A Viable Framework for Private Investment in the Utility Sector: an analysis of the 2005 law On Concession Agreements

A Summary

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21 May 2006

Introduction

Over the past decade a number of countries have established a comprehensive legislative framework designed to attract private investment into public infrastructure, i.e. the transport and public utilities sectors. Perhaps most prominently the Private Finance Initiative (the PFI) in the UK has provided an alternative to privatisation in developing a new approach to the procurement and delivery of services by the government. Significant changes have also been introduced across South East Asia, South America and Central Europe where new general or sector specific laws governing private participation in infrastructure have been adopted as part of the measures taken to support the transition to a market-based economy.

The law On Concession Agreements of the Russian Federation (hereinafter the Law) that entered into force on 21 July 2005 represents the Russian attempt to derive the benefits afforded by the adoption of such a legislative framework. [1] Indeed, it was with the intention of concluding concession agreements for the operation and development of both infrastructure and networks that a number of long-term lease contracts were concluded in the water supply and wastewater sectors before July 2005.

This article identifies and describes the novelty of the concession agreement, as proposed by the Law; that it consolidates at least some of the basic conditions of an investment project within a single framework. In examining its efficacy in creating a framework for private investment, however, the central theme of this article is an analysis of how the Law fails to clearly identify the legal nature of the obligations and rights assumed by the parties towards one another, and in turn the related rights and obligations created by them with third parties.

Defining the legal nature of the relationship between the parties to a concessions agreement should not be viewed as a peculiarly Russian problem. In all jurisdictions the need to attain a balance between the interests of investors and consumers, in the provision of what are essentially social services, has been recognised. In France this is attempted within the framework of administrative law, the law providing acceptable conditions for private investors to invest in state property whilst simultaneously securing that the operation of the asset and the provision of the services is not interrupted. In contrast, it is precisely in the Russian attempt to promote the co-existence of an administrative and civil law approach within the Law itself that the root of many of the problems hindering the Law's implementation are identified.[2] This article identifies how this duality of approach is a

[1] Law No. 115 fz of 21 July 2005 O kontsessionnykh soglaseniyakh (hereinafter the Law). *Rossiiskaya Gazeta* 27 July 2005 No. 161.

[2] The Law expressly describes in article 3.2 a concession agreement as being of both a civil and non-civil law nature.

sympton of not only the compromise nature of the Law itself, but the very nature and scale of the reform that is required in the water utilities sector.

With regards to the former point the article details how the Law, in addition to its failure to permit the concessionaire to assign any of his rights under an agreement, lacks a number of the provisions commonly found in concession legislation. Most notably it fails to provide a method for the adjustment of payments that provides an assurance to a concessionaire that he will be protected from an unexpected change in economic circrcumstances, aswell as a clear identification of the circumstances upon which the concession agreement may be amended or terminated, and the consequences thereof.[3]

With regards to the latter point the article emphasises that as a result of the current circumstances, where unclear regulations, entrenched public monopolies without a viable economic base, a lack of transparency about the financial status of utilities, and a lack of commercial tariffs, predominate, the nature of the reform that is required is all-encompassing. The erection of a framework for the development of concession agreements not only requires the implementation of the Law, but, in addition, demands the integrated development: of the fiscal relationship between national and municipal government; of social policy, i.e. tariffs and subsidies, and; of access and right of usage rules. It is in this context that the article explores the challenges faced in introducing viable concession agreements in the water supply and wastewater sectors, the sectors in which the government has stated its intention to grant concessions for the operation and development of both infrastructure and networks in 2006.

1. Concession Projects in the Context of the Reform of the Municipal Economy

The ending of the system of unfunded benefits and the introduction of targeted subsidies must be viewed as inextricably tied to this reform of tariffs, as a necessary pre-condition to the identification and transfer of the assets of unitary enterprises, and, as a consequence, the establishment of contractual relations between the producer, the supplier, and the consumer. These changes need to be effectively legislated for and implemented if a long-term concession agreement, as envisaged by the Law, is going to be sustainable.

At present benefits are distributed as a discount for households on their utility bills. The municipal budget is supposed to compensate the unitary enterprise for this but in reality this does not happen; the municipal government covers the cost of the provision of such benefits through offsets to the unitary enterprise. The current operator of a lease or management agreement is as a consequence unable to register such losses as debts and remains liable for VAT which is currently based on invoiced revenue.

The law commonly referred to as the law On the Monetarisation of Benefits (hereinafter On Monetaristion)[4] is an attempt to end the system of in-kind benefits between unitary enterprises

[3] It is maintained that it is the new law On Tariff Regulation, rather than the Law itself, that contains key provisions aimed at maintaining the balance of relations between suppliers and consumers, whose application will determine whether private investors can expect to recover costs when investing in the utilities sector. Law No. 210 fz of 30 December 2004 Ob osnovakh regulirovaniya tarifov organizatsii kommunal'nogo kompleksa (hereinafter the law On Tariff Regulation) came into force on 1 January 2006. Sobranie Zakonodatel'stva RF (hereinafter SZRF) 3 January 2005 No. 1 p. 36.

[4] Law No. 122 f3 of 22 August 2004 O vnesenii izmenenii v zakonodatel'nye akty rossiiskoi federatsii I priznanii utrativshimi silu nekotorykh zakonodatel'nykh aktov rossiiskoi federatsii v svyazi s prinyatiem

and municipal government. As the sub-programme entitled 'The Reform and Modernisation of the Housing and Utilities Complex for 2002 through 2010' has recognised, setting tariffs at cost-recovery levels requires that subsidies are output-based with targeted recipient households.[5] The fundamental problem with the monetarisation of benefits remains, however, that the state budget covers only 50% of all guaranteed benefits. The federal government has transferred the problems caused by this very fact, the task of co-ordinating income and distributing benefits being passed to the municipal governments. The municipal governments have too little fiscal authority to cover the cost of providing benefits, the result being the reforms' large-scale non-implementation. As a consequence the provisions of the new law On Monetarisation have not been applied to housing and utility benefits. Without the reallocation of subsidies from producer to consumer as direct payments tariffs cannot be raised to improve cost recovery, and as a consequence cross-subsidisation remains the only alternative in current circumstances to overcome fiscal constraints.

A key aspect of concessions legislation is normally a guarantee that the tariffs received by the concessionaire cover all operational costs, that the value of fixed assets are preserved, and that contract performance is related to tariff levels. This can only be partially served by addressing the issue of the capacity of customers to pay tariffs by way of targeting subsidies. Crucially, whilst at the rhetorical level the goal of full cost coverage remains unchanged, a consensus has not been reached on the speed of the transition or on the methods of such a transition. As a consequence, the responsibility for setting tariff rates for utilities has been dispersed.

The authority of the municipal government to approve norms of consumption of housing and utility services has been previously confirmed.[6] Furthermore, as from 1 January 2006 water and sanitation services have been removed from the 'regulated tariff list' and transferred to within the competence of municipal government, i.e. water tariffs no longer need to be approved at the regional level of government by the so-called 'territorial energy commission.' In contrast, however, the regional energy commission, as the executive body of of the regional government responsible for tariff regulation, continues to set tariff levels for hot water, electricity and gas. Thus, whilst the tariff for heating is regulated by an executive body of the regional government, it is the municipal government that will be the concedent in a number of the concession agreements that are envisoned. The municipal government will appear as a party to such an agreement whilst the mechanisms for securing obligations, i.e. tariff levels, are in effect determined by a body that has not participated in the preparation of the investment programme.[7]

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federal'nykh zakonov o vnesenii izmenenii i dopolnenii v federal'nyi zakon ob obshchikh printsipakh organizatsii zakonodatel'nykh I ispolnitel'nykh organov gosudarstvennoi vlasti sub'ektov rossiiskoi federatsii I ob obshchikh printsipakh organizatsii mestnogo samoupravleniya v rossiiskoi federatsii. SZRF 30 August 2004 No. 35 p. 3607

5 Resolution of the Government No. 797 of 17 November 2001 O poprogramme Reformirovanie I modernizatsiya zhilishchno-kommunnal'nogo kompleksa Rossiiskoi Federatsii na 2002-2010 gody. SZRF 3 December 2001 No.49 p. 4622.

6 Resolution of the Government No. 707 of 18 June 1996 Ob uporyadochenii sistemy oplaty zhil'ya I kommunal'nykh uslug. SZRF 24 June 1996 No.26 p. 3139, Resolution of the Government No. 887 of 2 August 1999 O sovershenstvovanii sistemy oplaty zhil'ya kommunal'nykh uslug I merakh po sotsial'noi zashchite naseleniya. SZRF 16 August 1999 No. 33 p. 4116.

7 The stated aim is to erase this contradiction by way of drafting a set of methodologies for each sector; it is intended that whilst the respective methodologies will be prepared at the federal level municipal governments will possess the authority to develop their own methodologies to monitor actual performance. The role of the executive body of the regional government will be reduced to that of approving the methodology in terms of

Given the uncertainty of tariff collection and cost recovery there needs to be stipulated a clearly identified link between the investment programme in the contract and tariff revision. Adjustments should be made automatically in the event of a substantial change in commodity prices having an impact on the structure of enterprise costs. This link is not adequately provided for, there being a clear absence in the Law of an obligation of the municipal government to secure the regulation of tariffs in correspondence with competitive conditions and changes in market conditions.[8]

As for the performance levels to be achieved by the concessionaire, the contractual provisions of a concession agreement which relate to tariffs should be subject to a revision mechanism in order to ensure that the utility at all times benefits from a level of tariffs which permits its adequate development. To date, however, the risk faced by the concessionaire due to the lack of a clearly defined mechanism has actually been exacerbated by the introduction of an amendment in the law On Tariff Regulation in December 2005 allowing the federal government to establish limits for tariff increases until 2009.

2. Assets and Ownership

Before concession agreements are even negotiated a more immediate issue first needs to be addressed; the identification of the asset that is to be the subject of such an agreement and its legal owner by way of the registration of that aforementioned asset. Only after this has been done and the assets held by unitary enterprises are transferred to legal entities are such assets capable of being the subject of a concession agreement. The agreement must proceed from a proper initial evaluation of the condition of the utility as there is a need to reach a balance between the extent of performance level required from the concessionaire and the level of investments to be made in the infrastructure throughout the concession agreement.

At present, the majority of utility enterprises remain under 'economic management', a type of right peculiar to a 'transitional' legal system as the right can only be held by unitary enterprises established on the basis of municipal property.[9] Although unitary enterprises holding the property under the right of economic management are liable for their debts, the municipal government is not liable for the debts incurred by the enterprise.[10] Furthermore, although the Civil Code does not forbid the taking of a mortgage on municipal property article 295 requires that if the property is held under the right of economic management the unitary enterprise must obtain the agreement of the municipal government before offering such property as a collateral.[11]

The development of the very pre-conditions for the conclusion of a concessions agreement is therefore dependent upon the delimitation of municipal property. In reality the process of the

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achieving cost recovery. It should be noted, however, that in the event of a dispute it will be necessary for the concessionaire to initiate a court action to quash any unfounded decision that has been made.

8 Article 10.2 and 20 of the Law

9 Article 113 of law No. 52 fz of 30 November 1994 O vvedenii v deistvie chasti pervoi grazhdanskogo kodeksa rossiskoi federatsii (hereinafter the Civil Code). SZRF 5 December 1994 No. 32 p. 3302

10 Article 56 of the Civil Code

11 Article 295 of the Civil Code

identification and registration of municipal property is likely to take years to complete as assets were transferred into 'municipal ownership' in 1995 without any proper legal documentation. The concessionaire's right of 'use' of the concession property is likely therefore to be disputed. The government has suggested that if a concession agreement is concluded and it is later found out that the municipal government, as concedent, did not own the asset that was the subject of the agreement, the municipal government would be deemed to have violated its obligations under the agreement. At the very least this liability should be expressly identified in the Law, and, more importantly, in such circumstances adequate compensation must be guaranteed for the concessionaire. The real solution to this problem lies, however, in the increasing imposition of restrictions and regulations on the operation of municipal and regional unitary enterprises, a development that would provide an incentive for management to corporatise. The transitional right of economic management could, as a consequence, be eliminated.

3. Conditions of a Concession Agreement

In a concession agreement there must be mechanisms, related to performance indicators, making the agreement's amendment possible, as well as a clear division of obligations between the concessionaire and the concedent. Many current lease and trust management agreements fail to clearly define the obligations of the parties, include no procedure for tariff revision, and neither stipulate the limits of 'appropriate use' of the property nor what 'operating' the asset actually entails. The impact of such absences and lack of clarity on the actual operation of the asset are multifarious, i.e. in the event of a failure to value assets it remains impossible to define the concessionaire's tax liability.

In a similar vein, there is a need to precisely define in the concession agreement the investment obligations of the concedent as well as the application of the proceeds and timeframe for such investments. Crucially, there is a need to identify responsibility for maintenance works and replacement works. As the Law does not provide for a classical 'Build Operate Transfer' (hereinafter BOT) concession agreement the concessionaire should be responsible for maintenance works as they directly relate to the operation of the utility whilst the concedent will be responsible for replacement works.[12] To avoid any ambiguity it needs to be expressly identified in sub-legislation what is considered to be routine maintenance and what is considered to be capital expenditure.

Responsibility should be divided in accordance with the legal and regulatory framework applicable to the utility and the manner in which the parties determine to be most appropriate for the satisfaction of the performance indicators in the concession agreement. The timeframe for the satisfaction of performance level can then be based on an evaluation of the technical, financial and general capacities of the utility throughout the term of the agreement and not demand a level of performance that may adversely affect the satisfaction of other performance indicators.

Conspicuous absences from the Law itself are a number of provisions typically found in such legislation in other jurisdictions that ensure a balance of interests over the long-term, and both

[12] Article 3.1 of the Law

allow for the effective transfer and mitigation of risk. Indeed, the UNICTRAL Guide[13] stresses the importance of providing a legislative framework within which contractual mechanisms can be employed that deal effectively with the consequences of either legislative changes or unexpected changes in economic circumstances, thus preserving the long-term sustainability of infrastruture projects.

As has already been stated, perhaps the most important provision of a concession agreement is that regulating the procedure for tariff revision. This is in turn dependent upon the establishment of a clearly defined investment programme as it is on the basis of the investment programme that the financial requirements of the concessionaire are calculated, and it is on the basis of the established financial requirements that tariff levels are set in accordance with the law On Tariff Regulation.[14] By way of the application of these and other provisions of the law On Tariff Regulation a concession agreement may also be amended so as to secure the ability of the concessionaire to meet the financial requirements demanded by the investment programme in the event that the revenue from the operation of the asset drops.[15]

It is expressly stated that in the event that a loss of revenue occurs, whose cause is expressly contained within the Law, the concessionaire may apply for an 'early' revision of the tariff level.[16] The Law, however, provides only restricted grounds for the amendment, i.e. where the loss is caused by a change in legislation, this definition of legislation expressly excluding changes in legislation regulating the environment and public health.[17] Furthermore, provisions are currently lacking that identify the circumstances upon which this early revision mechanism can be triggered. In order to comply with international practice the Law should identify under what objective circumstances an amendment to the tariff can be made, such an unambiguous calculation requiring that the government also draft further resolutions outlining methodologies for the preparation of the investment programme, as well as for the calculation of tariffs. It is of crucial importance that the Law regulates such a situation given the fact that an obligation placed upon the concessionaire by the Law to grant privileges and discounts to household consumers.

As well as there being a revision mechanism allowing for the modification of the level of performance, legislation must contain provisions that deal with contractual re-negotiation. There appears to be a reluctance to include such a 'merger clause' in the model concession agreement being developed by the Russian government as it is thought that such a clause would have a negative impact upon competition. The Law should therefore expressly identify a 'pay out' by the state as an alternative to the right of the concessionaire to re-negotiate the agreement.[18]

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[13] At its 33rd session (July 2000) the United Nations Commission on International Trade adopted the UNICTRAL Legislative Guide on Privately Financed Infrastructure Projects (Official Reports of the General Assembly (A/55/17).

[14] Articles 2.6 and 2.18 of the law On Tariff Regulation

[15] Articles 13.6 and 13.7 of the law On Tariff Regulation

[16] Article 14.1 of the law On Tariff Regulation

[17] Articles 20.1, 20.2, and 20.3 of the Law

[18] In terms of securing the implementation of such a provision, the model concession agreement, that is to be passed by way of government resolution, should expressly provide that in the event of any premature termination an immediate payment be made to the concessionaire of the full market value of the improved or constructed asset, this value to be no less than the amount spent by the concessionaire after the deduction of

A key challenge of creating a viable framework for the third party financing of concession projects in any jurisdiction is that a concessionaire's primary asset is usually a contract right, the concession agreement, which may be the subject to termination in the event of a concessionaire's non-compliance with its obligations. The Law provides a wide unfettered scope for the concedent to submit an application for termination based on a breach of what amount to an onerous set of obligations.[19] Furthermore, the existence of a breach can be easily substantiated in light of the Law's failure to regulate the non-fulfilment by the concessionaire of his obligations under the concession agreement as a result of circumstances out of his control.[20] The Law therefore should establish an independent regulatory authority that can provide for an adequate assessment of the performance of the contractual obligations by the concessionaire.

4. Security of User and Third Party Rights

The Law is unclear about what type of right is being granted to the concessionaire, i.e. when the title to a newly constructed object is transferred to the state.[21] In addition, the Law does not clearly stipulate that the object is transferred to the concessionaire,and that only the concessionaire has the right to establish rules and conditions for the conduct of business on the territory of his concession.[22] As a consequence, the legal nature of the rights and obligations that may arise between the parties themselves, and the concessionaire and third parties, are unclear.

The Law provides for the grant of a lease right to land under the concession object.[23] At present, and of practical significance, is the fact that the concessionaire is not granted the automatic servitudes that are necessary for the exploitation of the subject of the concession, i.e. for transportation purposes. It is proposed to resolve this by way of affording the concedent the necessary servitudes as owner, the servitudes then being transferred to the concessionaire as part of the lease contract. This should be supplemented by an express provision in the concession agreement itself that upon the signature of the land lease the concessionaire shall have the full legal right and ability to access the project site from all roads.

Of greater significance is, however, the fact that the concessionaire is prohibited, by the Law from pledging the subject of the concession agreement,[24] this prohibition extending to the transfer of the concessionaire's rights under the lease contract to third parties.[25] In practice, this legislative prohibition on the assignment of rights prevents the secured financing of concession projects. In other jurisdictions, where both the ownership right is granted to the concessionaire and the pledge of the subject of the concession agreement is permitted (what is

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tax. In addition, it should expressly provide the concessionaire with a grace period to cure the alleged defect identified by way of written notice.

[19] Article 15.2 of the Law

[20] Article 12.3 of the Law

[21] Article 3.1 of the Law

[22] Article 3.9 of the Law

[23] Article 11.1 of the Law

[24] Article 3.6 of the Law

[25] Article 11.2 of the Law

referred to as a Build Operate Transfer project), 80% of the project financing is typically provided by third parties. If financing is to be accessed by future concessionaires, thus making projects viable, the Law must be amended to allow for the assignment of the rights of the concessionaire, as well as the pledge of rights under the concession agreement without the prior consent of the concedent.

This inability to use the concession object as collateral is exacerbated by the practical impossibility of pledging the future revenue stream as a result of regulations introduced by the Central Bank of Russia applicable to the collateralisation of a non-material asset. It is common practice in a concession agreement for financing to be raised against the revenue stream. At the very least, in concession agreements where the government is the main purchaser of services by way of shadow tolls or by service payments, the revenue stream should be expressly stated in legislation in general as being the possible subject of a security.

On a related point, if the concedent is to be able in practice to guarantee the difference between the actual maintenance and operating cost on the one hand, and tariffs collected on the other, legislation needs to be reformed so that sectoral agencies can issue guarantees.[26] In addition, the Budget Code needs to be amended so that where the cost of calls on guarantees is potentially of significance to fiscal policy allowance be made in the budget to meet the expected cost.[27]

As has already been noted, the Law does not adequately regulate the termination of the concession agreement, leaving both the concessionaire and any creditors exposed. In the event of the termination the agreement the revenue of the concessionaire is in effect expropriated, and as a consequence his ability to service any loans is extinguished. It is necessary therefore at the very minimum to amend the Law so that either the creditors have an automatic right to be repaid from the revenue stream, or the concedent has the right to take over the operation of the infrastructure with the creditors being adequately compensated.

Finally, both the 'use' right granted to the concession object and the lease of the adjoining land that are granted remain vulnerable to privatisation. Security for the concessionaire is in fact provided by provisions of the law On the Privatisation of State and Municipal Property which states that only property that has no obligations attached to it may be privatised.[28] Instead, this should be expressly stated in the Law itself.

Conclusion

The Law embodies an alternative approach to that possessed by other 'investment' laws, namely to exclude activity from the jurisdiction of general legislation. In contrast to the law On Foreign Investment[29] and the law On PSAs[30] the Law neither possesses an effective

[26] Article 13.3 of the Law

[27] Law No. 145 fz of 31 July 1998 Biudzhetnyi Kodeks RF. SZRF 3 August 1998 No. 31 p. 3823.

[28] Law No. 178 fz of 21 December 2001 privatizatsii gosudarstvennogo I munitspal'nogo imushchestva. SZRF 28 January 2002 No. 4 p. 251.

[29] Law No. 160 fz of 9 July 1999 Ob inostrannykh investitsiyakh v Rossiiskoi Federatsii. SZRF 12 July 1999 No. 28 p. 3493.

[30] Law No. 225 fz of 30 December 1995 O soglasheniakh o razdele produktsii (hereinafter the law On PSAs). SZRF 1 January 1996 No. 1 p. 18

stabilisation clause nor guarantees, the liquidity of an investment further being reduced by the mandatory reference of disputes to commercial state courts.

Indeed, in contrast to the provisions of the law On PSAs and corresponding amendments made to tax legislation, there has been a general failure to introduce a set of provisions in the Tax Code clearly establishing the concessionaire's tax liability, leaving the concessionaire liable for a plethora of federal and municipal taxes. The practical problems caused by the failure to amend tax legislation so as to correlate with the reform of civil legislation is perhaps best illustrated, however, by the fact that the concessionaire is liable for the payment of VAT on all sevices invoiced. The concessionaire is therefore not able to register losses resulting from the non-payment of services provided, a problem that is likely to persist in light of the decision not to monetarise benefits for utility services.[31]

As has been identified in this article, however, the Law's major flaw lies in its attempt to combine elements of both an administrative and civil law approach. In light of this confusion, it is apparent that instead of focusing on long-term concession agreements the government should focus on establishing a viable framework for the further development of simple management and lease contracts. Indeed, the Law's passage does not embody a common aim between the government and potential concessionaires with regards to the development of a framework for private investment. The very fact that the Law identifies the subject of an agreement as the asset and not the business performance of the concessionaire has resulted in a number of current operators in the water supply sector expressing their disinterest in entering a concession agreement on the grounds that the current assets and infrastructure are too large to operate profitably.

Notwithstanding this recognition it should not be forgotten that a viable framework, applicable to both long-term concession agreements and short-term lease agreements must be established before either type of project can be initiated. The establishment of such a framework is, as has been emphasised, dependent upon the initial identification and registration of assets, and thus the implementation of the proposed reform of the municipal economy. Its implementation is in turn inextricably linked to the ending of the system of unfunded benefits and the introduction of targeted subsidies, a necessary precursor to the reform of the regulation of tariffs. Only then will the public be able to benefit from private sector financing, as only then will the quality of services be truly contractible.

The successful performance of concession projects is also dependent upon the effective transfer of risk from the public to private sector. This is in turn based upon the achievement of impartaility in the award of concessions, and in their regulation. The development of such an approach demands a fundamental change in the relationship between regulatory authority and the private sector.

Finally, the maintenance of a balance between the concessionaire and concedent requires the active but impartial intervention of administrative courts. In this sense the French experience provides another point of comparison, of how the operation of a concession agreement requires flexibility, the scope of which must be defined by the judicial system. French legislation allows the concedent to modify the provisions of a concession agreement which are regulatory in their nature and which are not exclusively in the purview of contractual

[31] Law No.117-fz of 5 August 2000 Nalogovyi kodeks RF (hereinafter the Tax Code). SZRF 7 August 2000 No. 32 p. 3340.

negotiation. In such circumstances the administrative courts have recognised the right of the concessionaire to receive financial support from the concedent.[32] The very failure of the Russian government to implement the so-called 'administrative reform' and as a consequence to transform the system of regulatory authority, coupled with the failure to establish an effective system of administrative justice, in this comparative perspective as the most immediate impediments to the viable operation of concession agreements.

[32] A mixture of private and public financing is supplied in the following way: investment subsidies for financing works and the building of the concession; net loss compensating subsidies to cover net losses incurred by the service; and indemnities to cover unenforceable costs resulting in a loss of economic equilibrium of the concession.