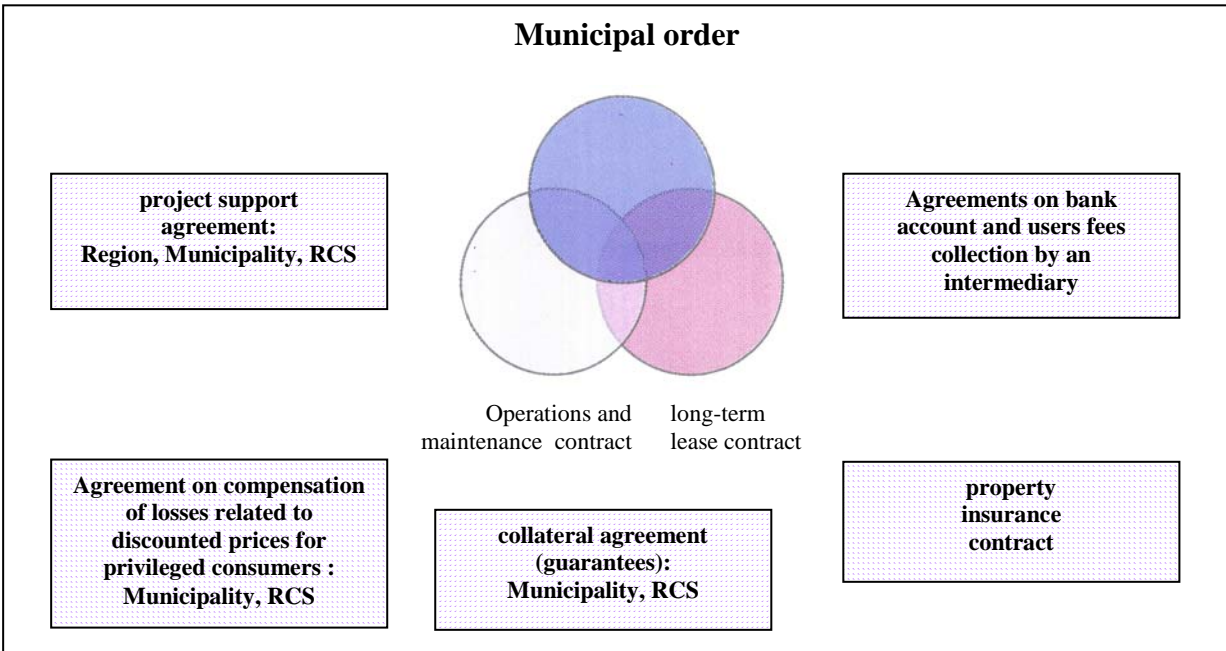
emergency trouble-shooting action. On the other hand, the economic and social rewards of the private operator’s improvement effort become obvious much sooner. In a smaller city, benefits per citizen are greater compared to million-strong cities and larger projects.

On May 28, 2004, the company sealed its first long-term (15-year) agreement in Kirov, having pledged US \$20 million investment in *water supply* infrastructure in the city. More long-term deals are in the works at Vladimir, Tomsk, Rostov, Tambov, Blagoveshchensk and Oryol.

**Ideally, RUS wishes** to be involved in urban utility management along the lines of combining long-term infrastructure leases with the *municipal order* arrangement (see chart below) for infrastructure rehabilitation and development. Financial recovery and infrastructure investment are conditional on long-term contracts ensuring steady, sustainable cash flows for the operator.

In consultation with municipal authorities, **RUS** has devised a new business model – effectively, a new lease concept – based on its first year of operating under 11-month leases. This new concept is close to what is commonly known as “concession,” blending municipal contracting with property leasing, when the operator invests independently in improvements, and the municipal authority pays back by installments over a long period of time, as rent payments arrive. The local authority states its needs within a municipal contract, defining the scope and qualitative requirements for utilities (see chart below). All facilities and improvements in WSS infrastructure created as part of contractual performance become property of the municipal authority.

**Structure of contract relations in a frame of business-model “Municipal Order”**



Source: «Russian Utility Systems». Material presented at the Conference in Vladimir.

The issue currently being mooted is how municipal authorities can join the governing bodies and acquire equity stakes in the regional operators, i. e. **RUS’** subsidiaries. In parallel, the company interacts closely with municipal authorities in the process of inventory-taking, technical and economic auditing, and state registration of municipal utilities infrastructure. The absence of such registration precludes long-term leases and investment deals.

### 3. Description of selected RUS Projects

#### 3.1 The Volgograd Project: general profile

<b>City</b>	<b>Volgograd</b>
<b>Population covered</b>	780,000 subscribers for water supply and sanitation, and 430,000 for heat supply
<b>Project owner</b>	<b>Volgograd Utility Systems</b>
<b>Sector</b>	Cold water, hot water, sanitation, electric power
<b>Type of contract</b>	<b>Lease on municipal property</b>
<b>Effective</b>	From February 25, 2004 to January 25, 2005

RUS has sealed a lease on municipal property previously in the operational custody of municipal unitary enterprises (MUEs). The lease was signed directly with the Volgograd Government. RUS and Volgograd Government are currently negotiating a partnership scheme along the lines of the “*municipal order*” model, aiming to secure investment in the revitalisation and improvement of the city’s utilities sector (see previous subsection).

#### 3.2 Achievements

**The company has pledged a total of RUR 65 million** in utilities infrastructure investment (major repairs and renovation) since the contract was signed. The funds have not been fully disbursed pending municipal payback guarantees envisaged by the *municipal order* arrangement. Of the RUR 65 million in private investment, RUR 50 million is expected to come in loans. In Volgograd during this year RUS plans to invest RUR 280 million in communal infrastructure rehabilitation and development.<sup>31</sup>

The *target* rate of returns on investment is 15% to 20%, while the *target* payback period is 4 to 6 years.

The city has already seen some improvement in the regularity and quality of its heat, water, and electricity supply.

The company’s financial standing has improved after it streamlined its sales operation. RUS, which is currently implementing a cost-cutting programme and management accounting system, believes in the principle of financial transparency. **Volgograd Utility Systems (VUS)** CEO S. Shishov told us: “*Thanks to the successful progress of investment programmes and organisational and technical improvements designed in conjunction with the municipal government, we are now poised to cut production costs by RUR 120 million, so lower retail rates on water supply, sanitation and heat may not be far behind. Moreover, the existing energy and materials prices do allow for lower tariff rates.*”

On August 12, 2004, **VUS** General Director Shishov and Volgograd Mayor E. Ishchenko signed a cooperation agreement focused on the uninterrupted supply of quality housing & utility services to consumers, stipulating a 17% cut in water supply, sanitation and heat supply tariff rates for citizens of Volgograd, effective as of September 1, 2004.

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<sup>31</sup> Source: <http://www.regnum.ru/allnews/311701.html>

### ***3.3 Obstacles and problems for the project***

**In the course of negotiating** with the local authority, the company discovered that municipal and regional authorities were *not in agreement* on the issue of public/private partnerships in the utilities sector.

The following problems have appeared **in the course of the project**:

- The issue of MUE debt is far from settled;
- Municipal, regional and federal governments all have debt arrears vis-à-vis utility providers;
- Authorities do not make a good case when it comes to the economic viability of their utilities rates;
- No legislation on long-term partnerships between private investors and municipal authorities.

**Some of the problems faced by the company are linked to, or caused by:**

- 1) gaps and flaws in laws and regulations: no concession legislation, arbitrary tariff regulations;
- 2) flaws in housing & utilities management: no formalised criteria to assess the performance of utility companies;
- 3) flaws in the government funding system and inter-budgetary relations: a huge debt backlog amassed by authorities at every level vis-à-vis utility companies, financially unsecured claims for rebates and subsidies for the population.

**The tariff policy** practiced by municipal authorities is fraught with formidable threats to the company's sustainable development, namely:

- as a private operator, the tariff rates on the company's services are set by a Regulatory body named Regional Energy Commission, not the municipality although, by law, the municipality bears sole responsibility for retail heat and water supply and sanitation services in the area it oversees;
- at that, the rates are set in a rather arbitrary manner (according to the company: "tariff-setting is a purely political affair so far").

**Table in Chapter One** of this Overview presents the challenges the company has encountered everywhere it works in Russia.

### ***3.4 How the contract was awarded***

Pending signature of RUS' "*municipal order*" agreement, the company operates under a short-term lease. **The lease was never offered for competitive bidding**, but the decision to contract RUS was made collectively by all branches of local government. The prospective lease was widely debated in the local media, and community meetings were held to discuss the terms, anticipated benefits, mutual warranties of the parties, and their warranties to subscribers. Realising that the **absence of competitive bidding creates extra risk for private utility investors** in the regions (including the risk of early contract termination when a new mayor or governor takes office), RUS has consistently lobbied for the practice to gain circulation.

However, not all local governments will be prepared to run competitive bidding in a professional manner. Local authorities lack the funds, experience and staff to hold tenders, not to mention the fact that heads of municipal governments sometimes resent the whole idea.

# ROSVODOKANAL

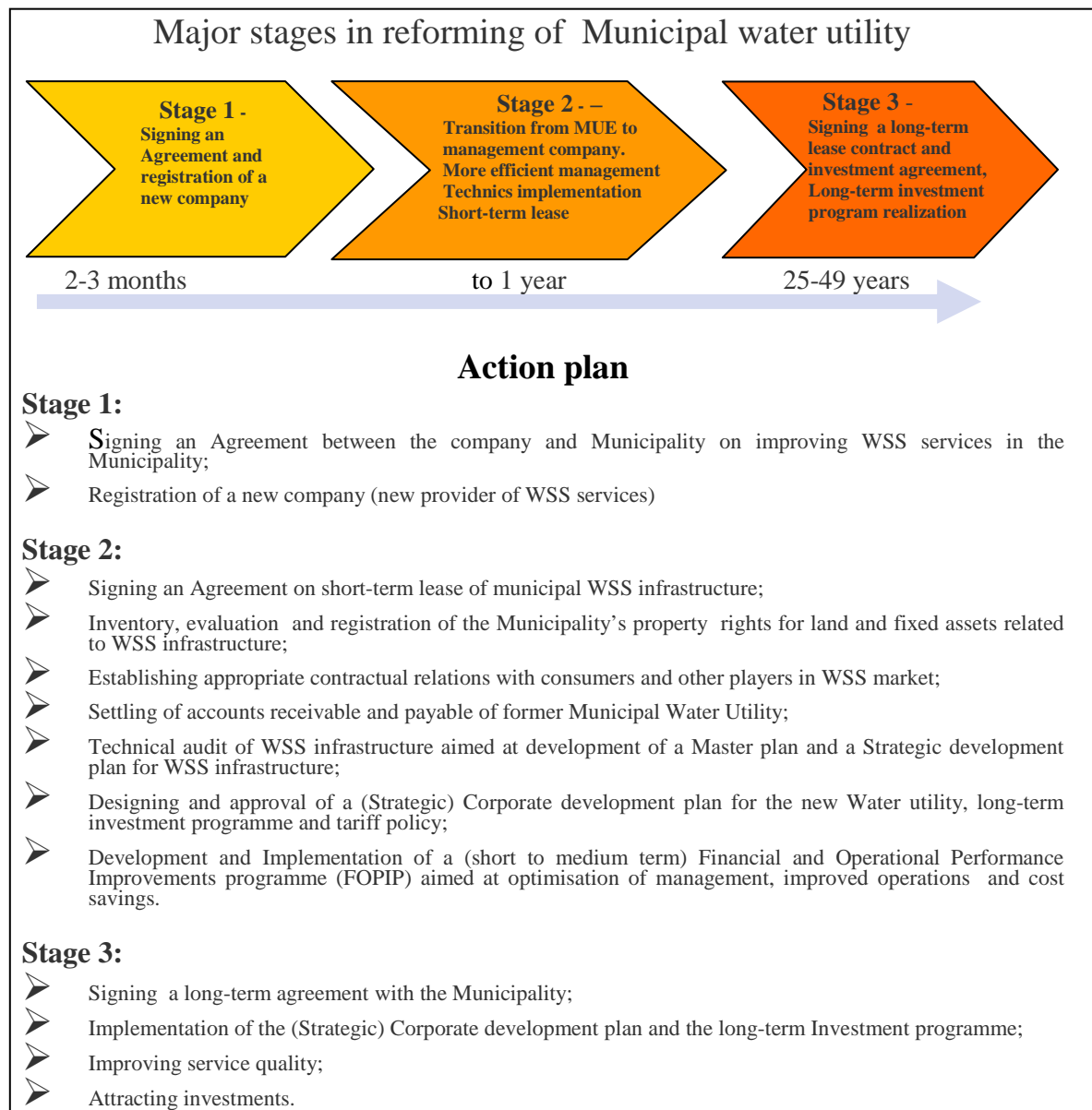
## 1. Cities and regions where the company operates

**Rosvodokanal** operates 10 regional subsidiaries in major cities including Khabarovsk, Ufa, Vladivostok, Novosibirsk, Chelyabinsk, Volgograd, Tver, Rostov-on-Don, St. Petersburg and Moscow.

**The water utility reform underway in Orenburg is Rosvodokanal's** pilot project in the capacity of 'operator.' In addition, the company has, in the past 6 months, landed a number of water supply and sanitation contracts with Russian cities with an aggregate population of over **2 million**. The company also renders engineering and consulting services to water companies in some Russian cities.

## 2. Main format of the company's involvement in utility services

**Rosvodokanal** is open to all common partnership formats with local authorities. However, a number of steps need to be taken before long-term contracting becomes an option:



### 3. Description of selected Rosvodokanal projects

#### 3.1 The Orenburg Project: general profile

<b>City</b>	<b>Orenburg</b>
<b>Population covered</b>	487,800 people
<b>Project owner</b>	Orenburg Vodokanal
<b>Sector</b>	Water supply and sanitation
<b>Type of contract</b>	<b>Lease on municipal property</b>
<b>Signed</b>	October 27, 2003

A new company – *Orenburg Vodokanal Ltd.* – has been established *jointly* with the Orenburg Government to manage water utility assets leased in Orenburg. The company possesses all the appropriate licenses. A short-term lease on municipal assets has been signed with Vodokanal MUE. Furthermore, **Rosvodokanal** and Orenburg Government have signed an Agreement on Quality Water Supply and Sanitation Services, and a contract defining regulatory aspects, powers and obligations of the parties, etc., including investment commitments and specific steps to be taken in order to upgrade service level and infrastructure.

*Project status:* a short-term investment project is underway; a sizable amount of engineering work is in progress; and preparations are underway for a long-term investment contract due for signing in the autumn of 2004.

#### 3.2 Achievements

The early months of the company’s operation in Orenburg have yielded the following results:

- Revenue up 16%;
- User charges collection rate up from 85% to 97%;
- Following a series of steps to optimise energy flows, energy consumption has shown a steady downward trend since March 2004;
- The incidence of network breakdowns has dropped to a quarter of its former value; all systems operate smoothly;
- Water losses have decreased from 27% to 21%;
- The company has been reorganised, and its divisions consolidated;
- A budgeting system has been introduced throughout the company and in each division;
- Financial planning and controls have been set up;
- A cut in non-production costs has freed extra funds that have been used to boost the payroll fund and step up major repairs.

#### 3.3 Obstacles and problems for the project

3.3.1 The company named the following major obstacles and problems:

- Local authorities are mistrustful of private operators and reluctant to cede control of water utility companies;
- Absence of a generally recognised “arbiter,” i. e. a consulting firm or NGO that would initiate and streamline the advancement of private operators into the water utility sector;

- Governments at all levels cannot guarantee reimbursement for retail utility rebates and subsidies;
- No standardised tariff-setting procedures; tariff-setting is plagued by political agendas.

### **3.3.2 Tariff policy in the municipality targeted by the project**

Applicable tariffs only partially cover the economically sound costs. However, the company notes that: (1) it knows from experience that any utility company, *if skilfully managed*, can cover its operating costs with existing tariffs and even make a profit by conserving, sustaining or even slightly improving the current state of its fixed assets. It's only a matter of the nature, scope, quality and, most importantly, expeditiousness of the required changes; and (2) obviously a more accurate estimate will depend on how the cost composition is interpreted and, specifically, whether or not the expenditures incurred by the company in upgrading its fixed assets, as well as other capital costs, are recognised as "sound" costs.

Although the tariff rates for WSS have not been changed since it started its local operation, the above-mentioned lack of standardised tariff-setting procedures and pre-eminence of political agendas in tariff-setting give rise to well-justified fears as the company gears up to commit investment funds to the city's water supply and sanitation sector.

### **3.4 How the contract was awarded**

The company's projects always require endorsement by both the head of government and local lawmakers. The company's policy is to push for competitive bidding as a procedure equally benefiting all the parties concerned while securing the legitimacy of long-term delegated management arrangements.

# NEW URBAN INFRASTRUCTURE OF PRIKAMYE

## 1. Cities where the company operates

- **Perm:** ongoing short-term lease, but long-term lease due for signature soon;
- **Berezniki:** general agreement with the city mayor;
- **Tyumen:** the company will be bidding in the second stage of a tender to operate water supply and sanitation utilities in Tiumen.

## 2. Main format of the company's involvement in utility services

In Perm, **Novogor-Prikamye** is operating under a *short-term* lease on municipal property, but a long-term lease on utility infrastructure is scheduled to be signed soon with the municipal government. The company plans to invest US \$50 million over the next 3 to 5 years, and is prepared to face the risks associated with the investment. The Perm project is described in more detail below.

## 3. Description of selected Novogor-Prikamye projects:

### 3.1 The Perm Project: general profile

<b>City</b>	<b>Perm</b>
<b>Population covered</b>	<i>data is not available</i>
<b>Sector</b>	Water supply and sanitation
<b>Type of contract</b>	<b>Lease on municipal property</b>
<b>Signed</b>	July 2003

INTERROS Holding and the Perm Region Government signed a Partnership Agreement on July 22, 2003, pledging mutual cooperation in investment projects targeting housing and utilities in the Perm Region, but for now, there is a short-term agreement on lease of municipal property (WSS infrastructure).

### 3.2 Achievements

#### 3.2.1 Investment

The company has invested RUR 64,070,000, including VAT, in WSS infrastructure since the contract was signed. This includes major repairs, rehabilitation, upgrading and new construction (see Table 1 below).

**Table 1. Investment**

(RUR thousand)

	Dec. 03	Jan. 04	Feb. 04	Mar. 04	Apr. 04	May 04	Jun. 04	<b>Total</b>
Major repairs	3,088	9,326	9,693	10,411	12,130	6,245	10,479	61,372
New construction	0	1,366	0	535	488	195	114	2,698
<b>Total</b>	3,088	10,692	9,693	10,946	12,618	6,440	10,593	64,070

All amounts were invested from the company from own funds, without attracting long-term loans.

### 3.2.2 Fewer water supply network leaks

During the first 6 months of 2004, 703 leaks and break-downs occurred in the underground pipes and wells of the water supply system, representing a 1.8% decrease from the same period in 2003 (716 during the first six months of 2003). The majority of leaks in the first six months of the years were from wells. A significant percentage of leaks occurred in corporate distribution networks.

Fewer leaks mean lower costs for the company. The company saved an extra **RUR 13,305,000** due to the lower incidence of leaks in the first 5 months of 2004.

### 3.2.3 Excavation at water supply and sewerage networks

**Water supply networks** were excavated **350** times during the first six months of 2004, 280 of them emergencies and 70 routine digs. The number of emergency digs was 12% lower compared to 2003 year on year, while the number of routine digs was 55.5% higher (see Table 2 below).

**Sewerage networks** were excavated **108** times, including 45 emergencies and 63 **preventive** routine digs. The number of emergencies was up 50%, and preventive routine digs, up 152% from 2003 year on year (see Table 2 below).

**Table 2. Excavation of water supply and sewerage facilities in H1 2004**

	Water supply digs				Sewerage digs			
	2002	2003	2004	% of 2003	2002	2003	2004	% of 2003
<b>Emergencies</b>	232	318	280	-12	42	30	45	50
<b>Preventive routine digs</b>	67	45	70	55,5	9	25	63	152
<b>Total</b>	<b>299</b>	<b>363</b>	<b>350</b>	<b>-3,7</b>	<b>51</b>	<b>55</b>	<b>108</b>	<b>96</b>

Notably, there were 35% fewer emergency excavations at water supply networks in the first 6 months of 2004, compared to the same period in 2003: 52 in 2004 vs. 80 in 2003. This year, 18.6% of emergency excavations were water supply digs. Overall, the number of both emergency and routine water supply and sewerage excavations is up 9.6% from last year, totalling 458 to date. As is evident from Table 2 above, the rise was due to more **preventive routine** excavations at water supply facilities, and more **routine** and **emergency** excavations at sewerage facilities. The rate of emergency excavations at water supply facilities is down.

**Fewer emergency and more preventive routine excavations** testify to more stable operation of the water company.

### 3.2.4 Financial situation

The company has consolidated its financial standing since the contract was signed. The turnaround time of accounts payable was shorter in the first six months of 2004 compared to 2003 year on year. The total accounts payable had decreased by RUR 269 million as the company steered clear of debt on its bills of exchange and tax payments. In the first 6 months of 2004, the company turned its production inventories around twice faster than in the same period of 2003, while inventories dropped 13% overall. The company also accelerated its debt turnaround time, mainly by slashing its debt overall. The company earned RUR 33,384 million in net profit in the first quarter of 2004.

### ***3.3 Obstacles and problems for the project***

The main challenge confronting **Novogor-Prikamye** in this project was its lack of experience in Russian utilities sector, necessitating a great deal of “creative” pioneer decision-making.

Flaws in the legal/regulatory framework, organisational structure of the housing & utilities sector, and lack of government funding **have not** significantly affected the operations of **Novogor-Prikamye**.

**The existing tariffs are sufficient to cover the company’s economically sound costs.**

### ***3.4 How the contract was awarded***

The contract was awarded **without competitive bidding as no other prospective bidders were in sight** at the time when the contract was sealed.

The decision to award the contract was issued by the head of the local self-government authority, backed by the Perm Region Governor.

# SYZRVODOKANAL

## 1. Cities where the company operates

Syzranvodokanal administers water supply and sanitation in two municipalities: the city and district of Syzran.

## 2. Main format of the company's involvement in utility services

At the moment, the company mainly provides utility services by managing the facilities it has received in trust for 5 years.

## 3. Description of selected Syzranvodokanal projects

### 3.1 The Syzran City Project: general profile

<b>City</b>	<b>Syzran</b>
<b>Population covered</b>	162 668 people (water supply), 120 986 people (sanitation)
<b>Sector</b>	Water supply and sanitation
<b>Type of contract</b>	<b>Trust management</b>
<b>Signed</b>	June 11, 2001

Syzranvodokanal has signed a **Trust Management Agreement** with the municipal authorities to manage WSS infrastructure (municipal property) for 5 years. The Agreement specified the following objectives of the trust management: providing 24-hour water supply for population, industries and institutions in Syzran City, providing wastewater collection and treatment services which meet established norms and standards, upgrade and development of WSS infrastructure in Syzran City.

The property was handed over to the company on July 1, 2001. As soon as the **Trust Management Agreement** was signed **Syzranvodokanal** hired all former employees of the municipal water utility (MUE).

### 3.2 Achievements

Overall, the city has benefited from the project in several ways:

**The company has invested** RUR 58.5 million in utilities infrastructure since the contract date. No loans for capital investments were attracted. From July 2001 till July 2004 **Syzranvodokanal** had invested almost all its Charter capital in the operated WSS infrastructure.

*Table 1.* Capital expenditure, finance from the Charter capital

Years	(RUR thousand)				
	2001 (second half)	2002	2003	2004 (first half)	Total
Capital investments financed from the Charter capital	-	7 961	15 588	4 517	<b>28 120</b>

The company underlined that by now it had not managed to recoup the investments made in WSS infrastructure in Syzran (more than RUR 28 million), while the effective agreement would be expired rather soon – in 2006. Prolongation of the agreement is needed in order to pay back its investments, and the company hopes that it will be extended for some more years

**As a sign of better service, water is now available to residents 24 hours a day.** Before the private operator took over, the local waterworks had been unable to ensure uninterrupted water supply due to a shortage or excessive wear of pumps and lack of funds to upgrade or replace them. As a result, **in some neighbourhoods water went on and off according to a time-table**, especially in summer.<sup>32</sup>

**The company's own financial state has markedly improved.** For example, in just 12 months the new management has achieved a considerable improvement in bill collection to 93% from the previous 80%.<sup>33</sup>

### ***3.3 Obstacles and problems for the project***

Shortcomings in the organisational structure of the housing & utilities sector create **contractual problems**, particularly, disputes with the heat supplier over hot water output volumes; they also result in a protracted, complicated and ineffectual debt recovery process, and so on.

A lack of government funding causes delays in reimbursements for subsidies and rebates granted to subscribers.

Flaws in the laws and regulations create **tariff regulation problems. Tariff-setting is a long, complicated, confusing procedure dominated by a political agenda.** The sequence is as follows: technical and economic calculations are filed with the Office of Pricing Policy at the Economic Development Ministry of the Samara Region, which reviews and changes them before endorsing retail utility tariff rates for corporate subscribers and households. The documents then go to the permanent Tariff Commission at the Housing & Utilities Committee of the Syzran Municipal Government, from where they are forwarded to the Economic Committee of the municipal government. Then the mayor issues a resolution advising the city Duma (parliament) to issue its own resolution endorsing the rates. The documents go to the city Duma, where they are reviewed by its various commissions before being adopted in the form of a Resolution. The new rates take effect as of the date when the Duma Resolution is published in a newspaper.

**While tariff-setting is only partially linked to production and investment plans, the present tariffs do eventually fully cover the operational costs.**

The interests of the private operator are not duly protected in this *project*. One irregularity is that, since some of the managed assets are unregistered (although Russian law clearly mandates that it must be), the agreement cannot be officially registered either. On the other hand, in order for the trust management agreement to be officially registered, it is necessary to procure an independent appraisal of the real estate properties placed in trust under the agreement. However, neither the municipal authority nor the company have been able to afford such an appraisal, and since no appraisal was conducted, official registration cannot be administered.

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<sup>32</sup> V.M. Musatkin (2002), Experience of Implementation of the Management Contract by Syzranvodokanal. Report to the 2<sup>nd</sup> meeting of EAP Task Force Group of Senior Officials responsible for urban water supply and sanitation reform in the NIS (2-3 December, 2002, Paris).

<sup>33</sup> Ibid.

What this means is that now, three years into the deal, the ownership status of the municipal property managed and operated by a private company on a trust basis, is still unclear.

### ***3.4 How the contract was awarded***

**The contract was awarded in a competitive tender** with two bidders. The rival of Syzranvodokanal Ltd. was a company named Spektr Ltd. **The criteria for the choice of winner** were determined by the Trust Management Policy for Municipal Properties in Syzran, ratified by the Syzran City Duma on May 30, 2003. The Policy requires that the bid of a successful contender contain the following information:

- the amount of expense reimbursements and fees of the trust manager (trustee);
- the trustor's anticipated income;<sup>34</sup>
- a compliance enforcement method under the trust management agreement;
- the trustee's business plan for managing the municipal property placed in trust.

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<sup>34</sup> The trustor is the owner of the municipal property placed in trust.

# **CES - MULTYENERGETIKA**

## **1. Cities and regions where the company operates**

*Sverdlovsk Region: 27 municipal districts, plus 22 cities and towns, including: Kachkanar, Verkhnij Tagil and Nizhnij Tagil, Kamens-Uralskij, Pervouralsk, etc*

*Komi Republic: Syktyvkar*

*Perm Region: Solikamsk, Berezniki, Tchaikovsky, Krasnokamsk, Kungur, Kizel, Vereshchagino, Chusovoi, Ocher, Gornozavodsk, Gremiachinsk, Suksun.*

**CES-Multyenergetika** carries on its utilities business in those regions where its parent CES holding company holds major equity stakes in energy companies, thus leveraging the synergy of business and asset management. **CES-Multyenergetika**, which is already active in gas distribution, electric power supply and heat supply, has plans to diversify into water supply and sanitation.

## **2. Main format of the company's involvement in utility services**

Partnership with regional and municipal public authorities and joint responsibility for performance of regional energy infrastructure helps Subjects of the Russian Federation to strengthen reliability and safety of energy supply for regional economy, promote development of energy market, including that is HCS sector, and promotes effective implementation of the principle of social responsibility of business.

**Major forms of company's participation in providing communal services are as follows:**

**In gas distribution** - consolidation of a stake of shares which allows for full control or blocking power in regional gas distribution companies, which have been privatized recently;

**In electricity and heat supply:**

- Establishing local private companies providing electricity and heat supply as joint ventures between **CES-Multyenergetika** and relevant municipalities; and
- Short to medium term lease of electricity and heat supply infrastructure.

Combining heat supply and electricity and gas distribution businesses in one company, and operating relevant infrastructure provides a lot of synergy, brings benefits from improved efficiency and creates a basis for substantial investments in communal infrastructure and networks in the regions, applying new efficient process technologies.

The company use modern management approaches to the business, including optimization of resource use and allocation, development and implementation of unified technical policy to the benefit of the regions energy infrastructure and the company operating in market environment.

### **3.1 General information**

#### **3.1.1 Distribution business in Komi Republic**

Established on March 31, 2003, *Syktyvkar Heat Investment Company* JSC is tasked with reforming the *heat supply* system in the city of Syktyvkar. A business strategy has been drafted

for the project; contracting with prospective project partners is underway; and a pilot area has been designated where new technology will be put into action for a better heat supply system.

The project proposes to exclude intermediaries/resellers from the supply chain, as well as a set of new tariff-setting procedures, a system of targeted subsidies for the underprivileged, an own subscriber network, a system for payments and allowances, competitive shopping for new equipment and components, and a 20% to 30% cut in network heat loss by optimising heat supply lines.

The heat supply system reform in Syktyvkar is designated as a federal project. If it succeeds, the new know-how, generated by the project in streamlining the heat supply business, will be recommended for rollout to other regions of Russia.

**CES-Multyenergetika** is also eyeing the options of building a gas-turbine thermoelectric power plant in Syktyvkar along with upgrading the existing boiler houses and building a number of new small boiler houses with outputs ranging from 1 to 5 mWt.

### 3.1.2 Distribution business in the Perm Region

On March 2, 2004, a constituent meeting was held for Comprehensive Energy Systems – Prikamye (**CES-Prikamye**), co-founded by Comprehensive Energy Systems, Energy Company for Municipalities – Perm, *Oblkommunenergo*, a regional public unitary energy company, and 9 municipal unitary enterprises:

- Urban Electric Utility Networks (Solikamsk)
- Gorelectroset (Kungur)
- Electric Utility Networks (Kizel)
- Vereshchagino Urban Electric Networks (Vereshchagino)
- Urban Electric Networks (Chusovoi)
- Ocher Urban Electric Networks (Ocher)
- Gornozavodsk Electric Networks (Gornozavodsk)
- Gorenergo (Gremiachinsk)
- Suksun Electric Utility Networks (Suksun)

**CES-Prikamye** sells electric power to municipalities, and services electric networks operated by its founding companies.

In the future, **CES-Multyenergetika** plans to expand its business geography by consolidating electric utility assets in cities not originally included in its line-up of stakeholders.

In addition to its project for a regional *electric utility* company, **CES-Multyenergetika** offered the Perm Region Government another project, envisaging the establishment of a similar regional *heat utility* company. The fundamental policy in establishing such a company would be to consolidate heat networks in cities that are home to Permenergo thermoelectric power plants, namely: Berezniki, Tchaikovsky, and Krasnokamsk. In May 2004, CES and the Perm Region Government signed a framework agreement to design the organisational and technical aspects of a project involving the establishment of a regional *heat utility* company.

### 3.1.3 Distribution business in the Sverdlovsk Region

**CES-Multyenergetika** pursues projects in gas distribution, electric power distribution, and heat supply in the Sverdlovsk Region. **CES-Multyenergetika** has consolidated majority stakes in 8,

and “blocking” stakes in 2 of the region’s 13 *gas distribution* entities. Company’s investment programme for 2004 envisages the construction of a 170-km gas pipeline worth RUR 87 million.

**CES-Multyenergetika’s** *gas distribution* business includes natural gas transportation, liquefied gas retail and pipeline construction. The company’s natural gas sales target for 2004 is 8,597 million m<sup>3</sup>, or 82% vs. 2003, while its target for liquefied gas is 27,930 tons, 4,265 tons or 18% above the 2003 figure. Higher sales are projected for all liquefied gas consumer brackets: 8,625 tons in industry (up 11% from 2003), 12,105 tons in household consumption (up 17%), 7,186 tons via automobile gas filling stations (up 31%), and a 2% rise in ‘intra-system’ sales. The company plans to increase its thermal power output by 101,500 Gcal in 2004, up 172% from 2003.

As part of its *heat supply* business development drive, **CES-Multyenergetika** is set to increase the thermal power output of its boiler houses at the Construction Materials Factory in Kamyshlov from 3,900 Gcal to 31,300 Gcal by upgrading the boiler houses (and switching them from fuel oil to gas). The company also plans to increase thermal power output at its facility in Mikhailovsk from 25,000 Gcal to 105,000 Gcal by building new capacity.

In its *electric power distribution* business, **CES-Multyenergetika** teamed up with a several municipalities in 2003 to set up a new entity, *Regional Network Company (RNC)*, whose mission is to ensure reliable energy supply to meet solvent demand. **RNC’s** more specific tasks include:

- Lobbying for better tariffs rates at the Regional Energy Commission;
- Monitoring (supervision) of the technical condition of electric networks operated by the company;
- Settlement of debt issues between consumers and MUEs;
- Financing for contractors, including endorsement of annual cost budgets for contractors, contractor compliance monitoring (supervision), and monitoring of general contractor’s spending.

**RNC** currently operates in 11 administrative districts of the Sverdlovsk Region: Asbest, Sukhoi Log, Bogdanovich, Revdinsky District, Kamensk-Uralsky, Rezhevskoi District, Serov, Severouralsk, Krasnoturyinsk, Sredneuralsk, Berezovsky, Sysert, Krasnoufimsk, Pervouralsk, Irbit, Tabory, and Artinsky District. In 2003, the company delivered 770 million kWt/hour of electricity into the retail network. By 2004, sales are projected to reach 1.5 billion kWt/hr as new subscribers sign up. **RNC** has plans to invest around US \$10 million in 2004.

### ***3.2 How tariff policy is pursued in municipalities where the company operates***

Electric power, heat and water supply is regulated by government agencies (Regional Energy Commissions) at the regional level. But gas supply is subject to regulation by both the Federal Tariff Service and Regional Energy Commissions.

While governmental tariff regulation is a solid institutionalised process, “institutionalisation” applies more to the procedural aspect than regulatory principles. This is a result of both a fast-changing regulatory and methodological framework, and the “disposition” of players in the energy market.

As a consequence, the production and investment plans of utility operators become secondary to the same plans of major “traditional” energy market players such as AO “Energos” of RAO UES

and divisions of RAO Gazprom. When the government regulates “caps” on tariff hikes, and as long as such regulations persist, they cater primarily to the financial appetites of major monopolies, while utility infrastructure needs are only met out of the surplus, if any. Therefore, it would be fair to say that this whole process is substantially “politicised.”

### ***3.3 Methods of gaining control***

In the *gas supply* sector, the company gained control by consolidating its majority (or strategic) equity holdings in regional gas distribution entities formed through privatisation (as happened in the Sverdlovsk Region).

But in *electric power* and *heat supply*, the company uses a mixed array of methods to gain control, including:

1. Incorporating companies in which both local self-government authorities and CES receive an equity share;
2. Leasing utility infrastructure on a short- and medium-term basis.

The power to transfer municipal property on lease is vested in the appropriate local self-government authority, authorised by its municipal charter. While formally, the decision is up to the head of the local self-government authority, the top official usually tries to avoid political risk by first securing the backing of the elected local self-government body.

For all intents and purposes, **the practice of competitive bidding for the right to lease utility infrastructure does not exist.** The company names two reasons: (1) local self-governments are not prepared to organise and run this procedure in a professional manner; and (2) private operators in the utilities market lack proven “histories.”

## WTE WASSERTECHNIK

### 1. Russian municipalities where the company operates

#### 1. List of the municipalities where the company is implementing main projects

No	Municipality	Description
1.	<b>South Butowo, Moscow</b>	<b>WTE</b> was awarded the BOOT <sup>35</sup> -contract for the design, finance, construction and operation of the waste treatment plant with extended waste water purification, filtration and UV sterilisation for 250,000 PE. The construction of this plant started in 1997 and now it is in operation since December 1998 till the year 2011.
2.	<b>Zelenograd, Moscow</b>	A waste water treatment plant with extended waste water purification, filtration and UV sterilisation for 370,000 PE. <b>WTE</b> began a construction in 1998 and started operate in December 2000. It will end in 2013.
3.	<b>Ljuberzy, Moscow region</b>	In Ljuberzy the waste water treatment plant especially the line 13 is converted to the Symbio process to save energy. The line 13 has a capacity of nearly 100,000 PE. The project starts in 1997 and was commissioned in 2000. The project is still in the monitoring face.
4.	<b>South West Moscow</b>	<b>WTE</b> built a new water supply plant for 1 m inhabitants each day. It is gained from the surface water of Moskwa river. <b>WTE</b> won the contract this year and it is now under construction. <b>WTE</b> will start operation in 2007 for a 10-years-period.

The WTE business development strategy is based on **WTE** projects in Moscow. The first was a BOOT-project in South Butowo which is a success. The next contract in Zelenograd, Moscow was awarded to **WTE** after *European wide competition*. Both WWTPs are now operated by **WTE**. So, **WTE** also gains experience in implementing BOOT-contracts as a service provider.

#### 2. Main business-schemes applied/to be implemented in Russia

The company offers a complete package for the waste water treatment plants in the form of BOOT-contracts. Though there is not special regulation in Russia for BOOT schemes, it can be successfully implemented in the framework of effective Russian legislation. Annex 2 contains a chart presenting organisational and financial scheme applied for **WTE** projects in Moscow. While next section explains in more details how the scheme works.

As a result of the projects implementation, the local community gets the full range of services from planning, designing, financing, building and operating the plant over a long term period (from 10 to 25 years).

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<sup>35</sup> BOOT means Build-Own-Operate-Transfer.

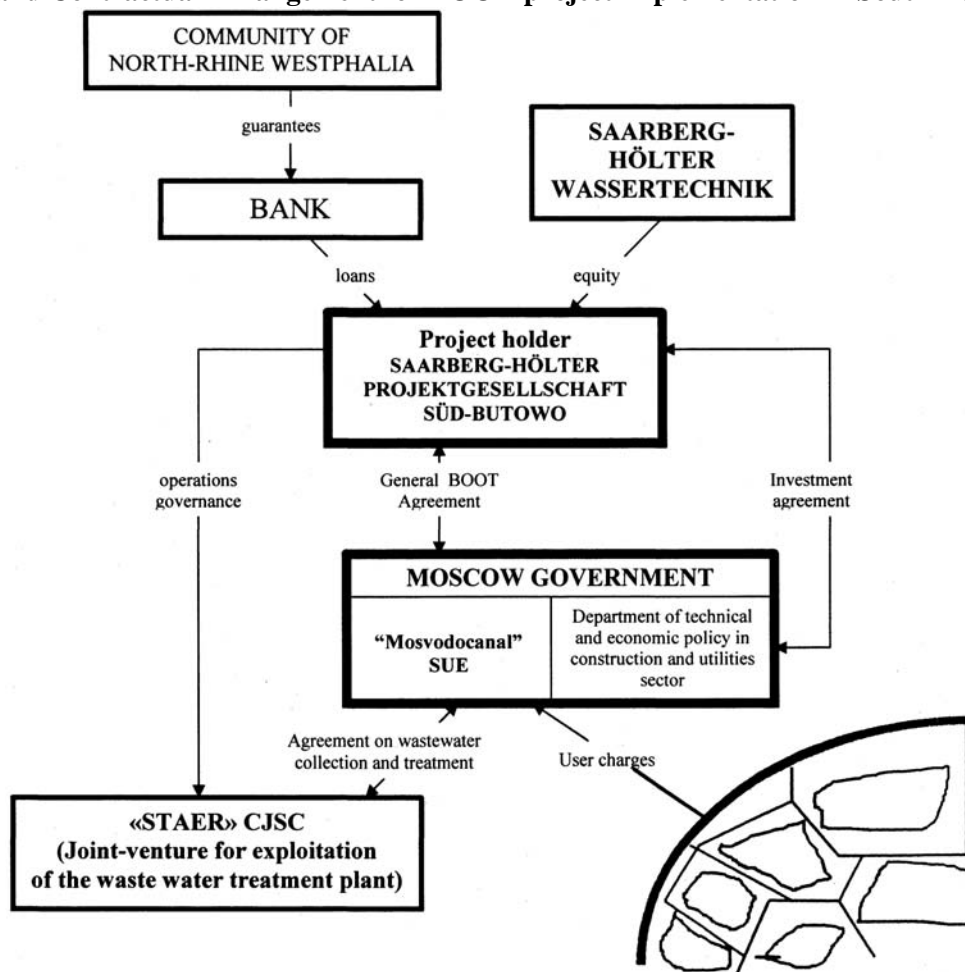
### 3. Brief description of WTE main projects in Russia

#### 3.1. General information about the project in South Butowo

<b>City</b>	<b>Moscow</b>
<b>Services population</b>	<b>250,000 PE</b>
<b>Project Companies</b>	“Saarberg Hölter Projektgesellschaft Süd-Butowo GmbH” is a <i>special purpose company</i> established to manage the project in South Butowo; <i>STAER</i> CJSC is a joint venture company to operate the waste water treatment plant.
<b>Sector</b>	waste water treatment
<b>Form of participation</b>	<b>BOOT</b>
<b>Start of Project</b>	1996

Intensive housing construction in some districts of Moscow led to extremely high demands for wastewater treatment. In particular, it was necessary to build a new wastewater treatment plant in the district of South Butowo. As the company were able to offer the high-quality products and services that were required according to the public tenders specifications, **WTE** was awarded the contract for the design, finance, construction and operation of the WWTP. A BOOT-contract was chosen with a construction period of 17 month and an operation period of 12.5 years.

#### Financial and Contractual Arrangement for BOOT-project implementation in South-Butowo



Source: Hramenkov S.V. (2001), Moscow experience in water supply management and investment projects. Proceedings of French-Russian workshop “Water resources management and water supply delegated management: French-Russian experience”

The BOOT model for the wastewater treatment plant in South Butovo, as well as the mutual powers and obligations of the parties and key financial aspects are governed by a General Agreement signed between the Moscow Government and Saarberg-Hölter Wassertechnik GmbH,<sup>36</sup> which had won an international tender at the end of 1996. The General Agreement stipulated the top investment value, interest rate, and construction timeline. The provisions of the General Contract were elaborated in detail by a series of supplementary agreements, namely:

- Investment Agreement (construction and financing);
- Agreement establishing a joint venture to operate the wastewater treatment facility;
- Operating Agreement for the wastewater treatment facility;
- Agreement to receive and treat wastewater;
- and others.

*Current project status:* The project is successfully underway. The plant, commissioned for commercial operation in 1998, will be managed by **WTE** until 2011. Therefore, the project is already in commercial operation. **WTE** teamed up with Mosvodokanal State Unitary Enterprise (SUE) to establish a joint venture, *STAER* CJSC, which is in charge of operating the plant.

### **3.2. Achievements**

**WTE** constructed the plant which was designed to cope with 250,000 PE and is capable of handling 80,000 m<sup>3</sup> of waste water per day.

**WTE** made a total investment of more than **EUR 31 m**. The investment made by the project company was financed as follows: 25 % - from equity and loans provided by **WTE**, and 75 % - from loans provided to the project company by a bank consortium.

It should be added, that the invested capital is covered against political risks up to 95 % by the Federal Republic of Germany (CL Deutsche Revision and Hermes Kreditversicherung). Additionally to this the community of North-Rhine Westphalia will cover 75 % of the invested capital, because **WTE** has its headquarter in Essen and the subcontractors of the mechanical and electrical equipment will come from North-Rhine Westphalia, too. Fixed assets and all erected buildings and parts of the plants, are put as collateral for the bank consortium till they are paid or better till the loan is paid back to the consortium.

During the investment phase **WTE** gained the money. **WTE plan** with a gross profit of EUR 3.4 m during the investment phase, but the *actual* profitability is now EUR 4.7 m **for the investment phase**. It is not the total accumulated profit for the whole time of the project. This profit concerns only investment agreement with the City of Moscow, not the operational activities.

Since December 1998 the plant has been under operation of **WTE**. During the operation time the company reach a profitability of approximately 10 %.

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<sup>36</sup> Saarberg-Hölter Wassertechnik GmbH no longer exists, having been renamed to **WTE Wassertechnik GmbH** as of January 1, 2002. Concerns Saarberg and Heltter are no longer **WTE**'s parent companies. **WTE** was acquired by a new parent, **EVN AG**, in October 2003.

### 3.3 Project milestones

#### 3.3.1 Investment stage

For the purposes of the wastewater treatment plant project, the tender winner, Saarberg-Hölter Wassertechnik GmbH, established a subsidiary named *Saarberg-Hölter Projektgesellschaft Süd-Butowo* (“Project Holder”) in Germany.

The Project Holder, which took out a bank loan against the government guarantees of the North-Rhine Westphalia Community, acts as the Customer in the construction project, engages contractors, and provides the necessary funding for the project. Contractors are selected on a competitive basis.

To the extent of plant construction and financing, the relationship between the Project Holder and Moscow Government is governed by an Investment Agreement, signed on behalf of the Moscow Government by the Office of Investment Policy and Municipal Funding. Under the laws of Moscow, the Investment Agreement has been entered in the Consolidated Debt Register of the Moscow Government.

When construction was completed in December 1998, the property title to the plant passed to the Project Holder, a non-resident legal entity.

Within 20 years from the date of the plant’s commercial launch, i.e. from 1999 to 2018, the Moscow Government will reimburse the Project Holder in full for its expenses associated with building the plant, whereupon the plant will become property of the Moscow Government. Originally denominated in German marks, all payments are now in euros.

#### 3.3.2 Operational Stage

To ensure that the plant is managed professionally, the Project Holder and Mosvodokanal have established a joint venture named *STAER* CJSC, and the owner of the plant (i. e. Project Holder) has transferred the completed facility into the operational custody of the joint venture under an agency agreement. *STAER* CJSC has taken out all the permits and licenses it needs to operate a wastewater treatment plant in Russia.

Under a separate arrangement with Moscow water utility - **Mosvodokanal** SUE (Agreement to Receive and Treat Wastewater), the joint venture has undertaken to receive and treat water in an uninterrupted manner. For its part, Mosvodokanal collects the user charges **at applicable rates set for WSS by Moscow Government**, and compensates *STAER* company according to a mutually agreed dual tariff, consisting of two parts:

- a flat annual fee to cover the conventional fixed operating costs of the plant; and
- a variable fee, depending on the volume of wastewater treated.

The plant is expected to be handed over to the Moscow Government, and become its property, in a fully functional condition on June 30, 2011. To monitor the plant’s condition and procure equipment replacement as necessary, a Supervisory Commission has been formed comprised of Moscow Government and Mosvodokanal representatives.

### ***3.4. Main obstacles and problems faced by the company***

The South Butowo project was the first project of the company in Moscow, but working closely with Mosvodocanal **WTE** was able to solve all problems in a very short period. Nevertheless **WTE** has to learn a lot about the regulatory framework and the organisational structure of the water sector in Moscow and especially about the City administrations and their several departments, especially in terms of release of documents, drawings etc. According to the financing and inter-governmental fiscal relations **WTE** learnt that the City of Moscow is a very reliable partner, in which one can trust and can count on.

### ***3.5 How the contract was awarded***

In 1996, a bidding commission, established by resolution of the Moscow Government, held an open international tender to find an investor to build a wastewater treatment plant under BOOT conditions. It was a one stage tender, which was won by the aforementioned Saarberg-Hölter Wassertechnik GmbH. The winner was determined by Mosvodokanal in conjunction with the Moscow Government. The selection criteria were as follows:

- The use of the latest wastewater treatment technology;
- The best financial offer on the plant's construction and subsequent operation;
- Minimal construction timeframe.
- The experience in implementing BOOT-projects

The main competitors of **WTE** in this tender were four well-known European companies from France and Great Britain, including Degrémont and VA-Tech.

### **Declaration of Guiding Principles for Cooperation Between Public Authorities, Private Business and Consumers in the Utilities Sector**

**This Declaration adopted by participants in the Inter-regional Housing and Utilities Sector Forum in Vladimir affirms the unity of purposes pursued by authorities, private businesses and consumers as regards the creation of a mature, competition-based housing and utility services market in Russia to enhance the sector's performance and quality of services while preserving affordable service prices. This document lays out the general conditions, principles and priority measures to effectively involve private business in the public utilities sector.**

The housing and utility sector is one of the largest industries in Russia serving the entire Russian population. There are over 25,000 municipalities in Russia and virtually each one has a local water utility, a gas pipeline and heating/power networks. According to the State Committee on Construction of the Russian Federation, the sector comprises more than 52,000 enterprises that employ a total of 4.2 million persons.

The public utilities sector, catering for vital human needs, is experiencing a deep systemic crisis. We are facing a real threat of a technological disaster. The depreciation of fixed assets reaches 50-70%, which results in frequent breakdowns. Neither the population nor the budget or the society in general can afford to preserve the current inefficient, resource-intensive and over-administrated housing and utility system.

In 2001 President Putin qualified housing and utility reform as "the most important reform in our life". The focus on market transformations and promotion of competition in the sector, declared by federal authorities soon thereafter, has generated response on the part of the private business. Commercial initiatives and the emergence of the first private operators in the public utilities sector create a realistic environment for implementing the Government's plans of systemic improvements in the industry and attraction of large-scale investments.

The housing and utility sector is potentially one of the most lucrative investment targets. The magnitude of the communal services sector in Russia (877 billion rubles worth of activities and services and a 5.9% share in total activities and services by Russian companies) indicates that an efficient use of market mechanisms can help raise investments in the sector and transform its production and sales chain into a dynamic business capable of bringing about major improvements in living standards in the immediate future.

To help private businesses successfully operate in the public utilities sector, a new comprehensive system of intra-industry relations must be created where municipalities will shape the demand for communal property management services while private operators will offer competitive products that meet the requirements of both municipalities and residents.

The first practical step in building a civilized utility services market is to lay down and reinforce the key principles to be adhered by all stakeholders claiming to have an interest in the public utilities sector:

1. The cornerstone of any business activity in the public utilities sector is the quality of services provided to the ultimate consumers. The key prerequisite for generating new projects in the sector is solving the task of rehabilitating and developing the existing communal infrastructure.
2. Targeted private business participation in public utilities reform, focusing on specific local projects with active involvement of all stakeholders.
3. Partnership and balance of interests in the process of transforming the communal infrastructure imply an optimal combination of the government's budget opportunities, investment interests of private businesses and solvent consumer demand.
4. The authorities and the business take equal responsibility before the society for the reliability and quality of services provided.
5. In building the system of utility sector regulation, legislators should proceed from the premise that the object of regulation is business activities and that the main criteria are utility service quality standards.
6. Adherence to the principle of fair competition. Creation of a competitive environment by awarding contracts through open tenders. Municipal authorities should rely on qualified expert advice when holding tenders.
7. Creation of transparent relations between the authorities and businesses to avoid reciprocal accusations and damage to reputation when implementing partnership projects in the sector.
8. All stakeholders adhere to the principles of open business in the public utilities sector. Equal access to information through the use of public offers and other options for potential competitor notification.
9. In the social and labor relations area, employers ensure decent remuneration of housing and utility staff, promote human capital growth in the sector and enhance the image of the profession.
10. Complete equality of various consumer groups.

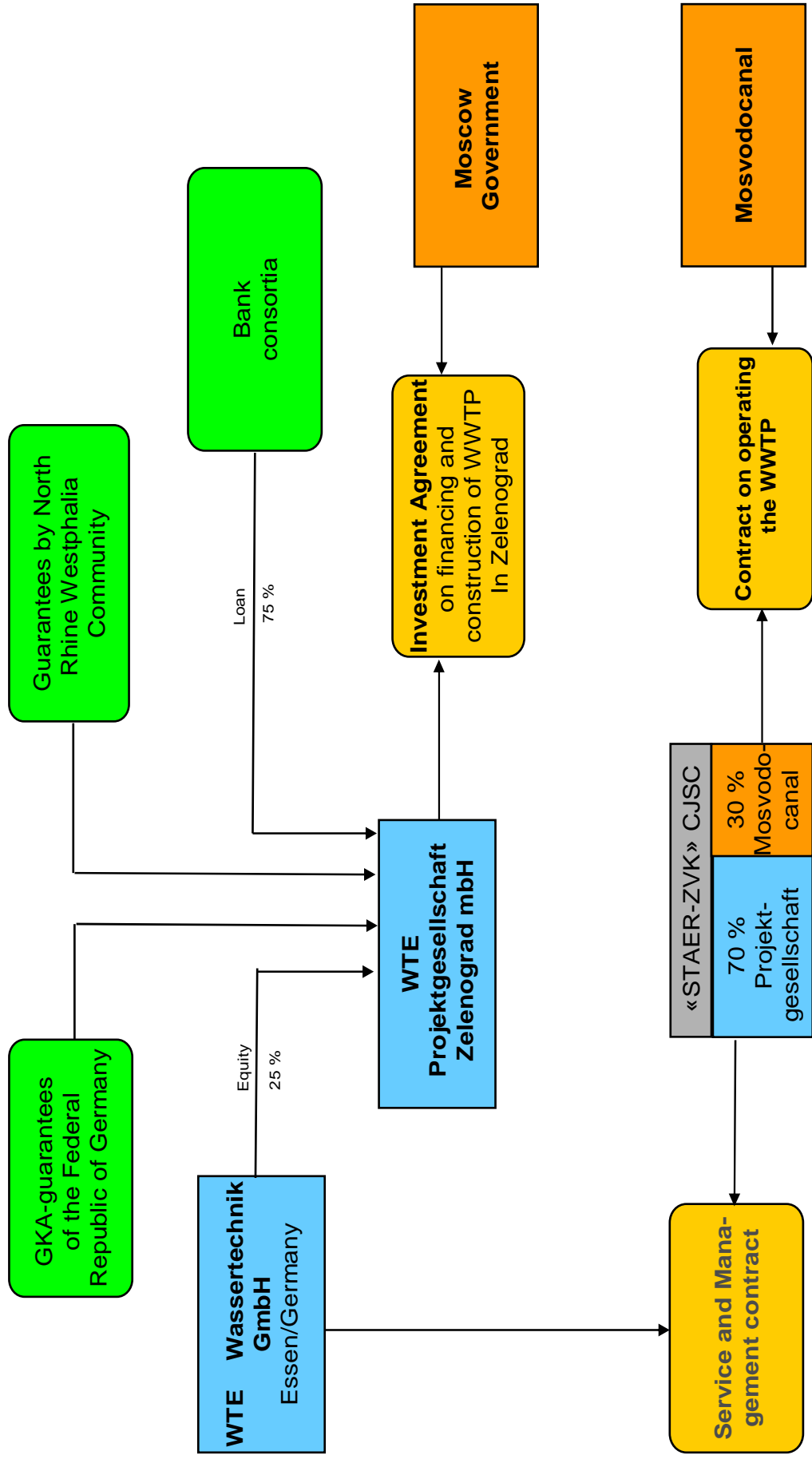
By this Declaration, the participants in the Interregional Housing and Utility Sector Forum in Vladimir serve on the authorities a joint "public assignment" for building a legal framework that will help raise investments, operate and maintain housing and utility infrastructure and guarantee the recovery of investments.

**Proposed priority system solutions to be undertaken by the federal and local authorities:**

1. To motivate private businesses to focus on communal infrastructure rehabilitation and development, initiate the adoption of the necessary legislation to support commercial activities in the housing and utility sector. Put in place the requisite legislative framework to implement concession-based communal infrastructure management arrangements. In tariff regulation, adopt principles providing business entities (private operators) with an adequate profit margin and long-term recovery of investment costs.

2. At the municipal level, create conditions for implementing long-term investment projects to rehabilitate the communal infrastructure, including:
  - arrange stocktakes, registration and adequate evaluation of communal fixed assets;
  - restructure utility liabilities, take measures to secure financial recovery in the sector;
  - draft general local development plans and respective long-range programs for developing communal infrastructure and sources of funding;
  - introduce clear criteria for private operator selection;
  - formulate production plans for private operators;
  - develop and standardize tender documentation.
3. Implement a strategic solution to address the issue of budget financing of allowances, benefits and subsidies by passing over all budget funds used to pay for housing and utility services to recipients, subsequently making them liable for paying the full price of supplied resources and services.
4. Lift restrictions preventing Russian commercial banks from providing long-term project financing.
5. Create an environment promoting investments in the utility sector, including by institutional investors such as pension and insurance funds etc. Based on a transparent investment risk evaluation system, put in place the necessary institutions to provide government guarantees to private investors in the public utilities sector.
6. Step up the efforts of environmental and law enforcement agencies to ensure compliance with environmental requirements and standards by companies operating in the public utilities sector.
7. Design and test an out-of-court settlement procedure for conflicts between counteragents operating in the utility sector (through arbitration tribunal, Union of Consumer Market Operators or other public organization).

## Appendix 2. Financial and organizational arrangement for WTE Wassertechnik GmbH BOOT project in Zelenograd



## QUESTIONNAIRE

### Part I. General presentation of the company.

#### 1.1. General information

Including:

- a. Name,
- b. Legal status and address,
- c. Chartered capital,
- d. Main shareholders and investors

#### 1.2. Domain/sector (water and sanitation, district heating, electricity/gas distribution)

#### 1.3. Brief description of the corporate strategy in Russia

Including:

- a. why the company entered the sector(s);
- b. Company's Mission , Strategic and mid-term objectives and targets;
- c. Business development strategy and business-schemes applied/to be implemented in Russia;
- d. Targeted level of investments for nearest 3-5 years;
- f. Targeted level of capital profitability;
- e. Relations to local community and general public.

#### 1.4. List of the municipalities

in which the company is active (**and in what form**)

(list of towns and cities where the company is implementing main projects with indication of the stage of project development and arrangements applied: lease, management contract, etc .)

### Part II. Brief description and analysis of some (1-3) main projects in Russia

#### 2.1. General information

including

- a. name of municipality;
- b. sector;
- c. form of participation (lease, management contract, concession, BOT etc).

#### 2.2. Achievements

- b. the level of total investments made;
- c. **in that**: the share of private funds (dividing between the Chartered capital, loans and other sources);
- d. improvements in service quality, coverage ratio etc.
- e. improvements in financial position (financial statements and/or financial stability) of the operated utility;
- f. planned and actual average profitability of capital investments;
- g. planned and actual Pay-Back Period.

### **2.3. Detailed description of main problems met**

The main objective of this chapter is to reveal problems related to:

- tariff regulation;
- the whole regulatory framework and failures in organizational structure of the sector;
- public financing and inter-governmental fiscal relations;
- unfair competition, resistance from local community, etc.

**a.** Description of main obstacles and problems faced by the company:

- (1) during negotiations with municipality,
- (2) during project implementation.

**b.** Short description of **how the tariff policy have been improved/implemented in selected areas**, its strong features and failures:

- (1) who regulates;
- (2) what are the formal procedures
- (3) how the tariff regulation affects operational and investment plans

### **2.4. How the contract was awarded**

If we speak about *private* company it is interesting to know **how it obtained the contract**:

- with or without the competitive tender
- what was the local support for this decision
- who took the decision: only head of local administration or also the deputies of local Duma, or maybe the entire local community (e.g. by voting )
- was there any resistance (social protests, negative publications etc.)

### **2.5 How are private investments and interests protected in the selected arrangements**

#### **III. Summary:**

**WHAT ARE THE MAIN CHALLENGES and PROBLEMS IN DOMESTIC PSP** which have been met/identified **by the company** so far