



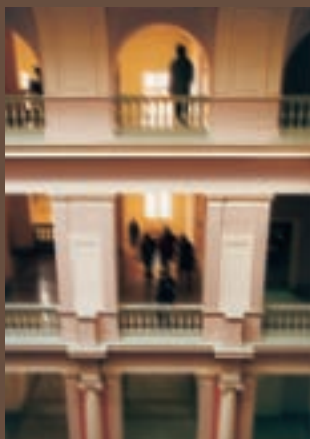
Law in transition 2007

- Public-private partnerships
- Legal reform in Russia



European Bank
for Reconstruction and Development

Law in transition 2007



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The European Bank for Reconstruction and Development (EBRD) is an international institution whose members comprise 61 countries, the European Community and the European Investment Bank. The EBRD aims to foster the transition from centrally planned to market economies in countries from central Europe to central Asia.

The EBRD's countries of operations are: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Mongolia, Montenegro, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

The EBRD works through the Legal Transition Programme, which is administered by the Office of the General Counsel, to improve the legal environment of the countries in which the Bank operates.

The purpose of the Legal Transition Programme is to foster interest in, and help to define, legal reform throughout the region. The EBRD supports this goal by providing or mobilising technical assistance for specific legal assistance projects which are requested or supported by governments of the region. Legal reform activities focus on the development of the legal rules, institutions and culture on which a vibrant market-oriented economy depends.

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Foreword

Boosting private sector participation in infrastructure

Jernej Sekolec, Secretary,
United Nations Commission on International Trade Law (UNCITRAL)



Throughout the world, the use of public-private partnerships (PPPs) has boomed in recent years as states and municipalities work with the private sector to modernise and develop much-needed infrastructure. Despite the huge interest in, and increasing use of, such partnerships, however, many countries still struggle with difficulties in planning, negotiating and implementing PPPs. It is very encouraging to see that governments in transition countries are interested in finding ways to surmount those difficulties, and that the EBRD is at the forefront of assisting them in this.

A key element is the sharing of risks and responsibilities between the state or municipality and a private party. From a legal standpoint, the PPP experience to date is based on concessions or other contractual arrangements whereby the private sector undertakes to provide services of a public nature. Best practice calls for each element of risk to be allocated to the party which is best equipped to manage it, so that risk can be minimised altogether.

When properly structured, PPPs offer a number of benefits to both the authorities and private sector, and, ultimately, to the public. However, they are not a panacea for rendering public services effectively and each project should be assessed carefully. Indeed, PPPs are highly sophisticated structures which require well-functioning legal frameworks and they may not be suitable for all projects. In contemplating and implementing private financing of public infrastructure, governments face many challenges, one of the most important being policy formulation, that is, the basis on which the legal framework can be developed and the institutional infrastructure implemented.

UNCITRAL has a long history of model law development in various areas, including PPPs. In 2000 it adopted

the *UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects*. This was followed in 2003 by the development and approval of the *Model Legislative Provisions for Privately Financed Infrastructure Projects*. The *Guide* has become a useful tool providing state actors with essential summaries of best practices, as well as vast explanatory materials and recommendations.

It is a source of pride for UNCITRAL that the EBRD has chosen the *UNCITRAL Guide* as the primary standard for benchmarking the quality of laws in the region where it operates. Cooperation between the two organisations is long standing. Besides mutual participation in conferences and seminars, it has included an invaluable contribution by the EBRD and its legal department to the preparation of the two publications mentioned above. Given the boom that the private financing of public infrastructure is currently experiencing, I am optimistic about opportunities for cooperation in the future. Indeed, the potential in transition countries is immense. The majority of them have only recently started experimenting with non-conventional forms of procuring public contracts and the trend is to consider as many options of public-private arrangements as possible to achieve high quality of services and best value for money.

One area where increased technical assistance will be needed in the short term is the training of public officials on negotiating well-balanced PPP contracts with experienced private sector counterparts. Obviously, both parties need good transactional skills to reach a fair, sustainable agreement.

For the EBRD's countries of operations that are still at the initial stage of public-private cooperation implementation, all the excitement lies ahead.

In Kazakhstan, Poland, Russia and Ukraine, whose vast territories represent constant challenges for the delivery of public services, private sector participation may become the solution for the modernisation that is so badly needed. The municipal sector, transportation, health and education are traditionally among the first areas where PPPs are tested and it is in these areas that they could prove especially valuable for these countries.

The current issue of *Law in transition* provides an extremely useful overview of many current issues regarding private financing of public infrastructure. Readers will no doubt appreciate the contributions of recognised specialists in the relatively small community of international PPP expertise. It is hoped that this issue of *Law in transition* will promote a greater understanding of public-private cooperation mechanisms and, perhaps, spark ideas for new projects.

Because this issue of *Law in transition* is being published at the time of the EBRD's annual meeting in Kazan, Russia, articles on concessions and PPPs are combined with a stream of materials on Russia: the current status of its economic and legal development, the challenges ahead and the government's plans to upgrade its legislative framework.

Everyone with an interest in fostering transition in the region where the EBRD operates will find excellent food for thought in this new issue of *Law in transition*, which comes as a judicious reminder of the need to promote further the rule of law in that part of the world.

Jernej Sekolec

Public-private partnerships

For over a decade, various forms of private sector involvement in public contracts, particularly in infrastructure, have attracted increasing attention globally. The need for flexibility in public service provision coupled with the increased demand for modern infrastructure projects and the implementation of national initiatives have led to a wave of demand for public-private partnerships (PPPs) as an instrument of providing public services while sharing responsibilities between private businesses and authorities. The establishment of PPP units in a number of countries since the end of the 1990s as well as the introduction during the same period of modern, or at least modernised, laws governing concessions has facilitated the implementation of various forms of Build-Operate-Transfer type of arrangements both in Europe and globally. A good number of the EBRD's countries of operations have adopted a policy towards PPPs, enacted new laws and used at least some forms of PPPs in practice.

The articles in this section look at the legal framework and the general environment for PPPs in transition countries, providing views on what has worked well and what has gone wrong. The articles also consider the prospects for PPP development, while cautioning against overly optimistic

conclusions. Indeed, each PPP project should be assessed on its own merits and implementation of foreign experience is not a guarantee of domestic success. The section begins with an article by Alexei Zverev, EBRD Senior Counsel, and Milica Zatezalo, of the law firm Gide Loyrette Nouel. They analyse the results of the 2006 EBRD Legal Indicator Survey which focused on how concessions laws work in practice. The article discusses the differences and similarities of the various countries' regimes based on a case study and illustrates their findings with a rich spectrum of charts and graphs. François Gaudet, EBRD Principal Banker, looks at PPPs from a banker's perspective and presents the EBRD's financing experience in the field. Geoffrey Hamilton of the UNECE provides an outlook on PPPs from the point of view of a global organisation, while Peter Snelson of Atkins Ltd offers his experience of handling projects in central and eastern Europe as a private sector consultant. The focus section concludes with an article by Christopher Clement-Davies of the law firm Fulbright & Jaworski, examining how legal theory and project practice can be combined to help identify the key issues in implementing PPPs.

The image shows the grand, ornate stone entrance of a building. The entrance is framed by two large, fluted columns and a decorative archway. Above the archway is a coat of arms featuring a crown and a shield with a red cross. The double doors are made of dark metal with intricate gold-colored scrollwork and designs. A person in a dark coat is standing in the doorway, looking towards the interior. The building's facade is made of light-colored stone blocks.

**Concessions laws
in transition countries:
the EBRD's assessment**



Alexei Zverev
Senior Counsel,
EBRD



Milica Zatezalo
Senior Associate,
Gide Loyrette Nouel

In transition countries, the legal environment for concessions, which is vital to the implementation of many types of public-private partnerships (PPPs), has much scope for improvement. Most countries need to implement further legal and institutional reforms to allow PPPs to work effectively.

Concessions law plays a vital part in the implementation of many types of PPPs. Under a concession arrangement, a public authority entrusts to a private sector operator total or partial management of services for which that authority would normally be responsible and for which the private sector operator assumes all or part of the risk.¹ A key feature of concessions is the right of the private operator to exploit the construction or service granted as a consideration for having erected the construction or delivered the service.² For a number of years, the EBRD has been evaluating both the quality of national laws that are essential to the investment climate and their workability throughout its countries of operations. Recent evaluations were devoted to concessions legislation and practices.

There are numerous ways in which the private sector may invest in public infrastructure. Depending on the level of associated risk, the variety of possible contractual arrangements ranges from public procurement, where a contractor does not assume project risks, to privatisation, where public assets or shares in a publicly

owned company are disposed of to an investor together with all associated risks. Arguably, the most interesting and sophisticated arrangements lie in the median between procurement and privatisation. Such options are recognised to be more effective than those at the extremes of the spectrum.

Since the early 1990s, the volume and number of PPPs have increased significantly worldwide. When regulated effectively, PPPs allow for flexible risk sharing between the public and private sectors, with the aim of carrying out infrastructure projects or providing services for the public in areas including transport, waste management, water distribution and public health and safety.

This article focuses on a particular category of PPPs – concession type and Build Operate Transfer (BOT)/Design Build Finance Operate (DBFO) type arrangements – and does not address privatisation or procurement contracts. The selected category is regarded as the most complex since it involves sophisticated legal and financial arrangements as well as risk sharing.

Quality of legislation

In 2004-05, the EBRD undertook an assessment of concessions laws (the 2005 Assessment) in transition countries.³

This involved a detailed analysis of concessions laws in selected core areas: (a) the general policy framework; (b) the general concession legal framework; (c) definitions and scope of the concessions law; (d) selection of the concessionaire (the entity to which a concession has been awarded); (e) the project agreement; (f) availability of security instruments and state support; and (g) settlement of disputes and applicable law.⁴

The selection of core areas⁵ and the questionnaire used in the 2005 Assessment were based on international standards developed in the concessions field by the United Nations Commission on International Trade Law (UNCITRAL)⁶ and other organisations and on EBRD's experience in implementing PPP projects.

In many transition countries a general policy framework for PPPs has not been identified. The existence of such a framework is, however, not necessarily linked to a good quality law.

A number of challenges emerged during the 2005 Assessment implementation including:

- Deciding which elements should and which should not, from a best practice perspective, be included in a concessions law. That is, the creation of an analytical instrument which assesses whether the law is over-prescriptive or whether it contains problematic omissions. For example, it was decided that the existence of a model project agreement or model provisions should only be considered as a positive feature if the use of such models was not compulsory.
- Deciding on the rating methodology. For example, should there be a weighting of questions and/or core areas and how should countries that do not have a general concession law be assessed? In 2004 eight countries did not have a concessions law and in 2005 seven countries did not have one.

Regarding the first challenge, it was decided that neither the questions nor the core areas should be weighted (that is, each question and core area is assigned equal importance). In fact, the evaluation of the importance of a particular question/core area is a subjective task, depending in particular on the party involved (for example, a lender to a PPP project would probably not accord the same weight to a question related to step-in rights as would a public entity representative). However, given that a negative answer to certain questions could be considered a deal breaker (for example, if international arbitration is forbidden), the overall evaluation of the law takes such difficulty into account.

Regarding the second challenge, several options were considered. The first option was to exclude countries without a general concessions law from the concession assessment process, given that, strictly speaking, the basis for the assessment was missing. The second option was to base the evaluation solely on the answers to the questions of the first two core areas, as these questions did not directly concern the general concessions law. The third option was to create a revised concession checklist, for the purposes of assessing these countries.

The third option was selected as being the best suited for the purposes of the assessment (that is, identifying the reforms needed). Thus for countries where rules governing concessions are contained in various contract laws and/or sector-specific legislation, a separate checklist of questions

was elaborated. Rules in these countries were benchmarked against internationally accepted principles only.

General results⁷

Using the answers provided by lawyers in the transition countries, the relevant laws were assigned a rating of their compliance with internationally accepted standards and principles, ranging from very high to very low.

As can be seen from Table 1, only Lithuania achieved a very high rating. Three countries were rated very low, while the majority achieved medium compliance. This illustrates the need for reform of concessions legislation in virtually every transition country.⁸

Results by core area

In many transition countries a general policy framework for PPPs has not been identified. The existence of such a framework is, however, not necessarily

Table 1 Quality of concessions laws in transition countries⁹
Compliance/conformity with international concessions standards and principles

Very high compliance/ Fully conforms	High compliance/ Largely conforms	Medium compliance/ Generally conforms	Low compliance/ Partly conforms	Very low compliance/ Does not conform
Lithuania	Bulgaria Czech Republic Slovenia	Bosnia and Herzegovina FYR Macedonia Moldova Montenegro Romania Russia Serbia Slovak Republic Ukraine Armenia Azerbaijan Estonia Kazakhstan	Albania Croatia Hungary Kyrgyz Republic Latvia Turkmenistan Uzbekistan Poland	Belarus Georgia Tajikistan

Note: Countries in brown did not have a general law on concessions when the assessment was undertaken in 2005. For these countries, the assessment rated the level of conformity of other relevant laws – such as contract law or sector-specific legislation – with internationally accepted principles.

Source: EBRD Assessment of Concessions Law 2005

linked to a good quality law. For example, Latvia scored strongly for policy framework, but did poorly in the overall assessment. Conversely, Lithuania does not have an extensive general policy framework, but its concessions law is very close to best international standards (see Chart 1).

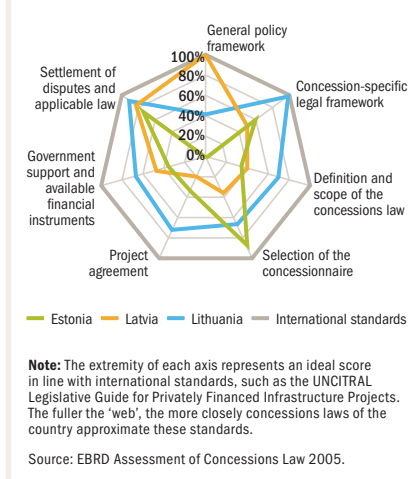
Chart 1 also pinpoints strengths and weaknesses in the concessions legal regime of the three Baltic states. For example, while rules governing disputes settlement in Latvia approximate to international standards, project agreement rules are not adequately regulated. Estonian laws are reasonably strong in terms of the selection of a concessionaire and dispute resolution, but rather weak in all other core areas.

Where a general policy exists, it is often based on policy framework documents. The existence of a PPP taskforce is rare. In most of the countries, it is difficult to identify the legislation applicable to the award of a concession in a particular sector owing to: (a) unclear boundaries between the general concessions law and sector-specific laws; and (b) unclear boundaries between the concessions law and the public procurement law.¹⁰

Certain laws do not define the term concession (for example, the Hungarian law) and most laws contain unsatisfactory definitions (such as the term “the right to use”). Contracting authorities are often referred to in fairly imprecise terms. The majority of laws do not discriminate against domestic or foreign persons becoming concessionaires, though some do (in Tajikistan and Georgia for example, domestic entities are discriminated against). Numerous laws contain a list of sectors in respect of which concessions may be granted (for example, the Albanian, Bulgarian and Hungarian laws), but certain laws limit the scope to a very limited number of sectors (for example, in Uzbekistan the law is limited to natural resources).

Most countries scored well for settlement of disputes and applicable law, due in part to the ratification by many countries of the relevant

Chart 1 Quality of concessions laws in the Baltics



international treaties on enforcement of arbitral awards and protection of foreign investments. However, few countries scored well on the availability of reliable security instruments for lenders regarding the assets and cash flow of the concessionaire. This includes lenders’ rights to step in, that is, to select a new concessionaire to perform under the existing project agreement, in case of a breach of contract by the initial concessionaire.

The survey also found that state financial support and guarantees rules were generally entirely omitted from the law or contained unnecessary restrictions. Among the few exceptions were the Lithuanian and Albanian laws.

Although the majority of laws include provisions on competitive procedures for the selection of the concessionaire, very few contain sufficient guidance in this respect. Provisions related to direct negotiations and unsolicited proposals are often not regulated with sufficient precision and so they leave room for uncertainties (for example, in Turkmenistan).

Legal provisions regarding the terms of the project agreement are often prescribed too narrowly, giving rise to inflexibility and uncertainty as to what can be included.

Box 1 Recent changes in concessions laws

In central Europe and the Baltic states, the Czech Republic has adopted a concessions law that came into force on 1 July 2006. Latvia has drafted a new concessions law and responsibility for developing and implementing PPP projects has been given to the Ministry of Economy and the Latvian Investment and Development Agency. Poland’s new PPP law came into force at the end of 2005 and three ordinances to deal with PPPs have been issued since then. The Slovak Republic continued developing its policy framework for PPPs.

In south-eastern Europe, Albania is in the process of reforming its concessions legal framework. Bulgaria has adopted a new concessions law, which came into force on 1 July 2006. Croatia is in the process of adopting PPP guidelines. Romania has adopted the Ordinance on Granting of Public Procurement Concession of Public Works and Concession of Service Agreements, which came into force on 30 June 2006. A Slovenian draft law on PPPs is before the parliament.

In the Commonwealth of Independent States (CIS), Kazakhstan has adopted a concessions law, which came into force on 19 July 2006. Russia has recently adopted a model concessions agreement for the transport sector and communal infrastructure.

Results by region

Contrary to general perceptions regarding the relatively good quality of their investment climate and private sector development legislation, a number of countries (for example, Croatia, Hungary, Latvia and Poland) were rated as having a low level of compliance. However, with the exception of Hungary, in those countries there has been progress in the reform of concessions legal and/or policy frameworks since the completion of the 2005 Assessment (see Box 1).

Box 2 The preliminary questionnaire and case study scenario (summary)

Preliminary questionnaire:

Have concessions ever been awarded in your country successfully?

If the answer is yes:

- (a) have such concessions been awarded on the basis of a concessions law?
- (b) have concessions been awarded following a transparent, competitive, selection procedure?
- (c) was there a possibility to challenge the award?
- (d) have project agreements been fulfilled by the parties without serious claims?
- (e) if a project agreement has been terminated prior to the end of the contractual period by the contracting authority, has fair compensation been proposed to the concessionaire?
- (f) how many terminations have there been to your knowledge?

If the answer is no:

- (a) is there a concession/project agreement in discussion?
- (b) are you of the opinion that there are no legal/social/political obstacles to implementing concessions in your country?

Case study

Your client is an international operator involved in a municipal utility concessions project in your country (for example, water distribution, bus transportation or solid waste collection).

Part 1

Your client has been informed that the concession he is bidding for has been awarded to a local competitor who, to your client's knowledge, did not meet the qualification criteria. Your client considers that his proposal should have won under a fair and transparent selection process and has incurred significant development costs.

Is there any action your client can take under the concessions law or any other applicable law to challenge the award? Would you advise your client to proceed with the challenge? If the chances of a successful challenge to the award are small, is there a chance to recover a substantial proportion of the client's development costs?

Part 2

Your client has been awarded the concession. Three years later the project generates the expected cash flow and your client is making the anticipated profit. However, he faces difficulties obtaining the contracting authority's acceptance of the tariff increase provided under the project agreement. This is due to political and social opposition to such an increase.

When faced with a complaint by your client, is the contracting authority most likely to:

- (a) refuse to implement the tariff increase without providing compensation to your client;
- (b) refuse to implement the tariff increase with adequate compensation;
- (c) abide by the terms of the project agreement despite the social and political opposition.

If the contracting authority refuses to implement the tariff increase, is there any action that your client can take to challenge the contracting authority's decision and oblige the authority to comply with the tariff increase?

In the event that the tariff issue cannot be resolved and your client decides to terminate the project agreement and obtain an international arbitration award entitling him to recover the non-depreciated value of its investment, are there any efficient methods of enforcing the arbitral award? Can the contracting authority delay or otherwise obstruct the enforcement process?

How the law works in practice

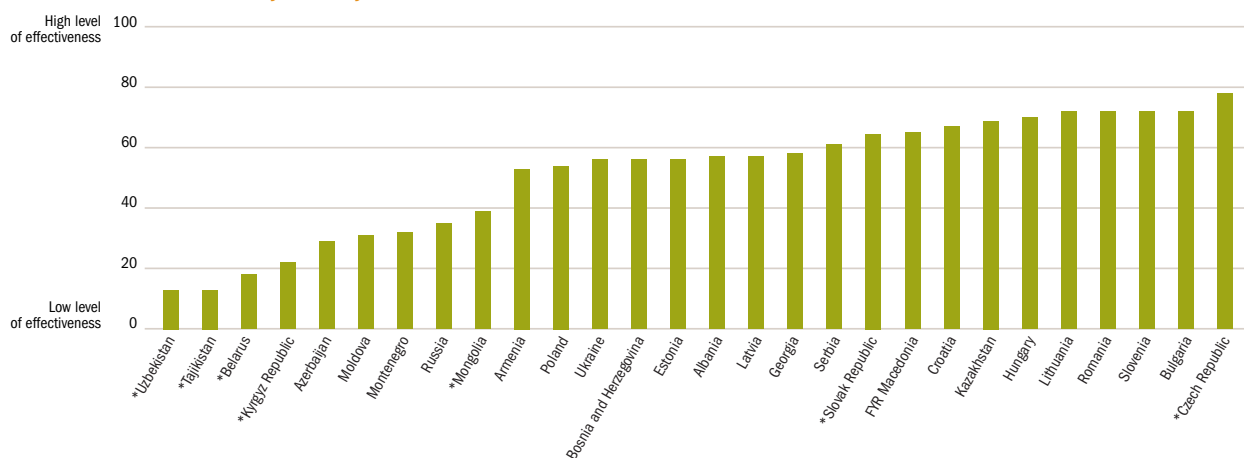
To complement the 2005 Assessment, the EBRD's 2006 Legal Indicator Survey (2006 LIS) measures the effectiveness of concessions laws in the transition countries. The 2006 LIS used a case study to assess how a country's legal and institutional framework for concessions functions in practice.¹¹

Lawyers in each country were presented with a typical scenario (see Box 2) for the award and implementation of a concession and were asked a series of questions about how the legal and institutional framework in their country would operate in such a situation. Given the nature of concessions and related agreements involving long-term partnerships between a public and a private party, the scenario was divided into two parts, the second taking place three years after the first. The case study was preceded with: (a) a short section containing an explanation of the terminology used (concession, concession law, concessionaire, contracting authority, financial close and project agreement) in an effort to keep answers consistent and avoid ambiguity; and (b) a preliminary questionnaire (see Box 2).¹²

Scores for effectiveness were based on four core dimensions of the concessions legal and institutional framework:

- **Presence** – whether concessions have been implemented successfully and/or whether there is a potential for such implementation;
- **Process** – whether there is a fair and transparent selection process, measured by the possibility of challenging a concession award effectively;
- **Implementation** – whether there is a fair and transparent implementation of concessions, measured by how effectively the contracting authority adheres to the project agreement terms and by the efficiency of remedial action in cases of non compliance;

Chart 2 How concessions laws in transition countries work in practice
Effectiveness by country



Notes: Effectiveness is measured on the following scale: very high (90 and above); high (70 to 89); satisfactory (50 to 69); low (30 to 49); very low (less than 30). Data on effectiveness for Turkmenistan were not available. Countries indicated with an asterisk had only implemented one concession project or none at all by July 2006.

Source: EBRD Legal Indicator Survey 2006.

In Bulgaria, according to the National Concession Register, nearly 300 state concessions and more than 500 municipal concessions have been awarded since 1997, generally following a transparent selection process and without major difficulties in implementation.

■ **Termination** – whether an investment can be recovered in cases of early termination, measured by the capacity to enforce arbitral awards and counter obstruction by the contracting authority.

Each of the four areas was rated out of 10 and a total of 40 points represented a score of 100 per cent. Effectiveness for all areas was graded as follows: very low (less than 30 per cent of the maximum total score), low (from 30 to 49 per cent), satisfactory (from 50 to 69 per cent), high (from 70 to 89 per cent) and very high (90 per cent and above).

Similar challenges to those encountered in the 2005 Assessment appeared during the 2006 LIS: that is, should there be a weighting of questions and/or core areas and how should countries with limited or no concession experience be assessed?

For the same reasons as for the 2005 Assessment, questions and core areas were not weighted. For countries that had only implemented one concession project or none at all by July 2006, the potential for an effective regime and any recent developments towards establishing one were assessed. The countries in this category comprised Belarus, the Czech Republic, the Kyrgyz Republic, Mongolia, the Slovak Republic, Tajikistan and Uzbekistan.

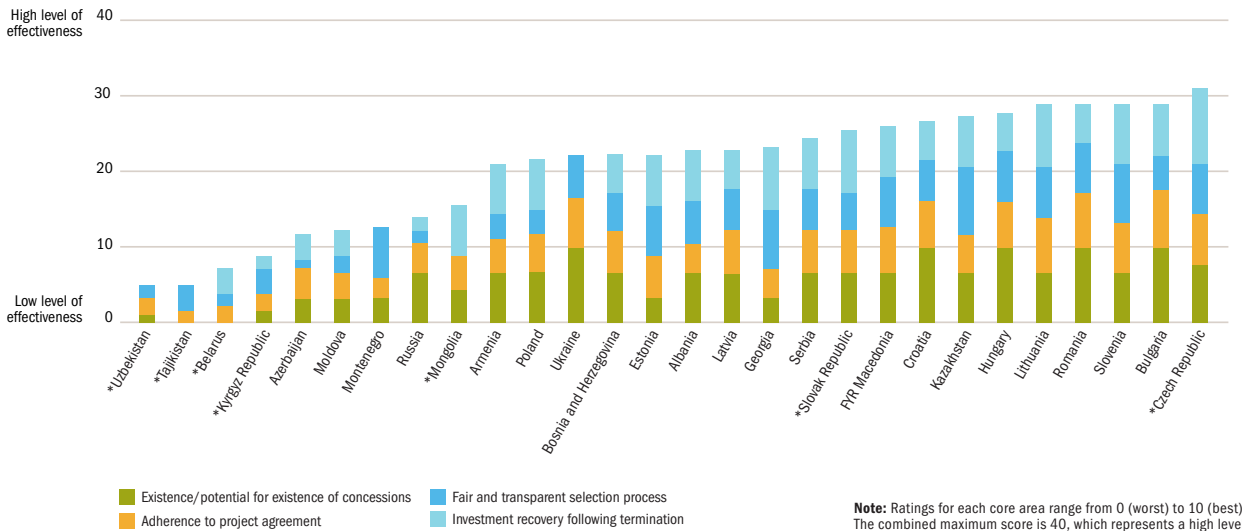
In the Czech Republic and Slovak Republic, a relatively quick move to the successful implementation of concessions in practice can be expected given the improvements in the legal and institutional framework and/or pilot projects. For other countries in this category, the route seems much longer, with numerous legal, institutional and/or political obstacles.

General results

Chart 2 shows that four countries with experience of concessions were rated as highly effective: Bulgaria, Lithuania, Romania and Slovenia. In Bulgaria, according to the National Concession Register, nearly 300 state concessions and more than 500 municipal concessions have been awarded since 1997, generally following a transparent selection process and without major difficulties in implementation. However, transparency of the award was sometimes criticised and some awards were challenged (for example, for the Trakia highway, Varna and Bourgas airports as well as the ports of Somovit, Svishtov and Oryahovo).

In Romania, the situation is similar to Bulgaria, with numerous concessions implemented in various sectors in the last decade, most of them successfully and on the basis of a general concession/PPP law. In Slovenia, concessions are awarded on the basis of various general and sector-specific

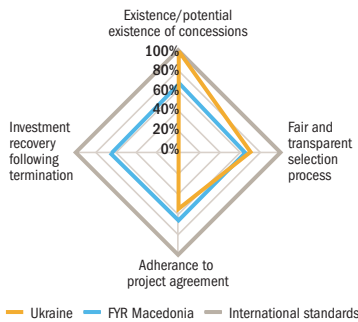
Chart 3 How concessions laws in transition countries work in practice
Effectiveness by core area (40 = highest)



Note: Ratings for each core area range from 0 (worst) to 10 (best). The combined maximum score is 40, which represents a high level of effectiveness. Countries indicated with an asterisk had only implemented one concession project or none at all by July 2006.

Source: EBRD Legal Indicator Survey 2006.

Chart 4 How concessions laws work in FYR Macedonia and Ukraine



Note: The extremity of each axis represents an ideal score which indicates high effectiveness. The fuller the web the more effective the system.

Source: EBRD Legal Indicator Survey 2006.

laws, and generally follow a transparent competitive procedure. In Lithuania, concessions implementation started recently and no difficulties have been encountered to date.

The Czech Republic was rated as potentially highly effective as its survey was based on a hypothetical implementation rather than any actual experience of concessions. In this country, even though many public services are carried out by private entities, such exercises are not based on concessions, but on licences. After the creation of a PPP Centrum in 2004, a new concessions law was adopted in the Czech Republic in 2006 and several concession-based pilot projects have been launched by various ministries, including for prisons, hospitals and motorways.

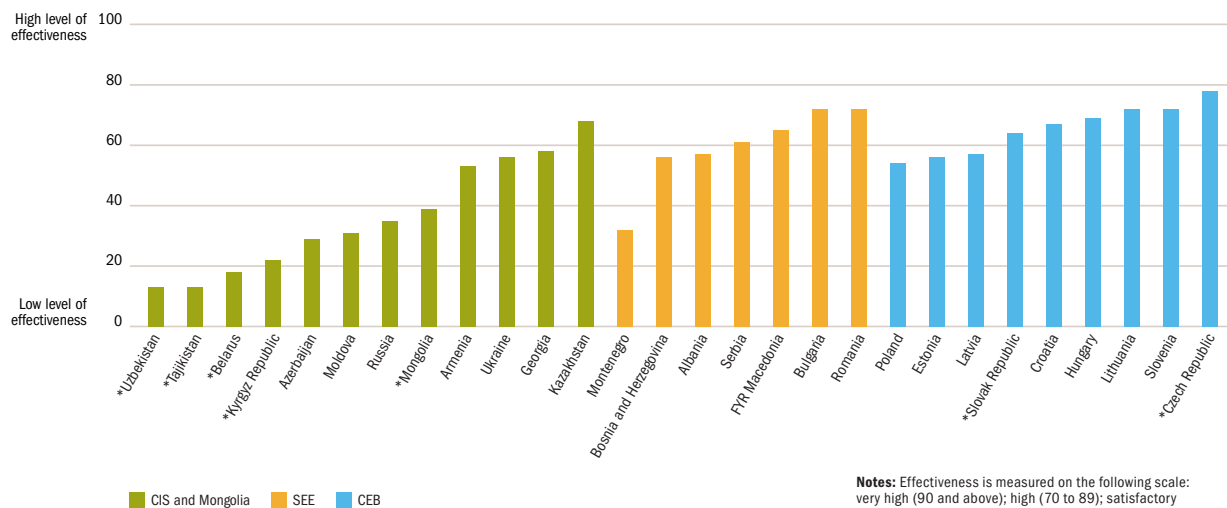
The high potential for concessions in the Czech Republic is supported by the following: concessions in discussion currently benefit from strong political

support; concession awards can be challenged before the contracting authority, the office for the protection of competition, as well as before administrative courts; public authorities generally adhere to the agreements to which they are party; and arbitration is widely recognised and generally not obstructed.

Five countries received a very low effectiveness rating: Azerbaijan, Belarus, Kyrgyz Republic, Tajikistan and Uzbekistan. In Azerbaijan, even though several concessions were implemented, in particular in the electricity sector, the implementation thereof was generally not successful (for instance, there were early terminations and disputes). Four other countries have little or no concessions experience and the general legal, institutional and/or political environments in these countries were not supportive of concession-type arrangements. Most of the transition countries fell into a middle category.

Although the findings of this survey give an indication of how effective concessions regimes are in the transition countries, the results must be treated with caution.

Chart 5 How concessions laws in transition countries work in practice
Effectiveness by region



Notes: Effectiveness is measured on the following scale: very high (90 and above); high (70 to 89); satisfactory (50 to 69); low (30 to 49 per cent); very low (less than 30). Data on effectiveness for Turkmenistan were not available. Countries indicated with an asterisk had only implemented one concession project or none at all by July 2006.

Source: EBRD Legal Indicator Survey 2006.

Although the findings of this survey give an indication of how effective concessions regimes are in the transition countries, the results must be treated with caution. First, they are based on the analysis of only one law firm in each country. Secondly, they relate to a specific set of circumstances and may not apply to all types of concessions. Thirdly, even though the focus of the survey was limited to concession arrangements, it involved projects of different sizes and scales in different sectors. Lastly, as mentioned above, not all countries have had experience with the types of concessions described in the chosen scenario and, therefore, answers from these countries are speculative.

Results by core area

Chart 3 shows the levels of effectiveness by core area. For all countries, the costs incurred in the preparation of proposals by the bidders are generally not recoverable. In the majority of countries, a concession award can be challenged, either on the basis of a specific provision in the concession law (for example, in Bulgaria

and the Former Yugoslav Republic of Macedonia or on the basis of general laws (for example, in Slovenia). However, local lawyers would not always advise proceeding with such a challenge, mainly because of the partiality of the court system or the length of time involved. In the majority of countries, the contracting authority cannot be forced to comply with the tariff increase mechanism in the project agreement if it refuses to allow such an increase.

The results give a surprisingly positive picture of the overall level of adherence by contracting authorities to contractual terms. Respondents in 16 out of 26 countries have indicated that the contracting authority would abide by the terms of the project agreement or provide adequate compensation despite social and political pressures. Effective enforcement of arbitral awards is regarded as especially difficult in the Kyrgyz Republic, Moldova, Russia, Tajikistan, Ukraine and Uzbekistan.

Some countries scored relatively uniformly in all core areas (for example, FYR Macedonia). In other countries the variation from core areas is significant (for example, Ukraine scored very well

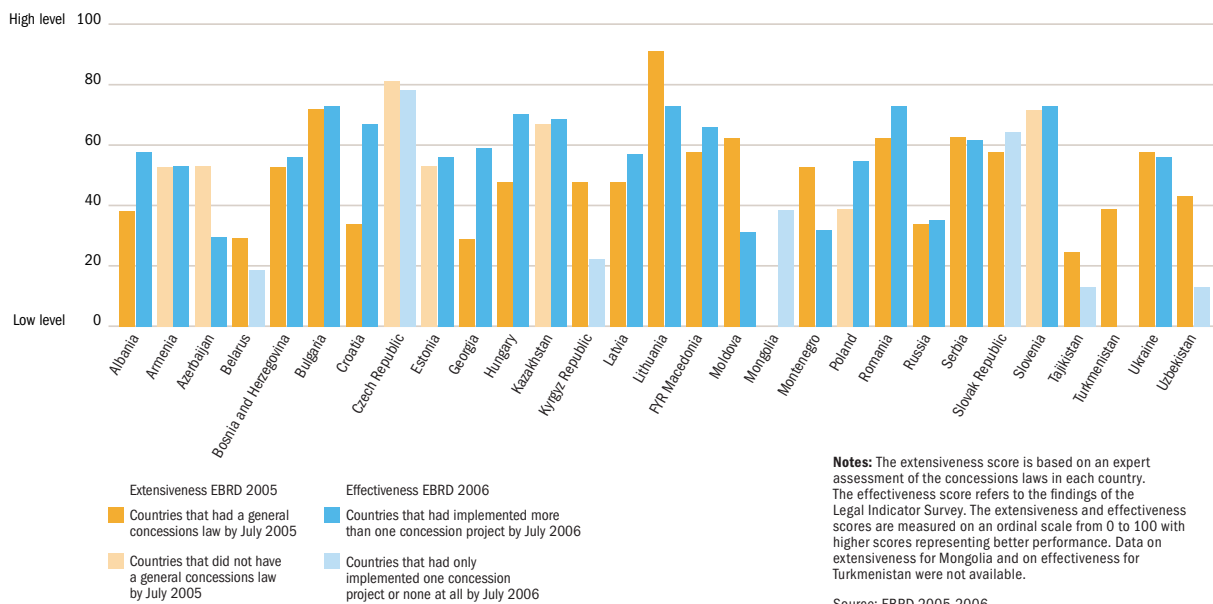
in the assessment of existence of concession projects, but performed very badly in the assessment of the possibility of effectively enforcing an international arbitral award (see Chart 4).

Results by region

Chart 5 shows that the strongest performance was in central and eastern Europe and the Baltic states, followed by south-eastern Europe (SEE). Montenegro, however, is well below the norm for the SEE region. The country has a weak legal framework for concessions and is inefficient in implementing concession projects. In Bulgaria and Romania, on the other hand, numerous concessions have been successfully implemented since the late 1990s on the basis of concessions law. Given recent reforms of the legal framework in these two countries, they are expected to progress even further.

In the CIS and Mongolia, the results are generally worse than in the rest of the transition region. The number of concession projects implemented by each country differs significantly. In Kazakhstan several concessions

Chart 6 Comparing extensiveness and effectiveness of concessions laws in transition countries



have been successfully implemented, particularly in the energy and transport sectors, but transparency of the award process has not always been respected and several concessions were terminated early.

Belarus, the Kyrgyz Republic, Tajikistan and Uzbekistan have implemented very few projects (for example, a gold deposit concession in the Kyrgyz Republic and an energy concession in Tajikistan) or none at all. The overall framework for the effective implementation of these projects is poor and this is illustrated by a non-competitive award practice, a lack of judicial independence and the impossibility of effective enforcement of arbitral awards.

Conclusion

The 2005 Assessment of the quality of concessions legislation and the 2006 LIS on how these laws work in practice have produced generally corresponding pictures (see Chart 6) in that most countries with a sound legal framework for concessions have effective mechanisms in place for enforcing the law. There are, however, exceptions.

In Azerbaijan, Moldova and Russia for example, concessions legal frameworks generally conform to relevant international standards, but policy, institutional and legal reforms do not permit projects to be implemented effectively. This is mainly due to the poor functioning of the court system and a negative attitude towards international arbitration.

In Azerbaijan and Moldova, problems encountered in concessions implemented to date may have a negative impact on the development of future projects. In Russia, the success or failure of important projects which are in the pipeline (for example, a western ring road in St Petersburg) will certainly influence the efficiency of the concession-related environment in this country in general. Conversely, in some countries where there are serious limitations in the concessions legal framework, concession projects can be implemented fairly successfully. This is especially true for Hungary and Croatia.

The explanation for this is the existence of several good precedents and a generally efficient institutional framework, which is essential for day-to-day implementation and enforcement. However, both those countries were rated as satisfactorily rather than highly effective, which suggests that there are some restrictions in implementing projects.

Overall, the concessions legal environment in transition countries has much scope for improvement. The majority of countries still need to implement further legal and institutional reforms if they wish to allow complex PPPs to work effectively. Not the least of these is the serious need for training officials on negotiating appropriate arrangements with private sector parties.

Notes

- ¹ See EU Commission Interpretative Communication on Concessions under Community Law of 29 April 2000, 2000/C 121/02.
- ² See Communication from the EU Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on Public-Private Partnerships and Community Law on Public Procurement and Concessions of 15 November 2005.
- ³ The 2005 Assessment is part of the EBRD's efforts to improve the legal environment in its countries of operations. Through such projects, the EBRD compares the legal environment in certain areas to international standards and, in doing so, aims to encourage, influence and provide guidance to policy and law makers, while developing the legal reform in the region. The 2005 Assessment is the fifth assessment of this type led by the EBRD. Previous assessments examined secured transactions, corporate governance, bankruptcy and securities markets legal environment. These assessment projects concern legal areas that the EBRD considers essential to the investment climate and private sector development. For more information, see: <http://www.ebrd.com/country/sector/law/index.htm>.
- ⁴ The EBRD worked with Gide Loyrette Nouel to finalise the EBRD concession checklist, undertake initial assessments of each national law, develop a methodology for rating concession laws, arrange for verification of the assessments by experts from each of the 27 countries of operations and ensure consistency of information and scoring. The project team comprised Alexei Zverev (EBRD), Bruno de Cazalet and Milica Zatezalo, (Gide Loyrette Nouel).
- ⁵ For a more detailed description of these core areas and the EBRD Core Principles of a Modern Concession Law, see the Bank's website <http://www.ebrd.com/country/sector/law/concess/index.htm>.
- ⁶ See UNCITRAL Model Legislative Provisions on Privately Financed Infrastructure Projects, 2003. Other international standards used are: Commission Interpretative Communication on Concessions under Community Law, 2000; UNIDO BOT Guidelines, 1996, European Commission Guidelines for Successful Public-Private Partnerships, 2003 and OECD Basic Elements of a Law on Concession Agreements, 1999-2000. See also the European Parliament Resolution on Public-Private Partnerships and Community Law on Public Procurement and Concessions of 26 October 2006, Communication From the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on Public-Private Partnerships and Community Law on Public Procurement and Concessions of 15 November 2005, the Green Paper on Public-Private Partnerships and Community Law on Public Contracts and Concessions of 30 April 2004 and a Report analysing all contributions of 3 May 2005.
- ⁷ The last update of the 2005 Assessment was completed in July 2005. Changes in the concession legal framework in some transition countries since July 2005 (see Box 1) are not taken into account in the results and analysis presented here.
- ⁸ The complete results of the 2005 Assessment are published on the EBRD web site together with the Cover Analysis Report and the full text of the EBRD Core Principles of a Modern Concession Law. See <http://www.ebrd.com/country/sector/law/concess/assess/index.htm> and <http://www.ebrd.com/country/sector/law/concess/core/mcl.pdf>.
- ⁹ For a more detailed explanation of results please see <http://www.ebrd.com/country/sector/law/concess/assess/report.pdf>.
- ¹⁰ Under the Community Law, the main difference between concessions and public procurement is the risk inherent to exploitation which, under a concession arrangement, the concessionaire has to bear.
- ¹¹ The EBRD worked with Gide Loyrette Nouel to finalise the case study, develop the 2006 LIS methodology, review the initial survey by experts from transition countries and present the results. The project team comprised Alexei Zverev (EBRD), Bruno de Cazalet, Milica Zatezalo, and Antoine Fontaine, (Gide Loyrette Nouel).
- ¹² Where the consultant on this project, Gide Loyrette Nouel, did not have an office, the EBRD contacted local law firms. The consistency of information was ensured through a review of the individual replies and a follow up on any questions that arose. The EBRD is indebted to all law firms, which participated on a pro bono basis: Associate Kalo & Associates; America CJSC; Chadbourne & Parke LLP; Branko Marić; Djingov; Gouginski, Kyutchukov & Velichkov; Šavorić i Partneri/Savorić & Partners; Luīga Mody Hāil Borenius; Mgaloblishvili, Kipiani, Dzdizguri; Assistance, LLC Law Firm; Law Offices of Klavins & Slaidins; Lideika, Petrauskas, Valiunas & Partners; Law Office Polenak; Turcan & Turcan; International Trade Centre; Vujacic Law Office; Finance & Projects, Linklaters Bratislava; Jaded & Pensa; Akhmedov, Azizov & Abdulhamidov, Attorneys; and, Denton Wilde Sapte, Tashkent.

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Public-private partnerships:
the EBRD's investment activities in
the municipal infrastructure sector



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Public-private partnerships (PPPs) in the infrastructure sector have great potential for positive transition impact and the EBRD's municipal and environmental infrastructure team has long been active, both as an equity participant and a lender, in PPP transactions in a wide cross-section of the Bank's countries of operations.

The expression private-public partnership (PPP) can be associated with a wide range of business proposals. The EBRD's approach to PPPs has been based on pragmatic market financing needs and no formal definition has been deemed necessary for project classification purposes. PPPs are generally understood as long-term contractual agreements between a public contracting authority and a private sector party to secure the funding for, and the construction or refurbishment, operation and maintenance of, an infrastructure project and the delivery of a service that traditionally had been undertaken or provided by the public sector. Concessions are probably one of the oldest and most developed forms of PPPs.²

In the EBRD's countries of operations, public authorities often use PPPs to call upon private sector know-how and expertise, to capitalise on the financing capacity of the private sector partner and/or to compensate for a lack of human resources or shortage of expertise within the authority's talent pool.

Risk transfer and value for money

Whatever the rationale for structuring a project as a PPP or concession, there will need to be a balanced transfer of risk between the contracting authority and the private sector partner, in which the project's individual risk components should be allocated to the party best able to manage them. Although the transfer of risk is an essential component of this type of agreement, each agreement differs in its allocation of risks and responsibilities, the ownership of the assets and the duration.

The EBRD sees PPPs as a procurement method for public infrastructure and services that, if adequately structured, encourages entrepreneurial initiative and public sector efficiencies. The balance in this risk allocation, arrived at either by negotiation or project design, is of the utmost importance in assessing a project's chances of success and the financing risk that the EBRD will ultimately be taking.

Overall, the contracting authority should be looking for value for money when using PPPs as a method of procurement. The concept of value for money is sometimes confused with the cheapest solution. However, financial and non-financial aspects have to be taken into account in determining whether value for money has been achieved.

Depending on the circumstances, value for money may be considered as having been achieved when procuring a service or infrastructure through a PPP has resulted in: reduced whole life cycle cost; better allocation of risk; faster implementation; improved service quality; or the generation of additional revenues compared with what would have been the case had the project been undertaken purely in the public sector. Non-monetary factors are too often left out of the primary considerations when they should be at the forefront of the debate.

If one focuses on the financial side of PPP projects, one realises that the potential source of savings is the private sector's need and ability to focus on

Public sector managers must often limit their focus to short-term goals owing to political agendas, the annual budgeting process and the drive to win votes for the next election. This short-term attitude is often incompatible with the long-term demands of infrastructure development.

efficient operations in order to maximise returns. The public authority will benefit from the sponsor's pursuit of profitability, which will reduce operating costs and increase efficient capital investment, as long as operating costs are not reduced to the detriment of the project company's quality of service or long-term interests. By creating incentives and/or sharing benefits, the contracting authority should encourage further increases in efficiency, such as the implementation of new management techniques, technology and know-how and methods of operation and maintenance.

In addition, the private sector is often considered to provide greater levels of efficiency when operating and managing local service companies than the public sector. This increased efficiency results from various factors including greater cost effectiveness, lower operating costs, novel commercial approaches to problem solving, insulation from political considerations, an ability to plan for best-value solutions on a whole-life costing basis and a better allocation of risk between the public and private sectors.

Public sector managers must often limit their focus to short-term goals owing to political agendas, the annual budgeting process and the drive to win votes for the next election. This short-term attitude is often incompatible with the long-term demands of efficient infrastructure development.

As concessions can last for periods of 25 years or more, concessionaires are forced to adopt a long-term commercial approach to project development and problem solving with independent views from the contracting authority.

Complexity and success factors

PPPs are a complex procurement strategy with a long lead time. Since value for money often comes from a balanced transfer of risks between the contracting authority and the private party, careful conception, structuring, tendering and contracting are of paramount importance for successful PPPs.

The long-term nature of PPPs should compensate in the long run for short-term resources and investment which are required for the use of this procurement method. PPPs should not be considered as quick fixes to longer term problems in the delivery of public services. It should be noted that, given the long-term nature of PPP type contracts, experience has shown that a reasonable level of flexibility in the contractual arrangements has proven beneficial and that a lack of flexibility is detrimental.

The EBRD recognises the challenges associated with structuring a sound concession or PPP. The key to success often revolves around and results from a combination of the following factors:

- an adequate legal framework
- political acceptance that the private sector could undertake the provision of public infrastructure or services
- a political champion to move the process and project forward
- a certain level of coordination between the various ministries and governmental bodies concerned with an individual PPP project
- the ability to allocate adequate government resources to implementation/monitoring
- the degree of development of the local capital markets which influences the level of long-term financing and the amount of access to international capital markets.

The EBRD continuously engages in open dialogue with public authorities that are considering this type of procurement route and private parties alike in order to create a convergence of the above contributing success factors and to help clients who are seeking advice on structuring PPPs.

Procurement issues

The EBRD's involvement in financing concessions cannot be divorced from the procurement process. Although the EBRD might be financing a private party to a concession, it still concerns itself with the procurement standards that were applied by the public sector entity in awarding the concession that it is considering financing. Private sector procurement policy requires that, where the Bank is to finance a concession or similar undertaking, the award process should have followed competitive tendering procedures that are acceptable to the Bank.

The Bank's concern arises because the infrastructure and public services involved often have a natural monopoly character and entail significant social dimensions. This makes concession agreements for the provision and financing of such services publicly visible, especially when they are for a long duration. Such agreements, therefore, can be politically sensitive and vulnerable to re-negotiation and abrogation unless the contracting process is perceived to have been open, fair and transparent. The Bank must, therefore, be particularly vigilant in relation to the transition impact, the effect upon reputation and credit risks.

The EBRD recognises that it is not always in a strong position to influence the procurement process – hence the preference for the EBRD to work early with the contracting authority on the project structure and its procurement – and it has identified certain core criteria

that must be met before the Bank can consider financing a concession. In summary, the policy requires as a minimum:

- formal competitive bidding with a tender process designed to achieve the policy objectives of economy, efficiency, transparency and accountability in cases where the Bank is assisting or advising the state sector grantor of the concession; or, where this does not apply:

(a) the process for selecting the concessionaire should demonstrate sufficient fairness, transparency and competition, (b) the process should be free of corruption and in compliance with all applicable laws and regulations, and (c) the outcome in terms of the concession agreement itself should be fair and reasonable in terms of price, quality and risk sharing in relation to market practice.

The Bank needs in all cases to be satisfied that the concession agreement is fair and reasonable as a matter not only of sound banking and public policy but also to ensure that any conflicts between these two objectives are, where practical, adequately addressed.

PPPs as a source of transition

The EBRD is sensitive to the transitional impact that PPPs may have and has identified the following potential key sources of transition impact in EBRD-financed infrastructure projects:

- *commercialisation of infrastructure services*, including tariff reform and changes in corporate structure, management and operations to make the infrastructure company customer oriented,
- *improved legal framework*, including changes to the laws and regulations that protect consumers and investors and set best practice environmental standards,
- *private sector participation*, which is expected to bring cost savings and improve the quality of service delivery compared with public sector alternatives.

PPP infrastructure projects share all the elements of the above mentioned sources of transition impact and, if properly implemented, should be positive for transition.

The EBRD's experience with PPPs in the infrastructure sector

Given the recognised positive transition impact potential of PPP projects, it was natural for the EBRD from the early years of its creation to be involved in the financing of PPP infrastructure projects across a wide cross section of its infrastructure portfolio and in a relatively high number of countries of operations.



The EBRD recognises that it is not always in a strong position to influence the procurement process and it has identified certain core criteria that must be met before the Bank can consider financing a concession.

Table 1 Municipal and environmental infrastructure PPP/concession projects financed by the EBRD

Country and year of investment	Project name	Type	Instrument	Sponsor
Regional 1996 ³	Multi-project Financing Facility	Service contracts/concessions	Debt and equity	Véolia Energy (Dalkia) (France)
Hungary 1999	Budapest waste water	Concession	Equity	Véolia Environnement (France)/ Berlinwasser Holding (Germany)
Slovenia 2000	Maribor waste-water treatment plant	Build, operate, transfer (BOT)	Debt	Suez Environnement (France)/RWE (Germany)
Croatia 2002	Zagreb waste-water treatment plant	BOT	Debt	RWE Thames Water, WTE (Germany)
Czech Republic 2002	Brno waste-water treatment plant	Operating contract	Debt	Suez Environnement (France)
Estonia 2002	Tallinn Water	Concession	Debt	United Utilities (UK)
Romania 2002	Apa Nova water treatment plant	Concession	Debt	Véolia Environnement (France)
Russia 2002	St. Petersburg south-west waste-water treatment plant	BOT	Debt	Skanska (Sweden), NCC YIT Corporation (Sweden/Finland)
Regional 2003 ⁴	International Water United Utilities	Acquisition of participation in concessionaire ⁵	Equity	United Utilities (UK)
Regional 2005 ⁶	Veolia Transport central Europe (Connex)	Service contracts	Equity	Véolia Transport (France)

Source: EBRD

This involvement was based on the state of transition at the time certain PPP deals were structured and, arguably, the state of legal frameworks available. Most of the projects in this sector are the responsibility of the EBRD's municipal and environmental infrastructure (MEI) and transport teams.

The MEI team's strengths are in water and waste water, urban transport, district heating and solid waste – all of which are natural sectors for concessions. Therefore, it is no surprise that this team's involvement in concession financing started in the early years of the Bank's existence.

The MEI concession portfolio is diverse and covers a range of products (see Table 1). On balance, PPP projects financed by the EBRD in the municipal and environmental infrastructure sectors have been successful in many respects. In all cases, the underlying investments, which were material in most instances, were completed on time and within budget.

On average, PPP projects in the municipal and environmental infrastructure sectors disbursed two to three times as fast as their public peer group projects, reflecting the professional experience of the private

sector partner dealing with project management. One exception contrasts with the rest of the MEI PPP cohort: the concession granted to International United Utilities by the city of Sofia where a longstanding difference of opinion has yet to be worked out. The Bank has sought to assist the parties to address these issues.

In addition to financing, the EBRD's involvement is often seen as a stabilising factor in projects that are frequently politicised in a context where the regulatory framework is often in its infancy and where the independence of the regulating authority has yet to be proven. The Bank's early involvement can help neutralise uncertainty in certain respects and contribute to ensuring that the allocated risks remain with the party best placed to bear them.

These are all factors that, if perceived as volatile, will inevitably increase the costs of the project. Caution should be taken in overemphasising the Bank's mitigating role but, through its ongoing dialogue with local authorities, the Bank is well placed to foster the necessary dialogue between the contracting authority and the private sector party in administering a concession or PPP.

Conclusion

Overall in the countries where the EBRD invests, it is difficult to identify a general trend, but it is clear that the willingness to undertake pilot projects indicates both eagerness to experiment and a reasonable level of scepticism. The institutional ability for states as a whole to learn from their initial experience and to replicate further transactions in different sectors is often limited by the absence of PPP units with the authority to oblige individual ministries to comply with best practice. This is an area where improvement is required.

In order to maximise the chances of PPPs achieving their full potential and benefit and to minimise the chances of having unsuccessful PPPs, a number of issues, subject matters and practices have been identified and recognised by

interested groups as recommended approaches to PPPs. These best practices should be cultivated within a PPP unit and within the administration acting as a central resource for PPP support. This would help with the standardisation, cost effectiveness, preservation of institutional memory and consistency in approach.

The EBRD has been active both as an equity participant and a lender in PPP transactions in a wide cross section of the Bank's countries of operations. The Bank will continue to pursue this promising infrastructure procurement method as PPPs have great potential for transition and the Bank can complement private sector financing in the structuring of these projects. While pursuing this, the Bank will need to stay aware of the need for projects to represent value for money. Achieving this requires a careful analysis at the structuring phase and the EBRD is well placed to help its clients on this path.

Notes

- ¹ Special thanks to EBRD colleagues Robin Earle, Jose Carbajo and Alexander Auboeck for their contribution, comments and editing.
- ² In this article the term concession is defined as an agreement or administrative act pursuant to which the contracting authority grants exclusive rights and undertakes obligations in relation to the construction, refurbishment, provision, management and maintenance of public infrastructures or services to a private sector entity to utilise government assets in order to provide facilities or services to members of the public.
- ³ With underlying investments in Lithuania, Poland, Romania and Slovak Republic as of October 2006.
- ⁴ With underlying investments in Bulgaria and Estonia.
- ⁵ The transaction consisted of the acquisition of water and waste-water facilities, alongside United Utilities, namely AS Tallinna Vesi and Sofiyska Voda.
- ⁶ With investments in Czech Republic, Hungary, Poland and Slovenia as of October 2006.

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The image shows a grand, ornate interior space, likely a grand staircase or a large hall. The architecture is highly decorative, featuring a large, vaulted archway. The ceiling of the arch is painted a vibrant blue and is adorned with intricate, dark brown or black scrollwork and floral patterns. The arch is supported by two large, fluted columns made of light-colored, possibly marble, stone. Above the arch, there are ornate, golden-colored decorative elements, including a central medallion and two large, leafy motifs on either side. In the foreground, a dark, ornate metal railing with intricate scrollwork is visible, suggesting a staircase. The overall atmosphere is one of classical elegance and historical grandeur.

**Promoting PPPs for
infrastructure development,
innovation and competitiveness:
the role of the UNECE**



Geoffrey Hamilton
Chief of the
Economic Cooperation
and Integration
Division, UNECE¹

Partnerships between governments and the business community can boost investments in infrastructure and help countries face the challenges of globalisation. The United Nations Economic Commission for Europe (UNECE)² has been working together with the EBRD and other international organisations to help governments get the most out of public-private partnerships (PPPs).

Many of the transition economies are currently enjoying a period of strong growth, in some cases fuelled by the high price of natural resources, in most cases by a competitively priced, skilled workforce and, in all cases, by a strong commitment to market-based reform. However, as growth accelerates, it puts pressure on the infrastructure to keep pace. Infrastructure is also a critical ingredient of a country's competitiveness and productivity.

Inadequate infrastructure across a number of sectors inhibits the investment of productive capital and restricts output. As infrastructure services include education and health, the lack of these services can also contribute to high levels of poverty and inequality. Consequently, in order to sustain economic growth and boost competitiveness and social development, many countries need to make large investments in their infrastructure.

Given the often insufficient resources available from national budgets, governments are turning to the private sector to meet these challenges.

One of the instruments used to upgrade existing and build new infrastructure with the help of the private sector is PPPs.³ In particular, a new interest in PPPs is emerging in the countries of eastern Europe, the Caucasus and Central Asia (EECCA).

The challenge

The United Nations (UN) views partnerships between government and the business community as a potentially positive mechanism to boost investments in infrastructure and meet the challenges of globalisation. Many of the commitments to address the global challenges of poverty and sustainable development have been set out in the Millennium Declaration.⁴

Given the scale of these challenges but the lack of government resources, the UN has, not surprisingly, identified the wide range of core business capabilities which the private sector provides, namely, their resources and roles in developing new technologies, providing essential goods and services and managing large-scale operations, as essential for achieving the Millennium

Development Goals (MDGs). In some commitments, such as in bridging the digital divide, the declaration explicitly encourages partnerships with the private sector. Accordingly, the United Nations and its various agencies, such as United Nations Development Programme (UNDP), the Department of Economic and Social Affairs (DESA), the Global Compact and the five UN regional economic commissions, take PPPs seriously.

A good illustration of the importance that the UN attaches to PPPs is the final declaration of the UN Summit on Sustainable Development which took place in Johannesburg in 2002, which made repeated references to PPPs and recommended the promotion of "Partnerships with the private sector, taking [into] account the interests of and in consultation with all stakeholders, operating in a framework of transparency and accountability, to improve the access of everyone to essential services."

In Europe there are various types of PPPs, established for different reasons, across a wide range of

One recent notable trend has been the use of PPPs in the delivery of social services such as health projects and education, as well as urban renewal and in new businesses related to information technologies.

market segments, reflecting the different needs of governments for infrastructure services. Although the types vary, two broad categories of PPPs can be identified: the institutionalised kind that refers to all forms of joint ventures between public and private stakeholders; and contractual PPPs, which have experienced a strong upsurge in recent times and cover a wide range of legal arrangements.

PPPs are being used in large national and pan-European infrastructure projects, in local development projects and in the outsourcing of different kinds of public services. One recent notable trend has been the use of PPPs in the delivery of social services, such as health projects and education, as well as urban renewal and in new businesses related to information technologies.

Increasingly, from this varied background, there are signs that the value of PPPs, in their ability to draw on the best of both the public sector (public interest concern, enforcement and regulatory capacity) and the private sector, (resources, management skills and innovation) for real social gains, is being realised. The concept of PPPs as a publicly accountable, sustainable developmental tool that meets real needs is gaining currency.⁵

PPPs provide the following benefits:

- help for governments to secure much-needed investments in public services without immediately having to raise taxes or increased borrowing
- track records for timely delivery which meets specifications
- transfer of management know-how and skills for innovative solutions.

On the other hand, the very benefits of PPPs also have a down side:

- PPPs enable projects to proceed with little or even no capital expenditure by the host government (the capital cost of projects is usually not counted against the government's balance sheet or borrowing limits). The government, nevertheless, sometimes takes on certain liabilities – for example, various forms of guarantees, that can leave it vulnerable if the project goes wrong.
- They also offer the possibility of transferring a number of risks to the private sector – for example, the risks of cost overruns, completion delays, low operational standards and fall in demand. PPPs offer the possibility of optimal risk allocation with each side taking on the risks it is best suited to manage. However, typically, the private sector seeks as far as possible to shift as many risks to the government side leaving the latter excessively exposed if the project fails.

In addition, in the case of contributing to achieve the MDGs, PPPs also have certain limits. The private sector, for example, is often not motivated to make investments in remote regions where the need for social services is greatest, but where the citizens are poor and do not have the purchasing power to offer them satisfactory returns. Governments can, however, employ better project management skills in order to maximise the social benefits from PPPs. For example, in order to improve educational standards or service delivery, governments can add clauses to the contract with the private entity,

which place financial penalties on the latter if these social benefits are not delivered.

It is important, therefore, in light of both the benefits and costs to adopt a pragmatic approach to promoting PPPs, to maximise their benefits and to minimise their risks while, at the same time, building strong management capacity within governments in order to achieve optimal risk allocation. This is particularly the case for EECCA countries. Many of them are now considering PPP options, but still have very low per capita incomes, public sectors with limited or no experience of PPPs and few, if any, public sector financing alternatives.

What is more, many inhabitants in these countries endure inadequate housing, poor transportation facilities and roads and dangerous levels of emissions from industry, including power plants. In such countries it is even more important to think of PPPs not just as bricks and mortar, but also as impacting on real people, communities and vulnerable groups.⁶

This approach of harnessing the respective skills and resources of the government and the private sector for social gain is the way ahead, mindful, however, that the private sector does not undertake its work out of humanitarian principles but as a business to make profit. Moreover, the benefit of this approach is not just to bring the best out of PPPs.

By making it a more popular tool and instigating projects that are acceptable to citizens and other stakeholders through transparency and accountability, far broader benefits will result.

Most importantly, this will help to remove suspicions of PPPs in places where previous privatisation experiences may have received negative press. In turn, broad support will generate stronger political will in favour of putting appropriate financial and legal frameworks in place that will encourage wider use of PPPs in the region.

Recent UNECE actions in the field of PPPs

In contrast to a development bank, the UNECE does not provide financial advice, loans or risk guarantees. It does, however, have a number of assets that have made a significant contribution to the promotion of PPPs. These include its neutrality, intergovernmental bodies, groups of experts, participation in regional cooperation programmes and involvement in global UN work.

High-level policy dialogues

Since its inception after the Second World War, UNECE has supported the development of public infrastructure in sectors such as trade, transport, energy, environment, housing and land management. It contributes to setting the framework for infrastructure developments on a pan-European basis.

In response to this interest, UNECE began an initiative in 1996 and held a number of large-scale, high-level policy dialogues on PPPs, involving representatives from the private sector, international financial institutions, regional development banks and export credit agencies. These events gathered together large numbers of people to discuss project case studies in various sectors from Europe and around the world.

A group of public and private sector experts was established to prepare guidelines.⁷ These experts consulted widely with senior government officials in preparing their findings. These findings confirmed that PPPs were here to stay and that they had a strong utility, although they were not a universal panacea. Consequently, governments were advised to adopt a pragmatic approach to using PPPs as part of their infrastructure policy.⁸

These high-level policy dialogues placed the topic of PPPs on the political agenda. They also promoted interest in the PPP model in countries which had no previous experience.⁹ These dialogues have also encouraged the use of the

Involvement of the private sector

Our challenge is to incorporate the private sector into our work to contribute to the UN's goals. We work for governments in this process, helping to create effective partnerships between them and the private sector. We also work with expert teams that have been established to identify and promote the concept of PPPs and which include representatives from different private sector professions, such as finance, law and construction. These innovative and dedicated teams, namely the BOT Group and the PPP Alliance, have made great commitments to dialogue, consensus building, breaking down barriers, increasing information flows and participating in close and active dialogue.¹⁰

Capacity building

One of the major barriers to the development of PPPs is the lack of skills within government to design, develop, finance and implement such projects. The implications for the private sector of weakness in the public sector include excessive bid costs, risks and delays.



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Intergovernmental bodies under the UNECE's Transport Committee have, for example, reached agreement on the multiple pan-European transport corridors that criss-cross our territory. Not surprisingly, in this work the question has arisen of how to finance transport corridors and member states have requested that UNECE explore the use of new project financing techniques such as PPPs.

PPP model in a number of government agencies that cooperate under the UNECE's auspices. For example, the UNECE Working Party on Land Administration, which consists of many of Europe's land registry offices, has elaborated guidelines on the use of PPPs in the delivery of their services.

Accordingly, the high priority is for domestic capability building in PPPs in negotiating skills, financing and project management.

UNECE's response to this challenge has been to encourage the establishment of national PPP units within governments. Such bodies, which are fully empowered to act for the financing arm of the government, can manage and prioritise

Box 1 UNECE draft guidelines on governance in PPPs (extract)

Principle 1: Transparency and openness Tendering procedures

1. Selective procedure

- a. General applicable law for all tender processes
- b. Specific laws according to the sector
- c. Harmonised rules under regional unification initiatives
- d. Corporate governance requirements
- e. Award procedure

2. Open participation and non-discrimination

- a. Companies whose headquarters are not based in the country are successful in tender processes
- b. Early publication of tender offers in local and international newspapers
- c. Open competition rules
- d. Level playing field

3. Good negotiation platform

- a. Expertise and dedication of negotiators
- b. Independence of judgement
- c. Defined goals and objectives in the negotiation process

4. Coordination

- a. Special governmental agency in charge of coordinating the project proposals and commencement of tender process
- b. Web site information and online pre-registration

5. Organised data gathering

- a. Centralised database with possible and actual contractors
- b. Due diligence on the bidders' financial and technical performances

6. Contractors' registry

- a. Qualification of contractors according to specific standards
- b. Contractors' updated profile
- c. Regular advertisement of status of contractors

Source: UNECE

the project pipeline. With 10 years of PPP experience in Europe, research shows that a strong correlation exists between a well functioning PPP unit and successful PPP implementation and that this has been achieved in both complex and difficult settings.¹¹ In May 2000, the UNECE BOT Group held an informal consultation with the government of the Czech Republic – following this the Czech government decided to establish a dedicated unit within the government to deal with PPPs.

Governments also need to consider the priority tasks and functions of the units, the different models including advisory, educational and project oriented and whether to place them at the local, regional or central level of administration. While each country will adopt its own approach, many common issues arise across different national programmes and it is important that PPP experiences are shared more effectively between authorities. Not sharing experiences can lead to more expensive PPP transactions and/or the failure of programmes.

UNECE took the lead under the auspices of its PPP Alliance, to organise a series of meetings of PPP units in Geneva, Barcelona and London, so that members could share experiences on topics of mutual interest and promote best practices.¹²

Building new institutions to create the capacity for dealing with PPPs is also linked to the need to improve the regulatory setting for PPPs. Overall, the role of governments is to create policy stability and the financial environment needed to stimulate the growth of the private sector in order to increase proficiency and competition in service delivery.

To manage private contractors, governments should develop their own financial management and administrative efficiency and be willing to enforce contracts. Governments must also have an 'arm's length' relationship

with the private sector, clear rules and open competitive tendering. This can be challenging for countries with no previous experience of such methods.

Accordingly, the UNECE PPP Alliance took the initiative to improve the governance of PPPs. It identified, through a number of case studies, key project governance issues. It then consulted widely with member states, holding a forum on the topic and then consultations (for example, in Canada), to explore the different practices and procedures which governments used in their management of PPPs at various levels of their administrations.¹³ From this analysis the UNECE guidelines set out five principles of good governance in PPPs: transparency; public accountability; social sustainability; timely and accessible dispute resolution; and enhanced security and safety. These guidelines are in the final stages of completion.¹⁴

Clearly, the challenge in improving governance is not simply to make recommendations but to cooperate promptly and effectively to implement them. Thus, the UNECE's proposed guidelines set out in detail the steps for each procedure to be accomplished. Governments can use these as a checklist to determine the extent to which their procedures are in line with these good governance criteria (see Box 1 for an example of one procedure).

Going forward and as the PPP institutions across Europe develop, it will be useful also to give accreditation to agencies dealing with PPPs that operate according to such good governance criteria. This project could also set standards for training. Implementing common approaches to good governance in PPPs would also be a good basis for cooperation between UNECE and our partners active in this field such as the EBRD.

UNECE has provided a neutral forum and encouraged dialogue between the different partners so that each better understands the capacities, motivations and constraints of the other.

Maximising the developmental impact of PPPs to make real contributions to the MDGs is also critical to improving governance. The UNECE is cooperating with a Swiss Foundation, the Réseau Universitaire International de Genève (RUIG), on a project under which a research team is preparing case studies, tools and instruments that will facilitate the contribution of PPPs to UN goals and sustainable development.

Mitigating the risks

In some PPPs, difficulties can occur where the expectations of the partners conflict. Typically, as mentioned above, private sector sponsors propose deals that would allow them to reap high profits over a short period but leave most of the risks to the national or local government of the country. Governments, in contrast, often expect private sponsors to agree to lower profits and to accept most of the risk.

UNECE has provided a neutral forum and encouraged dialogue between the different partners so that each better understands the capacities, motivations and constraints of the other. The forum has also fostered a better understanding among other stakeholders in PPPs such as between employers and employees. There has been concern, for example, from the trade union side about the threats posed by PPPs to their employment conditions. In response, UNECE has offered its platform to the employees to present their case and help to develop better understanding.

A regional focus

Operating at a regional level is an important way to implement projects and standards. Therefore, UNECE cooperates extensively in regional activities where there are close similarities between countries, issues and bases for regional cooperation. UNECE has good frameworks in which to promote regional approaches to PPP implementation. For example, in cooperation with the World Bank and under the auspices of the Southeast Europe Cooperative Initiative (SECI) and the Stability Pact for south-eastern Europe, it has helped to create national trade facilitation bodies. These bodies, also known as PRO Committees, operate on a PPP basis and have proven effective in reducing barriers to trade in that region.

Global reach

UNECE is one of five UN regional economic commissions. Its network extends beyond Europe and its member governments are brought into contact with others that face similar challenges. The lack of capacity in public-private management has also been a concern of our colleagues in countries outside of Europe.

Highly sophisticated promoters with a lot of international experience often sponsor many of these PPP projects and lead some governments to feel at a disadvantage in negotiations. UNECE in cooperation with the United Nations Commission for Asia and the Pacific (UNESCAP), therefore, prepared a

'Negotiation platform', which is a training tool for government officials, to protect the public interest in negotiations over PPP contract clauses.¹⁵

Going forward, UNECE will also cooperate with UNESCAP and the United Nations Economic Commission for Africa (UNECA) in a joint project to increase the capacity of civil servants to obtain the best from PPPs and to maximise their contribution to sustainable development. Europe has much to learn from the experience of other countries with PPPs, including South Africa and the Republic of Korea and, in an increasingly global PPP industry, such global reach can maximise our ability to obtain key learnings, insights and best practices.

Conclusion

In response to growing interest from countries in boosting competitiveness and innovation, UNECE has established a new Committee on Economic Cooperation and Integration.¹⁶ The main goal of this committee is to enhance competitiveness through innovation and private sector participation and to develop strong regulatory frameworks, intellectual property rights and successful PPPs that attract foreign and domestic investment. In these thematic areas, teams and networks of experts will identify and exchange good practice and experiences.

There are two challenges that need to be addressed in the promotion of PPPs for development. The first is to increase the

The challenge is to promote PPPs to get the best out of them so that we can meet the infrastructure challenges of the region. The EBRD has played a critical role in pioneering the financing of transition economies and has offered valuable legal advice.

available information on PPPs, through the identification and publication of successful case studies, knowledge of legal frameworks, key sector-specific success factors, PPP models and guidelines and so on, which are based on a sound evaluation of the record of PPPs in both transition and advanced market economies. Accordingly, the first task of the new committee will be to prepare an extensive comparative review of PPP experiences to date in transition and advanced market economies.¹⁷ In this regard it will be important to work with colleagues from the EBRD with their practical experiences of PPP projects in the region.

The second challenge is to explore the appropriate methods of capacity building in order to facilitate the implementation of PPPs. Few training programmes for public sector officials are available: UNECE, the EBRD, the European Investment Bank (EIB) and the EU have all made various proposals for capacity building programmes.¹⁸ As this effort goes forward, UNECE will work with its member states and partners to explore the best approaches to capacity building and implementation.



Russia, for example, has proposed the development of a project aimed at raising the qualifications of central government and municipal civil servants related to the “Development of public-private partnership institutions”. Such a project could be implemented through a series of seminars dealing with the integration of public-private partnership principles in the practice of public administration, distance learning programmes and the establishment of regional training centres.¹⁹

The challenge is to promote PPPs to get the best out of them so that we can meet the infrastructure challenges of the region. The EBRD has played a critical role in pioneering the financing of PPPs in transition economies and has offered valuable legal advice. Our activities at UNECE have complemented this work and, as the concept spreads, the demand on our respective activities is likely to grow. We look forward to close cooperation in the future.

Notes

- ¹ The views expressed in this article are those of the author and do not necessarily reflect those of the United Nations.
- ² The United Nations Economic Commission for Europe (UNECE) was established in 1947 by the United Nations Economic and Social Council (ECOSOC). It is one of five regional commissions of the United Nations (UN). UNECE strives to foster sustainable development among its 56 member countries. To that end UNECE provides a forum for communication among states; sets out norms, standards and conventions to facilitate international cooperation within and outside the region addressing trade, transport and the environment; supplies statistics; and promotes economic cooperation and integration.
- ³ Public-private partnerships in infrastructure, including energy, transport, municipal services, telecommunications and social services, can be defined as concessions or other contractual arrangements whereby the private sector operates, builds, manages and delivers a service for the general public typically in return for a payment. Successful PPPs combine the best the public and private sectors offer, while limiting the shortcomings of either the privatisation approach or the exclusive public sector delivery of services.
- ⁴ The Millennium Development Goals were derived from the United Nations Millennium Declaration, which was adopted by 189 nations in 2000. Most of the goals and targets were set to be achieved by the year 2015, based on the global situation during the 1990s.
- ⁵ In recent times, the main reasons for considering PPPs have been: increased pressure on budgetary policies, resulting in a reduction in public spending for infrastructure; the need to improve management practices and improve the efficiency of the public sector; increased emphasis on value for money approaches to public spending; and increased eagerness for timely delivery of infrastructure projects.
- ⁶ By taking this approach, the prime target of PPPs is fundamentally what local communities and beneficiaries actually want and need rather than lesser financial accounting objectives. It is, therefore, important to consult at the outset all stakeholders, including employees, on the value of projects where the private sector plays a significant role.
- ⁷ This group was known as the BOT Group. The acronym refers to a type of concession contract known as Build, Operate and Transfer.
- ⁸ Public Private Partnerships for Infrastructure Development, UN, New York 1999.
- ⁹ One country which is taking PPPs forward is Russia. The adoption of its Concessions Law and the creation of the Russian Investment Fund have opened new opportunities for the development of PPPs in Russia. The medium-term programme for the social economic development of Russia (2006-08) envisages the active use of PPPs to revamp transport infrastructure, promote the development of science and innovation and improve housing and social services, among other priorities.
- ¹⁰ As a result of recent UNECE reform, the activities of the PPP Alliance will be integrated into the network of experts on PPPs under the new UNECE Committee on Economic Cooperation and Integration.
- ¹¹ Paper submitted by Mme Corinne Namblard, Chairperson of the PPP Alliance to the UNECE Forum on Promoting Good Governance in PPPs, 17 November 2003 UNECE.
- ¹² See report of meeting of UNECE PPP Alliance 'The role of PPPs in revitalising cities', held under the auspices of the second UNHABITAT World Urban Summit, Barcelona 14 September 2004, in UNECE Document Trade/2005/3, 14 March 2005.
- ¹³ UNECE Forum on Good Governance in Public-Private Partnerships for Infrastructure Development, 17-19 November 2003, held under the auspices of the fifty-first session of the UNECE Working Party on International Legal and Commercial Practice.
- ¹⁴ The guidelines were prepared by a taskforce of government and private sector experts established under the auspices of the UNECE Working Party on International Legal and Commercial Practice. The Working Party discussed the guidelines at its fifty-second session in October 2004.
- ¹⁵ Negotiation Platform for Public-Private Partnerships in Infrastructure Projects. Document prepared for UNECE – UNESCAP joint training programme on PPPs, Dhaka Bangladesh, 15 February 2000.
- ¹⁶ UNECE Committee on Economic Cooperation and Integration: see: www.unece.org/ceci.
- ¹⁷ This work will include: identification of the major sectors and areas in which this type of cooperation is desirable; analysis of the modalities of operation and major problems encountered by PPPs; assessment of the role of PPPs in enterprise development; and assessment of how PPPs facilitate project financing.
- ¹⁸ Various EU bodies such as the Van Miert High-Level Group on TENs Transport (2004), and the DG Market Report on PPP Green Paper (2005) have echoed the need to increase public sector skills in PPPs in the EU.
- ¹⁹ Report of the first session of the UNECE Committee on Economic Cooperation and Integration, ECE/CECI/2006/6, 21-22 September 2006: at www.unece.org/ceci.

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A man in a dark suit is walking across a large, ornate hall. He is carrying a folder and talking on a mobile phone. The hall has a patterned wooden floor, white columns, and a large arched doorway in the background. The ceiling is decorated with red and white patterns. The text "Public-private partnerships in transition countries" is overlaid on the image.

Public-private partnerships in transition countries



Peter Snelson

Director, Project
Developments,
Atkins Ltd

Transition countries that have only ever used traditional public sector procurement processes face a steep and long-term learning curve when they embark upon public-private partnerships (PPPs). The advantages of PPPs include maximising value for money, reducing public debt and strengthening infrastructure.

The purpose of this article is to give an insight into my own interpretation of the current situation regarding PPPs in transition countries. Having been involved in advising governments and municipalities in Croatia, the Czech Republic, Georgia, Hungary, Poland and Romania on the development of PPPs, I have seen and learnt a great deal about how times have changed since the mid 1990s and, in some cases, how they have not.

The process of developing PPPs as a way of procurement, when starting from a system that has only ever used traditional public sector procurement processes, requires a quantum leap in understanding, procedures, institutional acceptance, market understanding and risk taking. It takes a long time to introduce such a significant change. In the United Kingdom, for instance, the development of the PPP, or Private Finance Initiative (PFI) as it is known, started in the early 1980s and is still being refined.

What is a PPP?

We must first accept a definition of PPPs for use in this paper. This is important because, apart from the classic “risk being shared by those best able to manage it” definition, most people and organisations in the PPP industry in central, eastern and south-eastern Europe and the Commonwealth of Independent States (CIS) have their own particular interpretations.

A public-private partnership is a partnership between the public and private sectors in which risks and benefits are shared. This is a simple concept unless you are a state body that has never been involved in a PPP before. The word “shared”, when related to risk, tends to be interpreted more along the lines of meaning “passed to the private sector” than shared equally. The concept of true sharing often only comes into the equation if there are benefits to the state.

Sharing risks and benefits is a concept with which countries frequently find problems. Even in the United Kingdom and Australia, two countries that have been implementing PPPs for many years,

the state is still reluctant to take risks it feels that the private sector should accept, and vice versa. It is a constantly shifting process.

A PPP is a form of procurement and contracting. It must be remembered that the most important element of a PPP is the contract. The contractual arrangements of a PPP are very different to those of a traditional turnkey construction or a design and build arrangement. The definitions within the contract are critical and it is far easier for there to be misunderstandings, errors and confusion in a PPP contract than in any other form of contract.

A PPP is not necessarily a form of financing; it is a form of delivery. In the eyes of many institutions, especially in the banking world, a PPP is a deal that involves the raising of large sums of money through investments, equity or bonds. This is only part of the picture. A PPP is about the private sector delivering a public service in partnership with the public sector. This does not necessarily require capital financing. In the United Kingdom, for instance, there are outsourcing contracts in place

that have an annual service value of €50 million with no capital, but they are all about the private sector delivering on behalf of, and in partnership with, the public sector. Public and private partners often even share the same office space and work in joint teams.

Finally, it is important to understand that there is no single approach to PPPs at either the national or local level and no single best-practice recipe for all countries or situations. While the concept of PPPs must be the core of any form it takes in any country or municipality, the format may differ for each. The models in use in countries that have PPPs can only be seen as that – models. Models must be assessed and the elements of those models that work in each individual situation should be adapted and used to suit.

Chart 1 shows what can be achieved by using a PPP. This can be summed up as the transfer of risk from the public sector to the private sector without shifting an excessive burden on to the latter.

Why introduce PPPs?

There are a number of reasons for introducing PPPs for the development and delivery of infrastructure and it is important for the government, either at the state or the municipal level, to establish what it actually wants to achieve with the introduction of this process before embarking upon the implementation details. The key reasons for introducing PPPs are shown below.

Maximising value for money

This refers to providing a service over a long time-scale in which the delivery by the private sector is designed to maximise efficiency and innovation as well as minimise cost and time overrun. It is important that the private sector is allowed to deliver innovation and best practice in order to ensure value for money. This is not a concept that is put forward in transition countries as the key reason for introducing PPPs, but it is a supporting reason for any PPP. In the Scandinavian countries, however, this is the key reason and the approach to PPPs in these countries is, therefore, different than in other countries.

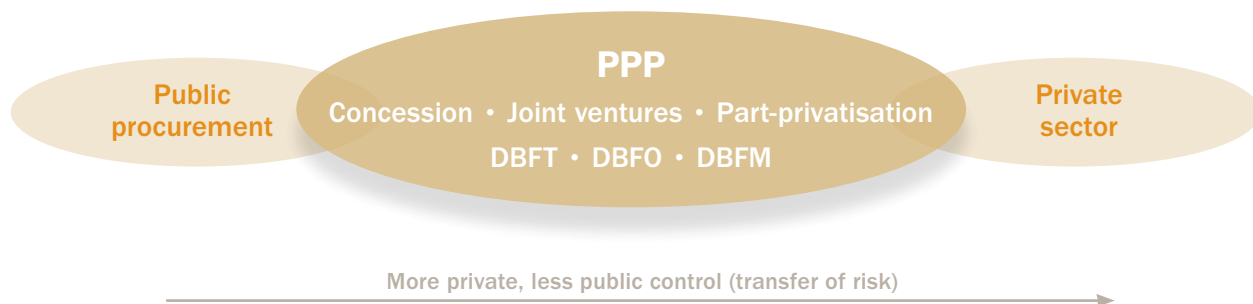
Reducing public debt or off-balance-sheet financing

This is seen by most of the transition countries as the key reason for introducing PPPs. The reduction of the public sector borrowing requirement to bring countries into line with European Union (EU) and Maastricht requirements is a very important driver. It also enables the procurement of services that are consistent with policies to drive economic development.

The implementation of major transport infrastructure is well known to be a key driver in assisting regional economic growth. This has been seen clearly in Hungary, for instance, where the growth in gross domestic product (GDP) is primarily along the corridors of the growing motorway network, most of which was built under normal public procurement procedures.

Public procurement can also pay for services which achieve the required quality and do not only deliver to a budget that may be easily overspent. However, in cases in which there are insufficient resources, quality may be reduced and in cases in which the delivery time is too long the infrastructure may deteriorate before it is even open to the public.

Chart 1 How PPPs transfer risk



Note: DBFT stands for design, build, finance and transfer; DBFO stands for design, build, finance and operate and DBFM stands for design, build, finance and maintain.

Source: Atkins Ltd

Having concessions, procurement and PPP laws is good but they must be referenced to each other in their drafting. Otherwise they may not comply with international rules on procurement.

Strengthening infrastructure

Strengthening infrastructure can provide services that would not otherwise be available within existing budgets. This does not mean that there is a need for off-balance-sheet financing. Rather, it means that there is not enough money but, nonetheless, new facilities need to be delivered efficiently and effectively. Standards need to be maintained and there must be flexibility in the delivery of services.

A classic example would be the operation and maintenance of a highway system where there is no requirement for capital investment but there is a need for performance-based operation and maintenance. This is a form of PPP that is being investigated in a number of new member states and transition countries.

Other reasons

There are a number of other reasons to introduce PPPs. The key is to achieve an influx of private finance. There are a number of countries that see the introduction of PPPs as a way to simply obtain private money to provide services through a direct payment system – a toll on a highway or a tunnel for instance. In these situations, the government does not have any money to contribute to funding even through payment to the concession, so co-financing through international financial institutions is key.

The need to introduce institutional reform is another reason to establish PPPs. Reducing the financial and institutional burden of large, overstuffed governments at both the national and municipal levels and outsourcing the service element to the private sector is key to institutional reform. This type of institutional reform-based PPP is being introduced worldwide.

Key issues in developing PPPs

When a country or municipality wants to investigate the introduction of a PPP into any part of its service delivery, it must first review a number of issues. The political will and drive must be present and are required at all levels. However, that alone is not enough. When developing PPPs, the following issues must be explored.

Has the need and justification for the project been defined? Often projects are pushed forward purely on political grounds and then turn out not to be feasible or, if they are feasible, very expensive. The project must be justified and all real options must be evaluated. There is no point demanding a motorway because it is politically required when it is not practical, justifiable or feasible. Also, it must be decided if a PPP is the best way to undertake the project. When the initial investigations are complete and, especially, when a public sector comparator has been calculated, the results may indicate that it would not be in the public interest to go down the PPP route for delivery.

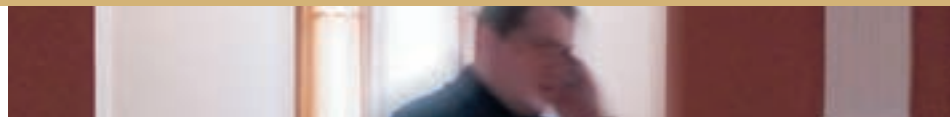
Does the state or municipality have the necessary and appropriate legislation in place? This can be a dramatic stumbling block if it is not adequately investigated. All the necessary laws and acts need to be linked in order to enable the establishment of PPPs. Having concessions, procurement and PPP laws is good but they must be referenced to each other in their drafting. Otherwise they may not comply with international rules on procurement.

If the key reason for introducing PPPs is to reduce public debt then the legislation should be reviewed by Eurostat in order

to ensure that it is able to deliver the correct forms for off-balance-sheet financing. The legislation should be transparent. This point is easily missed and necessitates much extra work behind the scenes in order to get contracts implemented. Fair and true competition for the contracting of PPPs is crucial. Many contracts have failed and been the subject of compensation payments because of a lack of transparency.

Is the project technically feasible? Are the risks manageable? Can the private sector deliver the project within existing standards and norms and is there enough flexibility to allow it to be innovative? It is often the case in transition countries that there is a requirement in the procurement legislation for all detailed design, costings and so on to be provided to the bidders. This is because the legislation has not been reviewed properly from the point of view of its practicality. The result is a PPP where value for money and innovation can not be realised. Permissions relevant to the project's activities must be in place and, if they are not, a time-scale for implementation is necessary. Again this is linked to legislation, as in some countries it can take years to get permissions, therefore delaying delivery to such an extent that the concession company is not interested.

Is the project capable of attracting bank financing? Is it commercially attractive to the private sector and will it give attractive economic returns? The public sector must remember that its private sector partner must be a profitable organisation or it will inevitably fail and the delivery of the services within the



The ability to blend EU cohesion and structural funding with PPPs is becoming clearer and this will assist transition countries in central Europe in establishing PPP strategies.

PPP will also fail. Is the project financially viable and will the international banking community want to finance it? Is the project big enough or is it too big?

Can the state or municipality afford the PPP? Each PPP, especially if it involves large sums of capital investment from the private sector, is a long-term mortgage and will cost money over an extended period, possibly up to 99 years. Is there enough allocation in the long-term budget to be able to pay for this? The cost of each PPP adds to the costs of the previous ones. PPPs must be seen as a package and not as individual entities. This is a critical issue in countries in which municipalities can enter into PPPs with no recourse to the central state government. There is no telling what the future will hold if there is no control.

Current market developments

Internationally PPPs are becoming more important in the delivery of public services while at the same time, they are being driven by limits in the amount of public funds available to cover investment needs. This is the case in transition countries but it can also be seen more and more in so-called wealthy countries. Germany, France and even the United States are rapidly developing PPP initiatives to deliver public services.

Because the market is growing in this way it is important for transition countries to realise that construction companies/concessionaires are looking for more certainty in the market and in the product and, therefore, require more certainty in the market in these countries. The scenario of the mid

1990s when the build, operate, transfer (BOT) boom was on and all major companies chased every major initiative is no longer still true today.

The ability to blend EU cohesion and structural funding with PPPs is becoming clearer and this will assist transition countries in central Europe in establishing PPP strategies. Poland, in particular, has dabbled with PPPs a number of times not knowing how its accession would affect PPP projects. Now that this issue is being clarified, there will be more stability in the market.

Raising private capital is easier than ever given the surplus of lenders searching for new investment opportunities. Only a few years ago there was just a handful of investment banks that were interested in PPPs, now banks worldwide are interested in PPP investment.

PPPs are seen as a stable form of long-term investment so long as the contractual arrangements are put in place correctly. This is helped greatly by PPP projects in which the public partner acts as a guarantor. These types of projects are increasingly raising interest with investors as they are less risky than having only private finance involved.

Some countries are, at last, putting the necessary legislation in place with either specific PPP laws, as in Poland, Romania and Slovenia, or the adaptation and use of concession, privatisation and procurement laws, as in Hungary, Latvia and Georgia. PPP centres staffed by people who are being educated about PPPs are being put in place in the Czech Republic, Bulgaria and Romania. These units are being given the responsibility

of assisting ministries to develop PPPs and providing advice on how PPPs should be developed and procured. In the Czech Republic and Romania, guidelines and standards are being formulated for PPP centres to help them provide guidance and advice to the ministries which are in charge of implementation.

Finally, in order to add to the knowledge base of the PPP centres, long-term advisory contracts are being given to international advisers. Thus, the way in which PPPs are being developed is being addressed by a number of transition countries and this will help to ensure that the development of PPPs is undertaken in a consistent and well thought out manner.

A number of consultancy studies are currently being conducted in order to define pilot PPPs in various sectors. In Romania, for instance, studies on the development of performance-based highway maintenance and a new pilot PPP for motorway construction are to be conducted. In Poland the development of performance-based highway maintenance is under review.

In the Czech Republic, where PPPs are being embraced probably more than in any other country, there are studies being conducted which review the possibility of PPPs in motorway construction, prisons, courts and hospitals. Another example is in Latvia where consultants are being employed to review PPPs in motorway construction, district heating and city lighting. However, on a cautionary note, past instances of this in Albania, the Czech Republic, Georgia, Poland, Romania and Slovenia have not resulted in PPPs being undertaken.

There are a number of recent developments that have been instigated by the European Investment Bank (EIB), EBRD and EU, that are worthy of mention here.

First, the Joint Assistance to Support Projects in the European Regions (JASPERS), which is a joint policy initiative of the EIB, EBRD and European Commission (DG REGIO). Its aim is to assist EU countries, principally new member states and acceding countries, to absorb structural and cohesion funds for the period 2007-13. This will be achieved through experts within JASPERS who can assist with project presentation and identification. The key priority of JASPERS is the preparation of PPPs to help ensure that they are compliant and compatible with necessary regulations.

The second key initiative is the European PPP Expertise Centre (EPEC). This is a joint EIB and EU initiative that aims to share policy knowledge and experience. It will provide information resources and one of its aims is to act as a network facility for member states. It will prepare review papers on EU experiences with PPPs. It will also undertake the preparation of case studies, generic guidance and tried and tested PPP structures. The setup of EPEC has not as yet been finalised but it will receive its core funding from the sponsoring organisations.

What progress has been made?

There have been some very visible PPP projects undertaken in transition countries, but there are a number of questions still being asked about these projects in terms of their long-term viability and also in terms of how much they truly embrace basic PPP philosophy.

In the transport sector there are motorway projects in, for example, Hungary with the M5 Budapest-Kecskemet-Roszke, which was originally a BOT with direct tolls but was then restructured with government support and is now under an availability payment. The M6 Erd-Dunaujvaros was recently let to the M6 DUNA concession company in which the state, through the State Motorway Management Company, has a 40 per cent share.

In Poland the construction of the A2 Oder-Poznan-Warsaw and the A4 Katowice-Krakow has been underway for many years and, recently, the construction of the A1 to the south of Gdansk has been granted as a PPP. In Croatia the A2 Zagreb-Macelj and the A8, A9 Bina Istra motorways have been under phased construction for a number of years.

In the field of airport development a number of contracts have been granted, or are to be granted in countries including the Czech Republic, Georgia, Hungary and Poland. However, it is clear from a number of these examples that the true definition of a PPP does not really fit with the forms of the contracts. In some cases the contracts have even resulted in legal action being taken by the contracted concession company.

Water and waste water is another area in which there has been a great deal of investment and interest in countries including the Czech Republic, Hungary, Latvia, Romania and Russia. These seem to be successful projects and are delivering key environmental services to the municipalities that have embarked upon them.

Whether these projects have been or are going to be successes, failures or compromises will only be seen in time. However, the key point to remember is that they are delivering the infrastructure even if it is not in a purist PPP form.

The challenges of applying PPP structures in transition countries

In my opinion the key challenges to applying PPPs in transition countries are no different, in many ways, to introducing them in any other country. The whole challenge can be summed up in two words, risk and uncertainty.

Risk applies in any country and can be divided into three key categories. First, there are commercial risks, also known as project risks. Commercial risks are those that are inherent in the project itself or the market in which it operates. Within this there are construction, operation and maintenance risks which, if the project is being implemented for off-balance-sheet financing reasons, are critical.

The private sector understands these risks and can mitigate against them so long as they are given sufficient flexibility to allow them to use their own knowledge and processing abilities in the delivery of the infrastructure.



Raising private capital is easier than ever given the surplus of lenders searching for new investment opportunities.

It is necessary for the public sector partner to understand the basics of shared and equitable risk allocation and not to try and insist on passing on risks that cannot be dealt with.

The most difficult type of commercial risk is the demand and revenue risk. When dealing with projects such as toll motorways or rail projects this type of risk is very difficult to calculate.

The difficulty of calculating the level of risk depends on the type of project. The risk associated with newly constructed greenfield projects is notoriously difficult to forecast and this was shown very clearly in the Standard & Poor's study undertaken by Robby Bain.¹ However, when dealing with an existing asset or brownfield site, the uncertainty is much more manageable and, therefore, more attractive. This is especially true in transition countries in which the economy is trying to grow to levels that have never been seen before and forecasting demand is, therefore, a truly difficult exercise.

Secondly, there are the macroeconomic risks, also known as financial risks, which relate to external economic effects that are not directly associated with the project. Again, this type of risk applies in any country including the transition countries. Knowledge of the stability or instability of inflation, interest rates and currency exchange rates are things that the private sector has to consider seriously, especially in countries in which the credit rating is low – for instance, below a BBB rating, or even nonexistent.

Thirdly, and the most important type of risk in many cases when dealing with transition countries, is political risk. Due to the relatively low maturity level of the political systems in place in transition countries, more frequent changes in the governments of these countries can occur and this can lead to high levels of uncertainty.

The swing from a positive approach to PPPs to a negative approach and cancellation of PPPs after an election is, unfortunately, commonplace in some countries. This has occurred in many countries and has become a watchword for concession companies which now look at how the procurement of a particular PPP will fit into the election cycle. In some cases the PPP can survive. For instance, the A1 project in Poland survived eight changes of government during its negotiation process.

Institutional instability often follows political instability: the latter often results in the transfer of competencies between institutions and the foundation of new institutions. It has occurred in a number of countries in which the roads administration body, for instance, starts as a single organism that delivers all state roads and motorways under one administration, then is divided into several units running motorways and state roads, then divided again into units covering the delivery of motorways and the maintenance of motorways. Then after a few years these organisations may be amalgamated, possibly due to a lack of overall resources.

Staff turnover within various institutions is also common. With the M5 in Hungary, for instance, there were five different Ministers of Transport in place during the development stage. The result of this type of political uncertainty and change of direction means that the contract award procedure can be drawn out, while senior staff in place at the beginning of the process change and new staff members have to start from scratch. This leads to higher transaction costs for both the public and private sectors with no certainty of success.

The final challenge to establishing PPPs in transition countries relates to government appreciation of what a PPP is and why it is being implemented, from both the government's and the private sector's points of view.

This concept of PPP allows a new method of delivery that is quite different to the traditional approach. One can no longer take for granted that a PPP is like other contracts. It is necessary for the public sector partner to understand the basics of shared and equitable risk allocation and not to try and insist on passing on risks that cannot be dealt with. This also applies to the private sector partner in that it should not try to make the state retain risks that it should accept and probably would in a more stable environment.

The issue of affordability is especially important for the public sector which must remember that each PPP needs to be added to the last one and that all future ones also need to be included. The public sector must ask whether there will be sufficient resources in future budgets to pay for the lifespan of the combination of all of the concessions. The public sector partner must understand that private finance is not free and must be willing to pay for it. This is essential in order to ensure value for money in the contract.

The procurement process must conform to the rules and be transparent. Opaque procurement processes that do not adhere to the rules have often been the downfall of PPP contracts in transition countries. This is a very expensive and damaging exercise to get wrong. To assist with this process international advisors, who are able to assess the best way to negotiate with the concession company's own international advisors, should be used during the procurement process.

Deals have been made and, in many cases, have had to be cancelled due to the lack of international-level negotiation ability. For the state, it is important to ensure that it gets the project, that the process of evaluation and justification is undertaken correctly and that it understands that the private sector has to make a profit. Otherwise, both parties may suffer.

Finally, the public sector needs to learn to be patient. It takes a long time to introduce PPPs – both the United Kingdom and Australia, two of the first countries to introduce PPPs, that have few of the transitional problems of countries in the EBRD's region of operations, are still refining the process. It may take many years for PPPs to become widely used and problem free in transition countries.

Notes

- ¹ R. Bain and M. Wilkins (2002) *Traffic in start-up toll facilities*, Standard & Poor's; R. Bain and J.W. Plantagie (2003) *Traffic forecasting risk: Study update 2003*, Standard & Poor's; R. Bain and J.W. Plantagie (2004) *Traffic forecasting risk: Study update 2004*, Standard & Poor's; R. Bain and L. Polakovic (2005) *Traffic forecasting risk study update 2005: Through ramp-up and beyond*, Standard & Poor's.

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A woman in a black coat is walking down a grand, ornate staircase. The staircase has a decorative metal railing with intricate scrollwork. The walls are a deep red color, and the ceiling features a grid of blue squares with gold circular motifs. The overall atmosphere is formal and historical.

**Public-private partnerships
in central and eastern Europe:
structuring concession agreements**



**Christopher
Clement-Davies**

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Public-private partnerships are increasingly being used in emerging market economies to finance much-needed infrastructure development projects. This article discusses the structuring of concession agreements, which often underpin such ventures and can be crucial to the success or failure of the project.

Public-private partnerships and concession agreements

Recent years have witnessed a sharp rise in the frequency and sophistication of attempts to apply public-private partnership² structures to infrastructure³ projects in the so-called emerging market countries⁴ of central and eastern Europe (CEE) and the Commonwealth of Independent States (CIS).

The trend appears to be accelerating. At one level, this is not surprising. Governments in the region have turned to this approach to infrastructure development for fundamentally the same reasons as governments in numerous other jurisdictions across the globe. Tight budgetary constraints, a growing faith in the virtues of privatisation, the extent and urgency of the need for new infrastructure, the search for better value for money in public services and the rapid evolution of the techniques and skills deployed in structures of this kind have all played their part, as they have in so many other regions and countries around the world as the project finance markets have expanded. This is now a familiar story.

Yet, the truth is that the attempt to make the same structures work in these emerging markets has often met with mixed success. There have been some high-profile success stories, but also some notable, and widely publicised, disappointments.

Many, if not most, of these projects are concession based, or involve concession or similar agreements of one type or another. Where they do so, the concession agreement will, from a legal perspective, underpin the whole structure, defining the relationship between public and private sectors, allocating risks and responsibilities, and representing a vital part of the lenders' security package.

What follows is a brief introductory discussion (designed principally for those not particularly familiar with this subject) of what the author sees as some of the main legal, commercial and practical issues that concession agreements can give rise to in CEE/CIS countries at an early stage of the evolution of their PPP systems.⁵

It is hoped that this will contribute to an understanding of the broader challenges involved in implementing public-private partnerships (PPPs).

Defining a concession agreement

In conceptual terms, concession agreements can be difficult to classify. One of the first tasks for a lawyer advising on a concession-related project is therefore to establish whether the local jurisdiction has a recognised jurisprudential concept of concessions. Many civil-law based jurisdictions place them in legal categories of their own, often within the area of public administrative law, with clear statutory definitions. Common law, by contrast, does not treat them as a separate species of contract, distinct from other forms of commercial agreement.

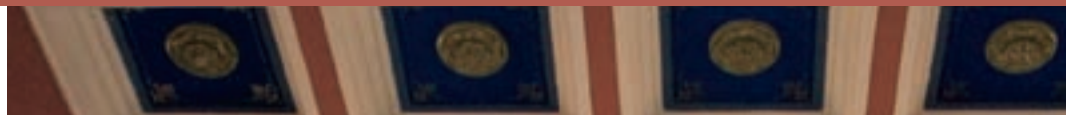
Under English law, a concession is essentially just a contractual licence. It will entitle the concessionaire to make use of certain facilities (often including real property) and to develop and implement the infrastructure project during the life of the concession. It may or may not be formally linked to a separate interest in land (such as a site lease).⁶

The objective should be to strike an appropriate balance that reconciles the concessionaire's need for autonomy and managerial freedom with the government's desire for an adequate degree of supervision and involvement.

Legislative background

Concession agreements in the countries of the region will often have to be drawn up in the context of an existing legislative framework. Concession legislation, where it exists, can obviously do much to smooth the process of developing and implementing a major project. It can create a clear framework for the public-private partnership in question, providing ready-made solutions for what could otherwise prove very difficult questions of scope and structure. On the other hand, the legislative framework can sometimes seem inflexible, obscure or politically skewed. Provisions may be imposed on the project sponsors which are not necessarily ideal for the project in question, and can represent an obstacle (and a potentially fatal one) to the raising of project-finance from international funding institutions.

The concessions laws in place in the jurisdiction of central and eastern Europe and the CIS are at differing states of evolution. The EBRD has carried out a comprehensive survey of them (available on its web site and see page 6), revealing an interesting range of strengths and qualities. Some of them (such as Lithuania) are regarded almost as model pieces of legislation of this kind. Others may need further refinement if they are to have the hoped-for effect.



Principal issues

Any number of issues can arise as concession agreements are negotiated. That is perhaps not surprising, given the extent to which any one infrastructure project will differ from another. There have been repeated requests for standardised concession agreements to be adopted internationally, but there have so far been few indications of real progress on this front.⁷ The next section of this article attempts to summarise some of the major issues typically encountered in negotiation.

Public sector control

One area that nearly always proves highly contentious in negotiation is the subject of the degree of control exercised by the public sector over the concessionaire during implementation of the project, whether before or after construction is completed. Obviously, the concession agreement will contain minimum standards, approval rights and controls designed to ensure that the concessionaire performs his side of the bargain.

Yet the public sector will frequently demand a greater degree of control than this, perhaps not surprisingly, given its residual role as guardian of the public interest. It may try to insist on a right to approve any change or modification to the concessionaire's equity structure, for example. It will often expect to have broad rights of participation and approval over the design documents as they are produced, the construction works on site, the negotiation of the project and finance documents and their final terms, and the contents

of the operational regime. Many of these demands may in fact be inappropriate, however, reflecting the time and experience it can take in some countries to make the transition from traditional procurement to the more hands-off approach encountered on a successful PPP structure. The political sensitivities often associated with high-profile projects can exacerbate the temptation to micro-manage.

The concessionaire will usually try to resist or limit these demands. He will argue that, in order to discharge his fundamental undertakings and manage the various risks impinging on his activities, he will need a high degree of freedom from interference. Excessive government control may prevent him from performing as well as he otherwise might. After all, the government is transferring the project to the private sector in order to benefit from its managerial and creative skills. Flexibility and the ability to innovate will be important to its ability to perform well. If additional finance is needed because the project is not going according to plan, it will be up to the concessionaire to find it, and his equity investments that stand to lose most up front as a result. The concessionaire's lenders will also be very concerned about the possibility of excessive government interference. In the end, the public sector will be protected by its termination rights if the concessionaire fails to deliver.

The outcome is often a heavily negotiated compromise. There are legitimate concerns on both sides. The objective should be to strike an appropriate balance that reconciles the concessionaire's need for autonomy

and managerial freedom with the government's desire for an adequate degree of supervision and involvement, taking account of the concessionaire's available resources for this purpose.

Some examples of the specific areas on which this discussion tends to centre include:

- **Standards and objectives:** The government entity should focus on the results to be achieved and standards to be met by the concessionaire, rather than the means by which the concessionaire achieves them (on the output specification, rather than the concessionaire's input methods, in the language of PFI).⁸

- **Debt finance:** The government entity will want to satisfy itself that the concessionaire has obtained the necessary finance to perform its obligations before the agreement is entered into, or at least becomes unconditional. The terms of the senior debt finance are likely to be relevant to its potential liability on a termination. For these reasons, at least certain rights of approval of the initial funding agreements may be unavoidable. The more difficult question relates to re-financing. What limits should be placed upon it?

Risk allocation

To a large extent, the underlying theme throughout the negotiation of the agreement will be the question of risk allocation. The starting point of many concession-based projects in emerging markets will be a wide-ranging assumption of risk by the private sector. The real question concerns what risks will be shouldered or retained by the conceding authority, and what protections it will offer the concessionaire against them.



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- **Approval of design and construction:** It should usually be sufficient for the conceding authority to receive copies of design documents as they are produced, and to have discretionary rights of inspection over the works as they progress, perhaps together with a power to counter-certify certain critical stages, such as practical completion.

- **Identity of shareholders:** Restrictions on changes to the concessionaire's shareholding structure are likely to have more significance during the comparatively high-risk, pre-completion phase, however, than after it. Once a stable operational level has been reached (perhaps a year or two after completion), it should not particularly matter if a shareholder wishes to sell down its interest.

- **Insurance:** The conceding authority should not usually try to prescribe the concessionaire's entire insurance programme. It will make sense, however, for it to seek assurances as to certain categories and perhaps minimum amounts of insurance relating to areas which impinge directly on its interest (for example, physical damage, third party claims, and employer's liability). Other areas (for example, business interruption, latent defects) should be at the concessionaire's discretion.

The answers will vary widely from project to project, and depend on many factors. Government risks may include (at least in part) some or all of the following:

- legal capacity and legislative authority to grant the concession
- site acquisition
- certain essential licences, permits and consents
- timely provision of utilities (for example, water and electricity)
- certain financial safeguards (for example, investment protection rights)
- political events
- nationalisation/expropriation
- protestor risk
- change of law/fiscal regime (to some extent)
- inflation and economic disruption (possibly)

- competition from other facilities
- government variation orders (cost and economic consequences)
- *force majeure* (in part).

In each case, however, there may be ways of sharing the risk between government and concessionaire, so that incentives to find constructive solutions to unforeseen circumstances are maximised. One of the central objectives in structuring a concession agreement should be to strike a suitable balance in terms of risk allocation. It is now a truism of project finance that risks should be borne by the party best able to manage them. As a risk allocation tool, however, this principle does little more than provide general guidance.

There is often a temptation for each party to attempt to induce the other to shoulder as much risk as it possibly can. For example, the conceding authority will sometimes try to back away from taking on obligations which no other party should rationally accept (the author has seen unsuccessful attempts to draft concession agreements without any clear-cut government obligations at all), whilst the concessionaire may ask for protection against unforeseen developments of almost any kind (for example, any material adverse event beyond its control).

One factor that will play a prominent part in determining the pattern of risk allocation is the question of the concessionaire's control over its charges or tariffs. Where the concessionaire is free to set and revise its tariffs at its own discretion, charging the public directly for use of the completed facility,

it will often be in a much better position to absorb and manage the impact of events beyond its control than would otherwise be the case. Its position will in some respects resemble that of any other entity doing business in a particular country.

This contrasts with many UK PFI projects using a shadow toll structure or government revenue stream, where tariffs will be determined from the outset by agreement with the public sector, and will not be capable of revision except in closely defined circumstances (subject to any market testing mechanisms).

Emerging market projects, including in central and eastern Europe and the CIS, tend towards the former model (partly because there is often less government inclination (or ability) to pay the concessionaire directly for its services). The difference between the two can lead to very different approaches towards risk allocation in the agreement.

It is, in many ways, in this context that the contrasts between PFI projects in the UK and emerging market deals becomes most striking. Sponsors and their lenders will often be in a position to ask for much broader protections in the case of the latter, given the very different risk profiles to which they are likely to be subject. But it is important to avoid the temptation to ask for too much in emerging market deals. The danger is that, if either side pushes too hard in negotiation, the project stands to suffer as a result, running the risk of precipitating a collapse of relations between the parties, or at least a continuing pattern of tension and confrontation, and leading to poor

value for money for the public sector (not to mention overly protracted negotiations). Ultimately, the most constructive approach is to adopt a flexible and rational attitude towards risk allocation, leaving risks where they can be managed and controlled most effectively. If the agreement is structured in a way which fosters a spirit of partnership and cooperation, of "win-win" solutions to problem solving, the project stands a greater chance of succeeding.

Tariff structure

One area where the subject of public sector control over the concessionaire's activities can become particularly acute is in relation to the concessionaire's tariffs or charges for the services it provides. The initial charges levied by the concessionaire can be contentious enough in themselves; they may involve charges to the public for services which hitherto have been provided free-of-charge. Even where this is not the case, there may have to be a significant increase in charges to enable new facilities to be financed and built.

The more difficult area, however, relates to increases in tariffs over the life of the concession. In what circumstances can this happen, and within what parameters? Where the revenue stream is provided by the public sector (which to date has only rarely been the case with PPPs in emerging markets in the region, in contrast with PFI projects in the UK, where it is the norm), the government entity will by definition have a large degree of control over any increases.

One of the central objectives in structuring a concession agreement should be to strike a suitable balance in terms of risk allocation. It is now a truism of project finance that risks should be borne by the party best able to manage them. As a risk allocation tool, however, this principle does little more than provide general guidance.



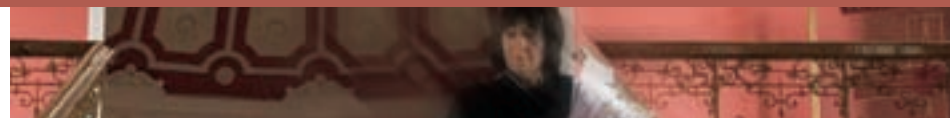
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The more problematic situation is where third-party users of the facility (the general public) are charged tariffs directly by the concessionaire (for example, tolls on a motorway or charges for clean water). Here, the concessionaire will often seek as much discretion as it can to make any increases which it regards as necessary. The government, however, may see it as critical to prevent undue tariff rises, especially given their political sensitivity.

If a well-developed regulatory system is in place, this may be the mechanism by which any increases are controlled, making it perhaps unnecessary for the concession agreement to address the subject. There are many examples, however, of concessions being awarded in the region in circumstances where a regulatory regime is underdeveloped or even non-existent. In that case (as mentioned above), the concession agreement may itself represent the government’s regulatory tool. This can lead the parties to draw up a set of regulatory principles applicable to tariff setting and any revisions.

Either way, the concessionaire and its lenders will seek adequate scope to pass through additional costs to customers in response to given events – for example, resulting from economic dislocation, changes in law, requirements for additional investment and other exceptional events.

Structuring a mutually acceptable tariff will obviously also raise much broader issues than ones of control. It will be fundamental to the agreed pattern of risk allocation. There may be complex questions, for example, about the most appropriate mechanism to use (a unitary charge or a series of discrete charges), about performance measurement and



the structure of a penalty regime, about pass-through components, the treatment of demand risk and availability and so on.

The concessionaire’s financing structure will play a prominent part in these discussions. On the other hand, the sophisticated bench-marking and market-testing techniques developed in the PFI context in the UK do not seem to have been applied yet to projects in the region.

Quality of service and performance standards

The subject of the definition and measurement of a concessionaire’s quality and level of service during the operational phase can also represent a complex area. Questions include:

- How is availability defined?
- How exactly are any penalties structured (for example, how are they weighted between the concessionaire’s different responsibilities)? How exactly will any deductions be applied?
- What are the quantitative and qualitative service level objectives?
- What is the distinction between wholly unavailable and merely sub-standard levels of service?
- What are the monitoring and measuring arrangements (for example, objectivity or self-monitoring mechanisms)?
- What are the tolerance levels and cure periods for defective performance?

This area is likely to need somewhat fuller development in the case of a concession involving a government-sourced revenue stream than one where the facility users are being charged directly, and where the concessionaire’s revenues will to some extent, by definition, be self-policing. In the latter case, revenues should to some extent rise and fall with levels and quality of service. A performance penalty regime may be inappropriate or unworkable. In the former, the public sector will be paying the concessionaire for the provision of a service.

The payment mechanism may therefore be structured so as to be conditional on the concessionaire attaining stipulated performance criteria. As already noted, PFI projects tend to involve the former model,⁹ projects in the region under discussion the latter.

Financial balance provisions

A concession agreement will usually contain a number of different clauses and provisions designed to protect the concessionaire against the impact of unforeseen risk. It can be helpful, however, to draw at least some of these threads together in the same provision, often referred to as a financial balance, change of circumstance or exceptional event clause. They tend to feature amongst the most difficult and contentious of the agreement’s provisions to structure and negotiate. In broad terms, the aim of a clause of this kind will be to put the concessionaire (typically) or perhaps both the parties (more unusually), as far as practicable, in the same

In emerging market countries, the concessionaire will usually press for the broadest possible protection against unforeseen risks. Sometimes, it will even be entitled to seek an adjustment for any material adverse event beyond its control.

net position as before the event triggering the adjustment occurred. Put more crudely, its main objective will usually be to provide a suitable degree of protection against risks that the concessionaire cannot absorb. It will achieve this by setting out a basis for modifying or adjusting the terms of the agreement to allow for the impact of these events – for example, by increasing tariffs or extending deadlines for the performance of certain tasks. Hence the contentiousness of these provisions in negotiation.

It can take time for the rationale for a clause of this kind to be fully appreciated. The need for it arises from the very long-term nature of a concession agreement, coupled with the fact that tariffs may be fixed or regulated under the terms of the agreement. This may leave the concessionaire with much less ability than parties to many other types of commercial contract to manage risks beyond its control – for example, by transferring their economic impact to third parties. Conversely, where the concessionaire has full and discretionary control over its tariffs, the need for such a provision diminishes. This question about control over tariffs should therefore be the starting point of any discussion of provisions of this kind.

There is obviously a considerable degree of overlap between a financial balance clause and a *force majeure* provision. A *force majeure* clause will relieve a party of liability for (certain) events beyond its control, but will not usually entitle it to compensation. A financial balance clause will also do the latter. There are really three distinct, if overlapping, areas that a financial balance clause must address, each of which can prove difficult to finalise and agree:

- Which events should lead to an adjustment?

- How should the impact of these events be measured?
- What form should any adjustment or compensation take?

The subject of which events should trigger the provision, potentially giving rise to an adjustment, is clearly a question of risk allocation. Certain events, such as political *force majeure* and change of law, are virtually certain to feature (at least in some form). Others will be more contentious non-political events of *force majeure*, for example, such as severe economic dislocation, the effect of competing facilities, failures of supplies of raw materials, interruptions in other necessary supplies and utilities, actions of other government bodies, changes in the fiscal regime, and so on.

Again, the scope of financial balance clauses tends to differ radically between emerging market projects, where risks may be much harder to predict, quantify and manage, and developed economies, with their more stable and familiar business environments. In emerging market countries, the concessionaire will usually press for the broadest possible protection against unforeseen risks. Sometimes, it will even be entitled to seek an adjustment for any material adverse event beyond its control (although a mechanism expressed in such generalised terms would generally be considered too vague today).

PFI projects in the UK, by contrast, often allow the concessionaire only very limited protection of this nature (limiting any change of law to discriminatory and specific changes, for example). In the end, the critical factor will be the perception of risk in the particular environment.

The second question is about the basis on which the impact of these events is measured and quantified. What criteria should be applied – for example, reduction in cash flow, effect on the concessionaire's net financial position (which may need to be defined), or some other basis? The public sector will justifiably be concerned about any basis that allows the concessionaire to claim losses too readily or too subjectively. In addition, what, if any, allowance should be made for windfall benefits derived by the concessionaire from unforeseen events? How should these be netted off against any adverse consequences?

Finally, there is the question of how the concessionaire should be compensated. How, exactly, are any remedies to be applied? Commonly, the agreement should leave considerable flexibility as to how this is done, since an over-prescriptive approach may be difficult to apply. The concessionaire will often be entitled to an increase in tariffs, an extension of the term of the concession agreement, an alteration to completion milestones or capital expenditure requirements, a cash payment, or a combination of all these. The agreement should ideally lay down an agreed, objective basis for determining how any adjustments are to be made, with remedies listed as a series of options, which the dispute-resolution procedures can give effect to, in the absence of agreement.

Change of law

The questions raised by the structure of a change of law clause often feature prominently in any concession negotiation. They illustrate several of the points made in the preceding



paragraphs. Which changes of law, exactly, should entitle the concessionaire to relief and/or compensation? In the UK context, compensation is typically restricted to a narrow range (discriminatory and specific changes of law, for example).

In a rapidly changing emerging market, however, this is unlikely to be sufficient for the concessionaire. The legal system in question may be subject to numerous uncertainties. It may be undergoing rapid, radical transformation (as it has already in most countries of central and eastern Europe), affecting many of the areas of law relevant to a PPP (such as security, environmental, tax and regulatory).

If the concessionaire is free to set its own tariffs, perhaps without restriction, what sort of protection, if any, does it

Termination and compensation

A concession agreement will typically contain a termination clause, but its contents can prove highly contentious. If exercised, it would trigger the unravelling of the matrix of agreements underpinning the whole project, and put the project assets (on which tens or hundreds of millions of dollars might have been spent) back into government hands.

The grounds on which termination rights can be exercised will be one area of difficulty. Some will be almost unavoidable. From a public sector perspective they are likely to include the insolvency of the concessionaire, abandonment of the project, and prolonged material breach of contract (which may have to be defined).

much compensation as possible where the government entity is in default, or where a convenience or public-interest termination is involved; they would expect this to be sufficient to cover the concessionaire's senior and junior debt, and to allow the investors an adequate return. It is therefore likely to include the full value of assets transferred back to the government, as well as a proportion of revenues foregone, together with unwinding costs. Calculations may be based on paying out senior debt and third-party creditors, followed by equity at market value (as defined), or on the net present value of the future revenue stream (minus operational costs). Alternatively, they may be tied to the sponsor's financial model and its assumed rates of return.

The more challenging question relates to a termination where the concessionaire is at fault. The conceding authority will usually be inclined towards the opinion that the concessionaire should receive

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really need? Will it be in a position to pass on its additional costs (in whole or part) to end users? If not, should there be a threshold amount which the concessionaire has to absorb before it can seek redress?¹⁰ Should changes of law requiring capital expenditure be treated differently from operational costs? Who should be responsible for obtaining any additional finance needed for the former? What if it cannot be obtained? What, if any, changes of law will entitle either party to terminate the agreement? There are no ready-made answers to these questions. Mutually acceptable solutions will have to be found through negotiation.

Equally, the concessionaire will need the protection of rights of termination based on effective annulment of the concession (expropriation of essential assets, for example, or withdrawal of certain permits and consents) or, again, unremedied breach of contract. Other grounds of termination – such as elements of country risk, or change of law or prolonged *force majeure* – will be more debatable.

The subject of greatest contention in this area tends to be the question of the termination payments payable in these circumstances. The concessionaire and its lenders and investors will expect as

no compensation whatsoever in these circumstances. If the government has agreed to step-in rights, and termination has proceeded after an unsuccessful attempt to exercise them, this argument may be reinforced. The project company's shareholders may be prepared to live with this approach, and to forego any return on equity (or other compensation) in this event.

The lenders will be more reluctant to do so, however. They are likely to have provided most of the project's finance (perhaps 80 per cent or more). They will usually find it unacceptable that most of this funding should simply be written

The public sector may simply find the notion of compensation on default deeply unacceptable. At the very least, it will try to ensure that the concessionaire has appropriate incentives to perform, and that it stands to suffer substantial losses if it fails to.

off, and the public sector receive a large windfall benefit, as a result of a default which they may not have been in a position to cure.

The outcome of these discussions will not be easy to predict. The issue tends to be highly emotive. The public sector may simply find the notion of compensation on default deeply unacceptable.¹¹ At the very least, it will try to ensure that the concessionaire has appropriate incentives to perform, and that it stands to suffer substantial losses if it fails to.

A compromise solution that has been applied to a number of projects in the region is to provide for full compensation for transferred assets to be paid as a starting point in these circumstances, but to allow the public sector to deduct its actual losses (for example, rectification costs) attributable to the concessionaire's default. Alternatively, assets taken back into public hands may be valued on a different basis than where the government is at fault (for example, a proportion of historic cost, as opposed to a depreciated replacement value). The current trend in the UK context is towards an approach based on the market values of the assets transferred. It is questionable whether this approach will often be readily available in the countries of the region.

Step-in rights

Where a concession-based project is being project financed (involving a limited-recourse, predominantly debt-financed structure, where repayment of the debt depends principally on future revenues), the lenders are likely to insist on step-in rights being granted to them in relation to it, set out largely in an

ancillary direct agreement. These will allow them, in effect, to take over the project, if necessary bringing in a substitute concessionaire, in order to forestall a termination of the concession agreement following the concessionaire's default. They will suspend the operation of any termination procedures and ultimately allow a novation (transfer) to take place of the project contracts to a third party to take place.

Project finance lenders will take the most wide-ranging package of security measures that they can over the project assets. Yet this will be virtually worthless if the concession agreement is no longer in place. If the agreement is terminated, the ability and right of the sponsors and the concessionaire to generate the cash flow on which the lenders will depend for repayment will be lost; the collapse of the other project contracts is likely to be triggered as well. For that reason, the lenders will regard it as essential to keep the concession alive, as it were, and give the project company (or a substitute entity) an opportunity to cure the default. Step-in rights are designed to achieve this.

Almost invariably, however, these rights prove controversial. For government bodies that have not encountered them before, the underlying principle can require a great deal of explaining and justification. The more awkward questions include the following:

- **Trigger events.** In what circumstances, exactly, should these rights be allowed to come into play?
- **Cure periods and procedures.** For how long will the government's termination rights be held in suspense, subject to ideal procedures, as the lenders attempt to cure a default and/or find a substitute concessionaire?
- **Project restructuring.** How extensive should the lenders' rights be to restructure the project, replace the shareholders, modify the project contracts and change the parties to them? What approval rights should the government have in relation to any new participants in the project?
- **Limitation of liability.** What responsibility should the lenders (or their step-in vehicle) have for the existing liabilities of the concessionaire – full, limited or none?
- **Step-out.** In what circumstances should the lenders be allowed or obliged to abandon their attempt to step-in to the project?
- **Insurance proceeds.** What obligations should the lenders have to apply insurance proceeds to rebuild, repair or replace defective works? In what circumstances can they simply apply them to reduce outstanding debt?
- **Interrelationship with termination payments.** If the lenders have negotiated extensive termination payments on a concessionaire default, do they also need step-in rights, and vice versa?



Law and disputes

The structuring of dispute resolution mechanisms in concession agreements needs careful thought; more so, in some respects, than in many other forms of commercial agreement. Three distinct forms of dispute resolution mechanism will usually be needed, relating to:

- Disputes about the interpretation and application of the agreement's provisions, where a breach of contract is alleged. Should proceedings be litigated or arbitrated?
- Questions about minor adjustments to the agreement (such as replacement of the component of an index) where expert determination can be used.
- Disputes about modifications to the agreement, in connection with the operation of a change of circumstance provision (for example, modifying deadlines or adjusting tariffs).

There is frequently fierce disagreement between the parties to emerging market projects about whether or not local law, the local court system or local arbitration should be used. Governments will often push strongly for the use of indigenous law and court systems. They may see a high-profile concession as an opportunity to foster recognition of these systems, and may find it difficult for policy reasons to agree to anything else.

Lenders and investors, on the other hand, may regard this as unacceptable. They may have concerns about the impartiality of local systems where a major government body is concerned. International arbitration, in a neutral location, under one of the more familiar international systems often becomes the compromise solution, but, in a surprising number of cases, the choice of local law to govern the agreement will eventually be accepted by sponsors and lenders alike. It is not unusual that the relevant legislation will, in fact, require it. Even if it does not, local enforcement considerations, public law issues and security considerations may, in fact, make this a perfectly rational end result.

Disputes about how to make fundamental revisions to the concession agreement, on the other hand, to give effect to exceptional event or financial balance provisions, may be less susceptible to resolution by arbitration.

It is a fundamental principle of English contract and procedural law that courts will not re-write the parties' agreement for them. An arbitration forum would need to be specifically empowered to do so, and its powers may anyway be limited. How exactly the parties will allow for alterations to be made to the concession agreement to give effect to clauses of this kind, in the absence of agreement between them, is likely to vary from project to project.

In general terms, however, the mechanism chosen tends to involve a form of refined expert determination, with more extensive powers than an expert would usually have, such as a panel of three experts, with appropriate experience and qualifications, to be constituted at signature, with power to apply the financial balance provisions when they arise. A panel may also be used in the first instance as a form of alternative dispute resolution, or mediation, before any final action is brought in the courts or arbitration forum.



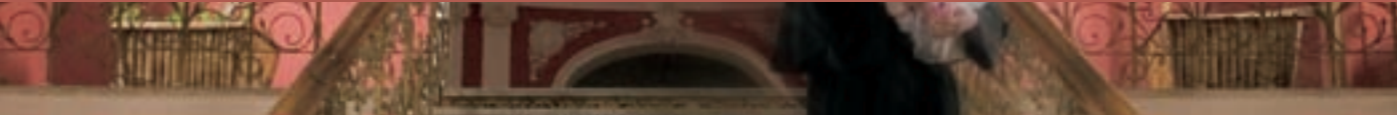
Governments will often push strongly for the use of indigenous laws and court systems. They may see a high-profile concession as an opportunity to foster recognition of these systems, and may find it difficult for policy reasons to agree to anything else.

The likelihood is that PPPs will continue to be adopted and refined on an increasing scale in CEE and the CIS. The need for a firm, sophisticated and balanced understanding of the contents of the concession agreements that underpin them is consequently as great as ever.

Conclusion

As this article has tried to suggest, the range of issues raised by the structuring and negotiating of concession agreements for emerging market projects can be as broad and diverse as the projects themselves. There is remarkably little consistency. For lawyers working on these agreements, this reinforces the need to be flexible and creative: innovative solutions frequently have to be found to take into account the idiosyncrasies of each project and the differing expectations of its participants. Precedents and guidance materials can be helpful but should not be used thoughtlessly. In the words of the PFI mantra, the emphasis should be on “deals, not rules”.

As familiarity with this type of agreement grows within the international legal and financial community operating in the region, however, greater consistency and predictability of approach is bound to follow. It remains to be seen whether further attempts will be made to standardise concession agreements. In the meantime, much can be gained by simply disseminating information about these agreements and the issues that typically affect them, as the author has sought to do here. The likelihood is that PPPs will continue to be adopted and refined on an increasing scale in CEE and the CIS. The need for a firm, sophisticated and balanced understanding of the contents of the concession agreements that underpin them is consequently as great as ever.



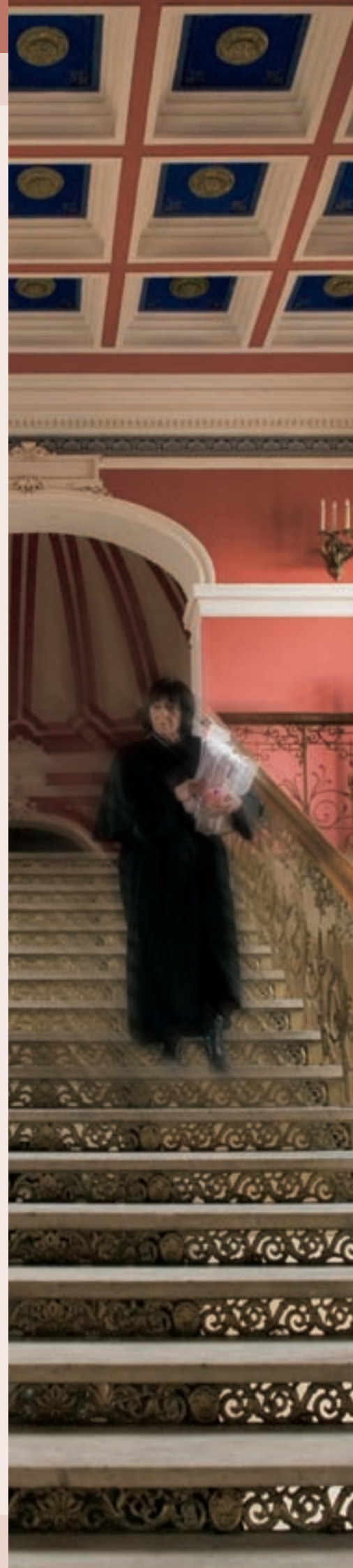
Notes

- ¹ Partner of Fulbright & Jaworski and a member of its International, Structured and Project Finance, and Energy Practice Groups. His experience of concession agreements includes drafting, negotiating or simply advising on concessions for the following projects: the Bucharest (water supply) Concession (Romania); Timisoara Water Project (Romania); the Crivina-Ogrezeni BOT Project (Romania); the Maribor Waste Water Project in Slovenia; the Almaty Water Concession in Kazakhstan; the Litoral Centro Toll Road Project in Portugal; the Hazira Port Concession (India); the Fort William and Inverness Project in Scotland; the Daldowie Project in Scotland; South Manchester Hospital (UK); the Channel Tunnel Rail Link (UK); the Pego Power Project (Portugal); the A55 Anglesey DBFO Project (Wales); the Second Severn and Skye Projects (UK); the Karachi Hydrocracker Project (Pakistan); the Port of Aden BOT scheme (Middle East); and the Bangkok Second Stage Expressway (Thailand). He has also advised the governments of Russia, Lithuania, the Czech Republic and Kazakhstan on their concessions laws, and acted as a special adviser to the United Nations UNCITRAL Committee on Privately-Financed Infrastructure Projects.
- ² This article uses the expression public-private partnership in the broadest sense. There is no generally accepted definition of the term. Increasingly it is being used to refer to the full range of structures that involve shared risks and responsibilities between public and private sectors for the development of infrastructure projects, from Build-Own-Operate (BOO), Build-Operate-Transfer (BOT), Build-Own-Operate-Transfer (BOOT), Design-Build-Finance-Operate (DBFO) and the many other variations on this particular theme. That is how it is used in this article. The term has been used extensively in the context of the Private Finance Initiative (PFI) in the UK. It is now being used increasingly commonly in the emerging markets context as well. The new market for these structures in the United States is referred to with the lucid term P3!
- ³ Equally, the author does not have any specialised interpretation of the word infrastructure in mind. The issues discussed are equally applicable to concession agreements in the water, road, port, health, telecoms and energy sectors – indeed, to any form of infrastructure.
- ⁴ The focus of this article is emerging market projects. It is by no means easy, however, to make hard-and-fast distinctions between practice in this area in emerging markets, on the one hand, and the so-called developed nation economies, on the other. Differences of approach will obviously be found. They will differ from place to place and time to time, however. It is notoriously difficult to generalise at any level about emerging markets as a whole, let alone the precise ways in which they differ from their OECD neighbours. Many, if not most, of the issues discussed here apply equally to the latter as the former. Where the author believes there is a clear difference in approach between the two, he notes this in the text. The text also contains a number of references to practice in the UK and other parts of the world, primarily by way of contrast.
- ⁵ A great deal of written material has become available on this subject in recent years. In particular, the Treasury Task Force (TTF) in the UK (now formally disbanded) published hundreds of pages of guidance in the past few years on the provisions of PFI contracts, culminating in the recent standardisation of contract documents. The author has therefore tried to concentrate in this article on the issues that have recurred most frequently in the negotiation of concession agreements with which he has been involved, with a focus on emerging markets.
- ⁶ This disparity in legal classification partly explains why there are now so many different labels for what is fundamentally the same form of agreement; project agreement, development agreement, implementation agreement (at least in certain respects), franchise are all largely interchangeable terms. Their use is sometimes preferred in order to avoid the confusion that concession can give rise to, given its different meanings and categorisation from jurisdiction to jurisdiction. However, in substance, the agreement to which these labels refer are often very similar, in terms of the legal, commercial and practical issues to which they give rise. For the purposes of this article, they will all be referred to as concession agreements.
- ⁷ In the UK domestic context, some very impressive work has been carried out by the TTF in standardising certain provisions of PFI contracts. See Treasury Task Force, 2002, *Standardisation of PFI Contracts*, Office of Government Commerce. Where clauses cannot be fully standardised, the published guidelines have anyway led to much greater consistency of approach in agreements. Numerous PFI projects based on the TTF's recommended clauses have now been signed. Access to a large body of precedents in the PFI context – often available to the private sector as well as government departments – has also led to much greater consistency. Certain sectors witnessed the rapid emergence of model form contracts.
- ⁸ See the list of papers available on this subject on the Treasury web site (www.hm-treasury.gov.uk). In particular, the *Guidance Note on Public-Sector Comparators* explains the more technical aspects of the UK government's approach to risk transfer and value for money.
- ⁹ "The negotiated performance regime will form a key element of the risk-transfer mechanism". (TTF guidance *Standardisation of PFI Contracts*). The structuring of performance penalties has, indeed, been a central part of the negotiation of most PFI projects, it seems.
- ¹⁰ The preferred approach on PFI projects is for any entitlement to compensation to be subject to a stepped or banded series of thresholds, so that the recourse available depends on which band the additional cost falls into. This is a good example of a risk-sharing mechanism. The idea is to maximise the concessionaire's incentives to manage this risk.
- ¹¹ There have been examples in the UK of projects being financed without it, although they appear to be rare. There seem to be very few examples in emerging market countries.

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Russia

This section is devoted to Russia, the country where the 2007 EBRD Annual Meeting of Governors is taking place. This is also the vast country where the EBRD plans to have 41 per cent of its annual commitments by 2010. The section offers a variety of views and topics authored by practising lawyers, Russian government officials and academics.

In the first article, Yulia Zvorykina, Director of the Investment Department at the Russian Ministry of Transport, presents the Russian experience with PPPs, bridging harmoniously the two focus areas of this issue of *Law in transition*. Jay Allen of the EBRD examines the insolvency system

in Russia, while Gian Piero Cigna and Elena Sulima of the EBRD dedicate their article to the quality of Russian capital markets legislation.

The Deputy Chief of Staff of the Russian Government, Mikhail Kopeikin, offers his comments on the status of the economic and legal situation in Russia as viewed from the 'White House'. Finally, Vladimir Peysikov, Provost of the Russian Academy of Justice, details the experience his institution has had with the training of judges, an area of critical importance for the development of the rule of law in the country.

A photograph showing three women gathered around a wooden table in what appears to be a library or office. The woman on the left is wearing a grey blazer and glasses, looking down at an open book. The woman in the middle is wearing a red and white striped shirt and jeans, also looking at the book. The woman on the right is wearing a black top and has her hand to her chin, looking towards the book. The background shows bookshelves filled with books.

**Public-private partnerships
in the transport sector:
a Russian view**



Yulia Zvorykina

Director,
Investments Department,
Russian Ministry
of Transport

The Russian transport sector has chosen the concession model as the main model of public-private partnerships (PPPs). If the public and private sectors are able to change their patterns of thinking and of doing business together, PPPs could prove to be a key element in the development of the Russian transport sector.

Fundamental changes to different sectors of the economy are being made in most countries and concern sectors which, until now, have invariably been under state ownership and management.

Enterprises working in these areas, mostly monopolies, cannot be privatised because of their strategic, public, social and economic importance. On the other hand, state budgets do not possess sufficient resources for adequate levels of funding. In such cases, the state may, on a medium- to long-term basis, grant to privately owned companies the right to operate gas, energy, transport, water supply and sewer systems, although it would retain the right to regulate them and control their activities.

These contradictions create the need to consider attracting private investment to sectors of the economy that have always been thought of as the prerogative of the state. Some countries have used PPPs in order to resolve such contradictions.

Nowadays PPPs are being used in more than 100 countries worldwide. PPPs have become the main tool used by states to address economic and social service resource issues and budget

limitations. This is due to the fact that private sector management is considered to be more effective than that of the state sector.

PPPs have been rediscovered in contemporary Russia. They could not be used in the former Soviet Union for obvious reasons. However, in Russia during the 1920s – the New Economic Policy period – PPPs in the form of concessions were a very popular and effective tool. Nowadays the public and private sectors need to relearn how to use this tool.

During the final stages of its transition to a market-based economy, Russia has been able to use PPPs as an institutional and organisational alliance between the public and private sectors. This type of partnership enables the state to implement socially important projects in a wide spectrum of activities ranging from the development of strategic branches of industry to the advancement of social services. As a rule, each PPP is established for a specific time-scale and a specific project. Partnerships or alliances are considered to be temporary, because they end after the project in question has been completed.

This article will focus on current challenges in the transport sector. In Russia, the level of financing and infrastructure for this sector does not meet the country's macroeconomic and social needs. The level of investment in transport infrastructure is less than 2 per cent of gross domestic product (GDP) even though in most countries it is at least 4 per cent of GDP or higher.

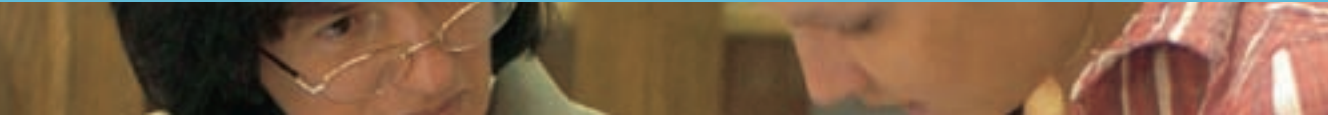
PPPs in Russian transport

Experts estimate that the potential volume of private investment in transport infrastructure in Russia is €12-15 billion per year. Private sector investors are interested in financing transport infrastructure but they are also keen for the government to set out clear goals in its long-term strategic plans.

In recent years the state has established several preconditions for increasing the use of PPPs. These preconditions, listed below, have largely been met:

- increased cooperation between state and private business, as well as consultations about the use of PPPs

From a legal point of view, one particularity of the Russian concessions law is that the agreement is construed as a private law contract.



- passing of the federal *Law on Concession Agreements*¹
- transition from one to three-year plans as part of budget reform
- adoption of the *Regulation on Investment Funds*
- adoption of standard concession agreements
- establishment of special economic zones and industrial and technological parks.

Concession agreements are regulated by the federal *Law on Concession Agreements*. The law governs the relationships that arise in the planning, conclusion, performance and cancellation of concession agreements. It also establishes the rights and interests of the parties to an agreement.

Developing concession agreements in Russia

A decision was made to use the concession model of PPPs in Russia. Concession agreements include elements of different types of agreements which have been approved by federal law. They focus on immovable property, the creation and/or reconstruction of which is stated in the agreement. The following types of projects can be the subject of concession agreements:

- motorways and transport infrastructure
- railway and pipeline transport
- sea and river ports
- sea vessels, river vessels and mixed-use vessels
- airport facilities

- unified air traffic management facilities
- underground and other types of public transport
- medical, social and welfare projects.

Land cannot be the subject of a concession agreement. The period of an agreement's validity is established by the agreement itself according to the date of the construction and/or reconstruction of the subject matter of the concession agreement, the investment volume and pay-back period and other obligations of the concessionaire under the agreement.

The concession payment should be specified in the contract. It can be set in the form of definite payments, product share, income from the activity which is the subject of the agreement or a transfer of the property belonging to the concessionaire. The functions of government authorities during the preparation, conclusion and execution of the agreement are established, as are the rights and duties of the parties including the concessionaire's duties toward third parties. According to the law, the agreement is entered into on the basis of the results of an open competition.

From an economic point of view, concessions allow the public sector to reduce state expenditure and attract external investment and management resources into areas which have high expenditure and are not very profitable. The use of concessions stimulates competition and helps to develop the investment market, which needs more private investment. From a legal point of view, one particularity of the Russian concessions law is that the agreement

is construed as a private law contract, even though in other countries other models are also used. The legislators adopted this approach as a matter of principle.

There are several reasons why the concession model of PPPs was chosen. Concessions are the most highly developed and complex form of partnership. Unlike most other types of contracts, concessions are long term and this allows both parties to carry out strategic planning.

With concessions, the private sector partner is given administrative and management flexibility. This decision-making freedom distinguishes this type of PPP from other models such as joint ventures and work contracts. In addition, the state retains the ability to exert pressure on the concessionaire if it breaches the terms of the contract or if the public interest has to be protected. The state transfers ownership and use of the assets to the concessionaire for the term of the contract. However, the public partner is responsible for monitoring the performance of the private partner and at the end of the contract ownership of the assets reverts to the public partner.

The *Law on Concession Agreements* forbids the pledging of assets that are the subject of a concession agreement and of the rights of the concessionaires selected by open competition. Most assets that are the subject of a concession agreement naturally remain in the public sector because they are for the public's use. Concession agreements may not be used to transfer assets that should remain state property, such as motorways, into private ownership.

The challenges of establishing concessions in the transport sector

The passage of the *Law on Concession Agreements* cleared up many of the difficulties attracting investment into transport infrastructure, but some issues still remain. It is important to create special-purpose funds for developing infrastructure or to develop a sector-specific concessions law that will specify which transport projects will be the subject of PPPs and concessions.

Limited development of and serious restrictions in domestic financial markets, in particular where long-term finance is concerned, cause problems with raising investment funds. One possible source of investment could be pension funds guaranteed by the state.

Another serious problem is that land legislation is not very advanced. In particular, the most difficult issues in the field of transport are the absence of specific rules governing the reservation and seizure of land, and issues related to the tenure of land upon which transport and infrastructure stands.

Improvements to the legislative system are being made with a view to facilitating the granting of concession agreements. Federal authorities must provide consultancy support at the regional and municipal levels. Consultants could help with supporting and monitoring concession projects, promoting best practices, retraining state and municipal employees and establishing centres of competence.

It is necessary to provide consultancy support to executive authorities at all levels during the preparation of concession agreements, co-financing for agreement implementation and budget guarantees. This should be done through the Russian Investment Fund and targeted budget programmes.

The Ministry of Transport has created an advisory council on PPP development in order to assist with entering into PPPs. The ministry has signed an agreement with the Russian Vneshekonombank whereby the bank acts as an investment adviser with respect to large infrastructure-based PPP projects.

and engineering infrastructure, including bridges, overpasses, tunnels, parking, checkpoints and toll booths for trucks.

The Ministry of Transport has developed and forwarded to the Ministry of Economic Development and Trade draft standard concession agreements based on Resolution 319 in the following areas:

- airports, buildings and/or facilities intended for take-off, landing, taxiing and parking of aircraft and industrial and engineering airport infrastructure
- sea vessels, river vessels, mixed-use river/sea vessels, ice-breakers, hydrographic and research vessels, ferries and floating and dry docks
- sea and river ports, hydraulic engineering constructions in ports, industrial and engineering infrastructures in ports
- railway transport facilities
- underground and public transport
- water engineering facilities.

At this stage the draft standard concession agreements mentioned above have been reviewed and revised by the Ministry of Economic Development and Trade and have been sent to the federal government.



Federal authorities must provide consultancy support at the regional and municipal levels. Consultants could help with supporting and monitoring concession projects, promoting best practices, retraining state and municipal employees and establishing centres of competence.

Legislation pertaining to state obligations, including the Budget Code and the Civil Code, should be amended. In order for concessions to be effective the legislation should be simplified, especially the sections that deal with permits, licences and so forth. Legislation on book-keeping and real estate registration should be harmonised with new laws.

The transport sector needs qualified employees and managers who are capable of undertaking large infrastructure projects. A special education programme was organised by the Transport Engineering Institute of Moscow to provide the Ministry of Transport with specialists in the field of transport concessions.

Russian Government Resolution 319 of 27 May 2006 approved standard concession agreements for motorways

The Russian Investment Fund (Investfund) was created in 2005 to provide state co-financing for large projects of federal importance. The use of Investfund resources is set to become the most important instrument of budget support for private business investment projects.²

Investfund is a PPP instrument that aims to make it easier for business to finance strategically important long-term projects which have low levels of return.

The availability of Investfund resources will expand the opportunities for businesses to invest in projects which cost no less than 5 billion roubles through direct co-financing. Up to 75 per cent of the cost can be provided by the federal budget and there will also be state guarantees.

State support will be provided in three ways:

- direct co-financing of the projects
- equity participation in the company managing the projects
- state guarantees, which will be different from current Ministry of Finance guarantees.³

Investfund plans to provide transitional financing, in the form of a long-term investment agreement between state and private investors. The possibility of sharing commercial risks also exists.

We will now turn from discussing ways to develop PPPs in Russia to individual investment projects and their particular features.

PPP projects in the Russian transport sector

The construction of a toll road, the Western High-Speed Diameter (WHD), in St Petersburg is a very good example of a concession-style project. This project has gone beyond having merely a regional purpose and is of great importance for the development and increased competitiveness of the entire Russian transport system. The WHD connects the large seaport of St Petersburg to a network of federal motorways and the European system of international motorways.

concession projects and basic liability for Russia's commitments under road concession projects lie with Rosavtodor, the federal road agency.

However, only the basic requirements for such documentation, membership of the tender commission and the terms for concluding the concession agreement were approved. The procedure for the transfer of federal government powers listed above to Rosavtodor was not stipulated.

A comprehensive list of areas of Rosavtodor's authority has not yet been determined. It is important, however, that the agency be given the following areas of authority:

- to decide which land to requisition to let to concessionaires
- to regulate and approve the tariff level

A PPP is a compromise between the public and private sectors. Taking into account the fact that the state budget is only approved for one year at a time, the state cannot guarantee that payments will be made in second or subsequent years of a project.

We should note that, during the first stage of PPP development in a country, the state must take risks in order to reassure private partners. In time and after a certain level of experience has been reached, risks may be shared more equitably between public and private partners. If this does not happen, the partnership mechanism will lose its meaning.

A PPP is a compromise between the public and private sectors. Taking into account the fact that the state budget is only approved for one year, the state cannot guarantee that payments will be made in second or subsequent years of a project. That is why the shift to a three-year budget plan is an important step in concession planning and creates a certain level of stability in public-private relations.

In addition, the southern section of the WHD directly adjoins the line of the ring road around St Petersburg and connects the seaport with 13 federal and territorial roads from St Petersburg in the direction of Belarus, Estonia, Finland, other parts of Russia and Ukraine.

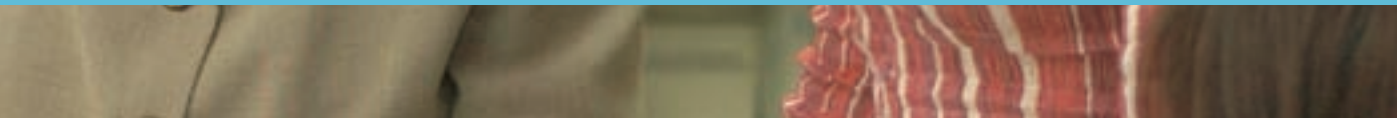
On the basis of Russian Government Order 1494-r of 31 October 2006, draft documentation for competitive tenders has been prepared. It has been reviewed by the Ministry of Transport and forwarded to the Ministries of Finance and Economic Development and Trade.

The federal government has approved the guidelines for carrying out competitive tenders for the WHD concession. The guidelines stipulate that the functions of the concedent on behalf of the state with regard to road

- to grant minimum income guarantees.

A market study showed that potential participants would definitely refuse to take part in concession tenders if there were not minimum income guarantees for pilot concession projects.

The tender documentation for concession agreements to construct high-speed motorways is now ready and has been circulated for review and revision. A motorway will be built on kilometres 15 to 58 of the Moscow to St Petersburg road. A new exit from the federal M-1 Moscow-Minsk motorway (the Odintsovo bypass) is also being planned.



The tender documentation was prepared with input from the draft concession agreement developed by the Freshfields Bruckhaus Deringer legal team, taking into account recommendations from the EBRD, World Bank, Ernst & Young, Citigroup and Macquarie Bank as well as investment market requirements and expectations.

Projects to design documentation for the investment project for the construction of the Krasnodar-Abinsk-Kabardinka toll motorway and for the construction and subsequent operation on a toll basis of the M-4 Don motorway from Moscow

The M-4 Don from Moscow through Voronezh, Rostov-on-Don and Krasnodar to Novorossisk project on kilometres 21 to 117 and 330 to 464 will create a 233 kilometre network of toll motorways. The project will entail the construction or reconstruction of 128 kilometres of road. The five pre-existing sections of toll motorways on this part of the road will be subsumed into this project.

The project will be carried out in two stages. During the first stage the design and estimate documentation will be developed, preparatory work will start on construction sites and a competition

- the share of domestic transport companies in the Russian international transit services market will increase to 50 per cent
- the tonnage of the merchant marine fleet in Russian waters which is registered in the national register and controlled by Russia will increase to 56 per cent.

The development and approval of the Development of Export Transport Services portion of the modernisation project has allowed us to take the first step towards creating effective tools to tackle existing problems. This, in turn,

A market study showed that potential participants would definitely refuse to take part in concession tenders if there were not minimum income guarantees for pilot concession projects.



to Novorossisk were approved on 21 November 2006 by the government commission for investment projects and are described below.

The civil engineering design of the Krasnodar-Abinsk-Kabardinka toll motorway has been approved by the commission for investment projects. It provides for the construction of a 147 kilometre four-lane toll motorway with seven tunnels and 76 bridges. The project will take place in two stages.

The first stage will comprise the development of the technical, design and estimate documentation and the preparation of the construction sites. The second stage will be the construction of the road. It is estimated that 50 per cent of the funding will come from the federal government, 24 per cent from the Krasnodar territory and 26 per cent from the private sector partner. The commission has allocated 1.2 billion roubles from Investfund for the preparation of the design and budget documentation during the first stage of the project.

will be held to attract private investors. The second stage of the project, which will begin in April 2008 and will last for approximately two years, will entail construction of new sections and reconstruction of the remaining sections of the road.

Investfund will allocate 167 million roubles for the first-stage design and estimate documentation. During the second stage, the construction of the road, it is estimated that not less than 50 per cent of the costs will be covered by a private sector investor.

The Modernisation of Russia's Transport System (2002-10) project is forecast to achieve the following results by 2010:

- transport services volume will double to US\$ 13.1 billion
- the growth of transit traffic will be 25-30 million tonnes
- numbers of airport transit passengers will increase by five to seven times, to 3 to 4 million passengers per year

has allowed us to depart from standard schemes to increase the proportional output of different types of transport infrastructure and to start using complex tools to enable infrastructure projects, including PPPs.

Examples of projects within the export transport portion of the project include the construction of port complexes in Murmansk and Novorossisk. These investment projects have been approved and private sector companies have competed in open tenders.

Projects related to the development of complex transport infrastructure include the construction of a versatile reloading complex, in the Ust-Luga seaport and the development of transport infrastructure in the port of Taman, including a dry cargo area. These projects have been positively received by the Ministry of Transport's Advisory Council on PPPs and have been recommended for consideration by the Investment Commission of the Ministry of Economic Development and Trade.

PPP projects have also been developed for building access roads to the Elginskoye and Elegestskoye coal deposits in the Tyva Republic and the development of port railway stations.

Conclusion

It is estimated that the completion of the complex transport infrastructure development projects mentioned above will increase Russian gross domestic product by 0.2 to 0.3 per cent. Transport infrastructure concessions could reach an annual investment volume of up to US\$ 2-3 billion by 2010.

In summary, I would once again note that in Russia today, the implementation of large projects for the construction of motorways, railways, ports and airports is only possible through the attraction of domestic and international capital on the basis of PPPs. Given current budgetary limitations, the adoption of the widespread international practice of using PPPs is the only way forward.

We must not allow narrow-minded perceptions, that private sector companies are efficient and the public sector companies are not, to persist. It is extremely important to dispel illusions about easy opportunities for private business in certain sectors to acquire a natural monopoly by using loopholes in relevant legislation, and then to establish their own rules of the game discriminating against other players.

The future of public-private partnerships in Russia depends on the success of large infrastructure projects. Both the public and private sectors need to prove that they are reliable partners that are capable of meaningful dialogue and mutual cooperation.

In Russia today, the implementation of large projects for the construction of motorways, railways, ports and airports is only possible through the attraction of domestic and international capital on the basis of PPPs.



Notes


- ¹ Law on Concession Agreements, Number 115-FZ, 21 July 2005.
- ² Pursuant to Russian Government Resolution 694 of 23 November 2005.
- ³ They will not have to be included in the annual budget and will not be terminated at the end of each year.

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**The Russian
insolvency framework:
building a credible system**



Jay Allen
Counsel, EBRD

The Russian insolvency system is neither as effective nor as efficient as it should be and the system of implementation requires reform. The EBRD and the Russian Ministry of Economic Development and Trade (MEDT) are working together to build the capacity of insolvency regulators and propose legislative reforms.

In recent years there has been a great deal of reform in the Russian insolvency system. Despite this, the system continues to lag behind international standards, having problems with effectiveness which can negatively impact the economy. At the heart of the problem is that the system relies upon insolvency administrators who are often insufficiently trained and qualified to carry out the functions given to them. Furthermore, the system of monitoring has the potential to open the system to corruption. The EBRD and the MEDT will undertake a project to address some of the system's major shortcomings.

Sanity from madness

When Spanish-born philosopher George Santayana wrote "Sanity is a madness put to good use", he was most assuredly not writing about the world of insolvency, but his words could not ring truer in that context.

Insolvency has a terrible reputation among the general population. It is seen as a negative, even disastrous situation. People lose money in insolvency, some lose jobs and others see their dreams crumble around them. A state of

insolvency can produce anger, fear and uncertainty. In itself, insolvency is madness and rightly seen as something to be avoided.

Without insolvency, however, an economy would suffer because assets would be used inefficiently, the ground rules of competition would be strained and economic growth could be depressed.

In our pursuit of a sane and rational world, how then are we to put this madness to good use?

We make the best out of a bad situation through the development of detailed processes and sets of rules and procedures to govern the actions of debtors and creditors in an insolvency situation. Insolvency laws establish the rules and procedures by which uncompetitive and inefficient entities are effectively removed from the market place and productive assets are diverted away from them. They create new prospects for wealth and growth. From debt and stagnation come prosperity and advancement.

Insolvency laws, by their very nature, are designed to allow the efficient reallocation of assets, encourage

risk taking by entrepreneurs and allow proper risk assessment. None of this, however, can happen in a vacuum. The best law is only as good as the people who implement it. A good law is not enough; one must work to build the system of implementation.

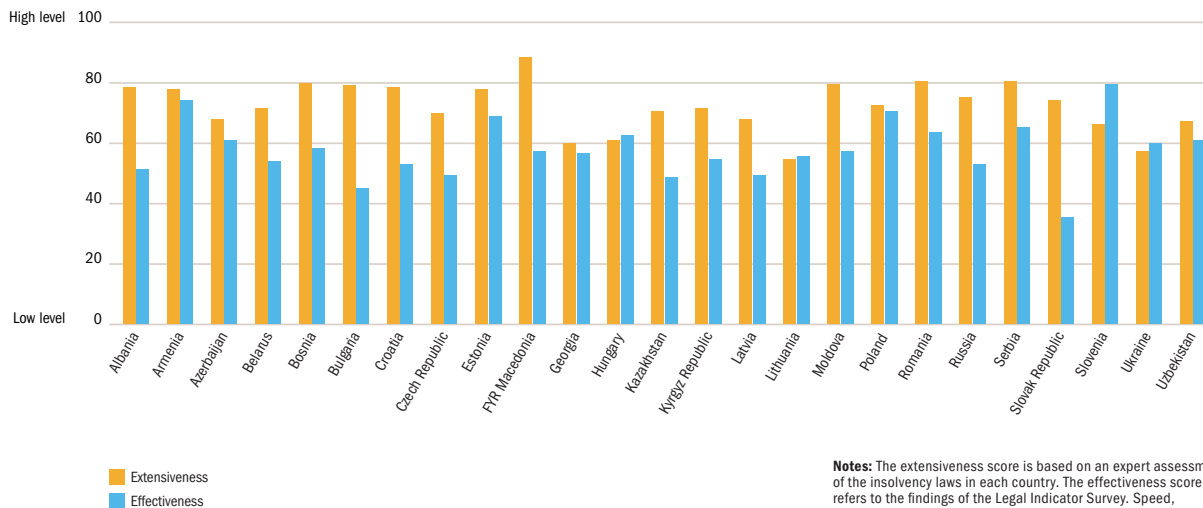
The EBRD, through its Legal Transition Programme, is committed to providing assistance to its countries of operations to help them establish not only good laws but also the frameworks that allow these laws to be properly implemented. One current project, for example, is designed to improve the capacity of Russian regulators to train, oversee and bring discipline to the practice of insolvency administrators.

This article outlines the development of the Russian insolvency system, review the state of the law and its practical application and provide an overview of the joint EBRD-MEDT Russian insolvency regulator capacity building project.

History

Russia's first modern insolvency law was adopted in 1992 and proved to be far less than functional. Its 1998 successor brought many important changes,

Chart 1 Insolvency legal regimes in transition countries
Extensiveness and effectiveness by country



Notes: The extensiveness score is based on an expert assessment of the insolvency laws in each country. The effectiveness score refers to the findings of the Legal Indicator Survey. Speed, efficiency and predictability scores for each country were combined to provide an overall effectiveness rating. The extensiveness and effectiveness scores are measured on an ordinal scale from 0 to 100 with higher scores representing better performance. Data for Montenegro, Tajikistan and Turkmenistan were not available.

Source: EBRD Insolvency Sector Assessment Survey, 2003-04 and EBRD Legal Indicator Survey, 2004.

but was riddled with loopholes and created a process that was easily manipulated in order to strip companies of assets, defraud creditors and stifle competition. It was often used for completely ulterior motives. The 1998 law proved to be a valuable tool for hostile takeovers with rivals buying up their competitor's debt for the purpose of bankrupting the competition.

Reforms in 2002 brought about what effectively amounted to a new law on insolvency, an amended version of which continues in effect today. The 2002 *Law on Insolvency (Bankruptcy)* saw major changes to the insolvency regime with the ultimate goal being to free the system from corrupt elements.

Among the notable changes were: amendments to the qualification requirements for administrators;¹ provision for the establishment of self-regulatory agencies which would train, oversee and assign the work of insolvency administrators; changes to the initiation procedures which, at least on paper, made it easier for creditors to initiate proceedings; and the adoption of a new form of restructuring called financial rehabilitation which, unlike

previously available methods of restructuring, would allow the incumbent management to remain in place under the supervision of a temporary administrator.

The reform also saw the enactment of stiff new penalties. Top corporate managers who disclose a firm's insolvency after it is too late face severe fines, deliberate bankruptcies can result in prison terms of up to six years and opposition to arbitrary managers and withholding or falsifying information can result in prison terms of up to three years.

In 2005 there was a significant reform with respect to the monitoring of insolvency administrators. On 13 October 2005 the Federal Registration Service (FSR) was created by presidential decree in order to take responsibility for, among other things, exercising control over the activities of self-regulating organisations (SROs) which are responsible for the registration and oversight of insolvency administrators.

The duties of the FSR include: ensuring that SROs comply with federal laws; conducting audits and checks of SROs; pursuing applications in the arbitration courts for the removal of SROs from the state register; pursuing court actions to bring administrators or SROs to administrative responsibility; taking part in the training of administrators; approving an examination for admission to SROs; and approving a uniform programme of training for administrators.

Evaluation of the law

In 2003 and 2004, the EBRD conducted detailed studies of the extensiveness (the quality of the law on the books) and the effectiveness (the way the law is applied in practice) of insolvency law regimes in the Bank's countries of operations.

Chart 1 shows that the extensiveness of these laws in the sample countries generally exceeds the effectiveness of their implementation. Reasons for the implementation gap can include poorly trained administrators, insufficient regulatory oversight and inadequate judicial capacity.

While Russia ranks among the top half of the group in terms of the extensiveness of its law, it rests in the bottom third in terms of the effective implementation of that law.

The Insolvency Sector Assessment – the extensiveness study – measured the level of compliance of each country’s insolvency legislation with international standards. Each country was measured across 97 different indices of extensiveness and was, ultimately, given a final score ranging from very low to very high in reference to its level of compliance with international standards.

Clearly, there has been progress in the development of Russian insolvency legislation. The 2002 *Law on Insolvency (Bankruptcy)* is a considerable improvement on previous Russian insolvency legislation. Nevertheless, Russia’s law only scored medium in the Insolvency Sector Assessment.

Chart 2 displays the data collected in the assessment and shows the level of compliance of the Insolvency Law with international standards in five core areas, with reorganisation and treatment of estate assets being highlighted as areas for particular concern.

Progress should be measured not by quantity but by quality

Undeniably, there has been a great deal of reform in Russian insolvency laws in recent years, but problems continue to exist, throwing into doubt the quality of the reform. The deficiencies noted in the assessment included that:

- the legislation fails to provide a balance-sheet test for insolvency; it fails to provide sufficient safeguards with respect to reorganisations, including a failure to prohibit critical suppliers from threatening to cut off supply unless past debts are paid in full
- the cross-border insolvency provisions are insufficient in that they rely on international treaties and reciprocity rather than the United Nations Commission on International Trade Law (UNCITRAL) Model Law or similar EU regulations

- the power of insolvency administrators to review pre-bankruptcy transactions is weak and ineffective, possibly preventing insolvency administrators from undoing improper behaviour by debtors and, thereby, maximising the estate value.

Most critically, however, the system was seen as:

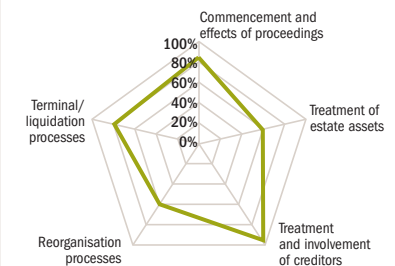
- slow – for example, the period of observation before any effective insolvency process becomes effective may last for seven months or more
- inefficient, in that it is usually necessary to obtain and then endeavour to execute a judgement debt before there will be sufficient evidence of cash flow insolvency, a process that can take 12 months or more
- presenting significant barriers to creditor participation, in that ordinary creditors are sometimes subject to the domination of state creditors.

While the Russian government should be commended for undertaking reforms, the overall quality of the implementation of the legislation remains relatively low in comparison to leading international standards.

When the EBRD Legal Indicator Survey (LIS) which studied the effectiveness of insolvency law regimes was conducted, it was decided to look at the practical functioning of insolvency law regimes from the perspective of both debtors and creditors. In each of these cases, many aspects of insolvency law regimes were measured. Specifically, with respect to insolvency administrators in creditor-initiated insolvencies, the competence of the bankruptcy administrator was measured. In debtor-initiated insolvencies, the quality of the debtor’s management, which is considered by bankruptcy administrators in many of the EBRD’s countries of operations, was measured.²

As Charts 3a and 3b demonstrate, the Russian system did not fare well.

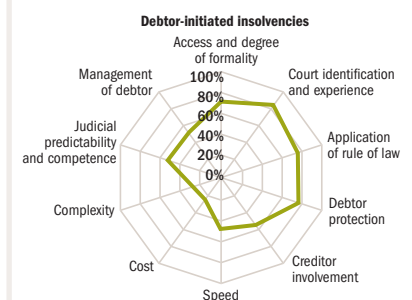
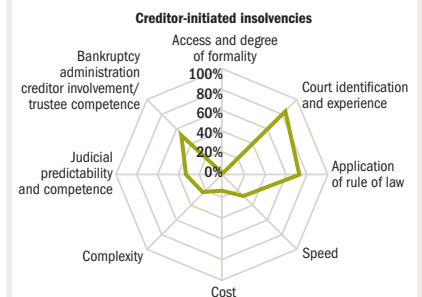
Chart 2
Quality of Russian insolvency legislation (2004)



Notes: The outer boundary indicates significant compliance with international standards. The fuller the web, the more comprehensive the system.

Source: EBRD Legal Indicator Survey, 2004

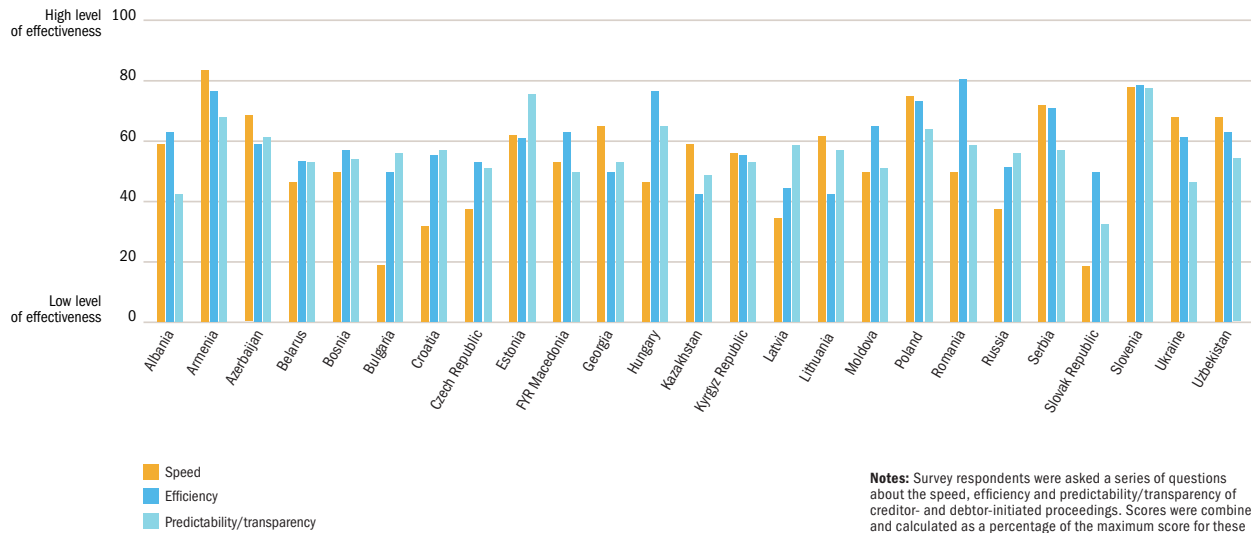
Chart 3a and 3b
Assessing the Russian insolvency system in practice



Notes: Survey respondents were asked a series of questions about the speed, efficiency and predictability/transparency of creditor- and initiated proceedings. Scores are calculated as a percentage of the maximum score for these criteria with higher values representing better performance. The fuller the web, the more effective the insolvency regime.

Source: EBRD Legal Indicator Survey, 2004

Chart 4 How insolvency laws work in practice
Effectiveness by principal criteria



Notes: Survey respondents were asked a series of questions about the speed, efficiency and predictability/transparency of creditor- and debtor-initiated proceedings. Scores were combined and calculated as a percentage of the maximum score for these criteria. Data for Montenegro, Tajikistan and Turkmenistan were not available.

Source: EBRD Legal Indicator Survey 2004.

The LIS demonstrated significant problems in most areas, with complexity, speed, cost and judicial predictability being identified as problems for both creditor and debtor-initiated proceedings. Especially problematic were the results relating to creditor-initiated insolvencies which demonstrated quite serious access problems and highlighted the difficulties faced by creditors when enforcing their rights. Overall, the data appear to indicate that the Russian system is somewhat slow, inefficient and unpredictable.

Chart 4 demonstrates that the Russian insolvency system lags behind many of the insolvency systems in other EBRD countries of operations. The Russian system's speed rating was amongst

the worst, while efficiency and predictability/transparency were rated as roughly average.

What is clear from the EBRD's analysis is that Russia performed poorly in practice with respect to insolvency administrators. The country has an adequate insolvency law but there is a large implementation gap and a lack of qualified administrators capable of effectively implementing the law. This is significant because Russia's insolvency legislation places a high degree of responsibility on insolvency administrators. The administrator is charged with the duties of running a transparent liquidation process, investigating suspicious transactions and, in cases in which financial

rehabilitation and external management are employed, managing the debtor's business.

Unfortunately, a good law that is not supported by well-trained and well-regulated insolvency administrators may, in some specific cases, be worse than a bad law which does not even contemplate many of the above duties.

Clearly, there is the scope and need for reform within the Russian system. It is not enough simply to reform the law; there must be quality reform of both the legislation and its implementation for there to be real change.



What is clear from the EBRD's analysis is that Russia performed poorly in practice with respect to insolvency administrators. The country has an adequate insolvency law but there is a large implementation gap and a lack of qualified administrators capable of effectively implementing the law.

The Russian insolvency regulator capacity-building project

There are now over 30 insolvency administrator-related SROs in Russia. This level of decentralisation brings with it a significant risk that the monitoring of administrators will be unequal between organisations and it creates an environment that allows corruption to exist. Within the Russian system, creditors who initiate proceedings have the right to select an SRO from which the administrator will be appointed. The SRO will then nominate administrators for the case.

It is possible that this could lead to SROs becoming beholden to certain creditors and working for their benefit to the detriment of other creditors. Another concern with the system is that the SRO control over the access to work could make individual administrators subject to corruption from within the SRO itself, either in the form of demands for bribes or pressure to carry out their duties in favour of a particular creditor.

Insolvency administrators are the heart of many insolvency systems. The starting point for real reform is to improve the quality of administrators and the system for their oversight in a country. At present, many administrators in Russia are poorly trained by their SRO, despite the best efforts of the FSR and the MEDT. Worse still, the system is vulnerable to unethical practices by administrators – for example, preferring the interests of a single creditor to the detriment of other creditors, or turning a blind eye to the illegal or unscrupulous actions of that creditor.

In order to improve this situation, the EBRD and the MEDT, with funding from the Swiss State Secretariat for Economic Affairs, are to undertake a project designed to build the capacity of insolvency regulators in Russia.

The project will involve working closely with the MEDT along with the FSR and the SROs to review existing training and monitoring procedures and suggest improvements that will build the overall regulatory capacity within the country. To that end, the EBRD will meet with local practitioners, lawyers, accountants, government officials and others in order to understand better the practice of office holders and to design and implement a survey to obtain an understanding of the conduct of insolvency cases in Russia.

This information will be used in the preparation of a comprehensive implementation manual in respect of the core practice areas for administrators for use by the FSR and the MEDT in overseeing and setting standards for them. Among other things, the implementation manual will include standards and best practices for the administration of insolvent estates, including reference to reviewing transactions, reviewing claims and conducting sale processes, methods for reporting by and monitoring of insolvency administrators and methods for carrying out disciplinary functions.

The project will also result in a review of the licensing examination and educational curriculum to suggest ways to improve the extensiveness of the educational material as well as the effectiveness of its implementation. These suggestions will build on the already established system and will work with the existing examination and curriculum. To assist with the implementation of this, the EBRD will “train the trainers” to use the revised products.

Finally, the project will include suggestions for relevant legislative reforms and, as required, comment on insolvency related legislative initiatives brought forward by the MEDT.

Notes

- ¹ Article 20. A Russian citizen meeting the following qualifications may be an arbitration insolvency practitioner, if she/he: is registered as an individual entrepreneur; has a higher education background; has a work record as an executive of at least two years in total; has passed a theoretical examination under the arbitration insolvency practitioners training curriculum; has undergone probation for at least six months as an assistant arbitration insolvency practitioner; has no financial or other serious criminal conviction; and is a member of a self-regulating organisation.
- ² European Bank for Reconstruction and Development, *Transition Report 2004*, Annex 1.1.

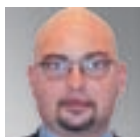
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The image shows a high-angle view of a grand, classical-style building interior. A large, multi-paned arched window dominates the left side, reflecting the sky and surrounding structures. Below the window, a statue of Lady Justice stands on a balcony, holding scales of justice. The building's facade is light-colored with ornate architectural details, including columns and decorative capitals. The overall atmosphere is one of grandeur and historical significance.

**Securities market
legislation in Russia:**
past, present and future



Gian Piero Cigna
Counsel, EBRD¹



Elena Sulima
Counsel, EBRD

A recent EBRD assessment found that Russia's securities market legislation is in medium compliance with international standards. This article discusses how Russia performed in the assessment, how it could improve its level of compliance and provides an insight into current reforms.

The EBRD recently completed an assessment on the quality of securities market legislation in its 29 countries of operations.² The initiative – which focused on the law in force on 31 May 2005 – is devoted to gauging the compliance of securities market legislation with the Objectives and Principles of Securities Regulation published by the International Organization of Securities Commissions (IOSCO).

This article focuses on how Russia fared in the assessment and provides an insight into current reforms there.

Compliance with international standards

In order to collect the data on national legislation in the EBRD's countries of operations, the Bank devised a questionnaire which covered the major aspects of securities legislation based largely on the IOSCO Principles. With nearly 300 questions, the questionnaire covered 11 subject areas, ranging from the powers of the regulator to money laundering issues.

The responses were analysed and each answer was assigned a score. Scores were then weighted according to the importance assigned to specific sections. Finally, the sum of the weighted section scores was averaged in order to derive a single numerical value for each country. Based on these results, each country was placed into a grouping that indicates its level of adherence to international standards for securities markets legislation.

The 29 countries were divided into five categories according to their score (see Table 1 overleaf). Very high compliance means that the international principles are fully reflected in national legislation. Countries with high compliance ratings have relatively sound existing laws in the majority of areas highlighted by the principles. Those countries with medium compliance ratings have areas of concern where improvement is needed. A rating of low compliance indicates a situation where the general quality of the legislation should be improved and a rating of very low compliance is a symptom of a legal system which needs urgent reform.

It should be noted that the assessment looks exclusively at the quality of the laws on the books. An analysis of the actual implementation of securities markets legislation is planned for publication by the EBRD in the second half of 2007.

Russia's securities market legislation was found to be in medium compliance with international standards. Chart 1 overleaf shows how Russia fared in each of the 11 subject areas.

As illustrated in Chart 1, some of the sections analysed by the EBRD assessment are in line with international standards. The existing legislation was found to be of very good quality especially with respect to self-regulation and money laundering issues. On the other hand, other sections showed several weaknesses where the Russian authorities should concentrate their priorities for reform.

Table 1 Quality of securities market legislation in the EBRD's countries of operations

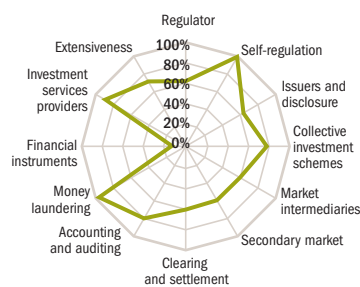
Compliance with international securities markets standards

Very high compliance/ (No countries)	High compliance/ (9 countries)	Medium compliance/ (11 countries)	Low compliance/ (4 countries)	Very low compliance/ (3 countries)
	Bulgaria Czech Republic Croatia Estonia FYR Macedonia Latvia Lithuania Slovak Republic Slovenia	Armenia Bosnia and Herzegovina Georgia Kazakhstan Montenegro Poland Romania Russia Serbia Ukraine Uzbekistan	Albania Belarus Kyrgyz Republic Moldova	Azerbaijan Tajikistan Turkmenistan

Note: The assessment took into consideration the legislation in force on 31 May 2005.

Source: EBRD Securities Market Legislation Assessment 2005

Chart 1 Quality of securities market legislation in Russia



Note: The extremity of each axis represents an ideal score, corresponding to the standards set forth in IOSCO's Objectives and Principles for Securities Regulations. The fuller the web, the closer the relevant securities market legislation of the country approximates these principles.

Source: EBRD Securities Market Legislation Assessment 2005

The regulator

The scope, responsibilities and independence of the regulator, including its enforcement and supervision powers, are detailed in the IOSCO Principles on the Regulator³ and on Cooperation in Regulation.⁴ Since March 2004, the Russian securities market regulator has been the Federal Service for Financial Markets (FSFM).

The FSFM was established by merging the competencies of the former Federal Commission for the Securities Market with those belonging to the Ministry of Labour and Social Development and the Anti-monopoly Ministry for supervision of the exchange and adding those of the Ministry of Finance for the supervision of pension funds. The FSFM operates directly under the jurisdiction of the government and its functions range from the regulation of securities issuance and trading – including the power to propose bills to the federal government – to the control and supervision of issuers, market participants and self regulatory organisations (SROs).⁵

The FSFM has access to the books and records of market participants and can decide to hold inspections. In cases

where irregularities are found, the FSFM can suspend or revoke a licence and can refer matters for criminal prosecution.⁶

All information received by the FSFM must be treated as confidential. Indeed, the law prohibits the use of such information for uses other than market supervision, but sanctions in case of a breach are generally too low to discourage illicit behaviour.⁷ Moreover, the law prohibiting insider trading has not yet been put in place (see page 71).

The FSFM is an ordinary member of IOSCO but has limited agreements in place for collaboration and information sharing with foreign regulators.

One of the major flaws revealed by the assessment is the FSFM's lack of independence: its chairman is appointed and dismissed by the government at its discretion and its resources depend entirely on the federal budget.

As a result, this core area of national legislation was found to be in medium compliance with international standards.

Self-regulation

IOSCO Principles six and seven deal with SROs, recommending their use for exercising oversight responsibility in some defined areas under the supervision of the regulator. SROs are organisations which exercise some degree of regulatory authority over the securities market and are able to enforce regulations on their members, such as minimum financial and reporting requirements. Typical examples of SROs are national securities exchanges, registered securities associations, or registered clearing agencies which are authorised to regulate the conduct and activities of their members, subject to oversight by the regulator.

Under Article 50 of the *Law on the Securities Markets*, SROs in Russia are organised as non-commercial organisations, made up of at least ten professional securities market participants.⁸ SROs are required

to submit to the FSFM the rules defining their organisation and membership as a condition precedent for obtaining the licence. SROs are required to cooperate with the FSFM and other SROs for the enforcement of laws, regulations and rules.⁹ SROs have the authority to enforce their own regulations, impose appropriate sanctions for non-compliance and ensure fair representation of their members on the board.¹⁰

SROs are also required to follow certain professional standards adopted by the FSFM. However, with the exception of certain requirements set forth in Chapter 13 of the Securities Law and Resolution Number 24, such standards have not yet been implemented. This was the only weakness registered by the assessment in this core area which received a rating of very high compliance of Russian legislation with relevant international standards.

Issuers and their information-disclosure obligation

Public offerings of securities, prospectus requirements, listing particulars and mechanisms to protect minority shareholders are other important elements of a well-functioning securities market.

According to Russian law, in public offerings of securities, issuers are required to prepare, distribute and register a prospectus with the FSFM. Prospectus requirements apply in cases of either open or closed subscriptions regardless of the total value of the issuance, provided that the number of acquirers exceeds 500.

Foreign issuers – other than international financial institutions – are permitted to place and circulate securities in Russia only on the basis of an international

treaty or an agreement between the FSFM and the securities regulator of the foreign issuer's country. To date, this practice is extremely limited as the only treaties in place are with some countries of the Commonwealth of Independent States. In case of a public offering and/or public circulation of a foreign issuers' securities, they must be registered with depositories incorporated under Russian law and meet requirements yet to be established by the FSFM.

The issuer is responsible for the contents of the prospectus and quarterly reports. Prospectuses must be co-signed by an auditor and, in some instances, by independent appraisers who join the issuer for liability in case of false, incomplete and/or misleading information.

This section, which was benchmarked with the IOSCO Principles for Issuers, showed an overall level of medium compliance. Some of the flaws highlighted by the EBRD assessment have been solved with recent amendments.¹¹ In December 2005 and July 2006, the *Law on the Securities Market*, the *Joint-stock Companies Law* and some FSFM regulations were amended to simplify the process of initial public offerings (IPOs) by Russian companies and to resolve issues that complicated the IPO process.

In December 2005, the *Joint-stock Companies Law* was amended to allow a shortened 20-day period for the exercise of pre-emptive rights by existing shareholders. In addition, the amendment allows the price for the exercise of such rights upon the expiry of this period to be set up. The purpose

of this amendment was to resolve one of the most notorious concerns in respect of the Russian IPO process, namely when market participants had to fix the share price long in advance of the placement.

During the same period, the Securities Law was amended to include the notion of a placement notice, to be filed with the FSFM instead of registration of the placement report. This simplified the placement registration.¹² Disclosure rules were also amended so as to provide better access by local investors to information about a company issuing shares in an open subscription. Information required to be publicly disclosed by a Russian company outside of Russia in connection with a subscription now has to be disclosed in Russia as well.¹³

In January 2006 the FSFM introduced certain restrictions with respect to the placement and trading of shares of Russian companies outside Russia, including in the form of depository receipts.¹⁴ The number of such shares cannot exceed 35 per cent of the total number of issued shares of the same type. The FSFM would grant its permission for the placement or trading of shares outside Russia, including by way of placement of foreign-issued securities, only if they are simultaneously offered in Russia. In addition, not more than 70 per cent of the total number of each issue can be placed outside of Russia.

In July 2006, new rules for the acquisition of more than 30, 50 or 75 per cent of the voting shares in a Russian open joint-stock company



Foreign issuers – other than international financial institutions – are permitted to place and circulate securities in Russia only on the basis of an international treaty or an agreement between the FSFM and the securities regulator of the foreign issuer's country.

Along with the development of a favourable Russian securities market infrastructure, the introduction of Russian depository receipts could provide an opportunity for domestic investors to invest in companies with substantial Russian assets that are listed outside Russia.

introduced in the *Joint-stock Companies Law* entered into force.¹⁵ Acquisitions in excess of these thresholds trigger both voluntary and mandatory tender offer rules on the remaining shares.

The amendments also introduced new so-called squeeze-out rules. The holding or the acquisition through a public offering by a person – alone or together with affiliated parties – of more than 95 per cent of voting shares in an open joint-stock company allows the purchaser to compel the minority shareholders to sell their shares. These rules do not apply to those shareholders that held more than 95 per cent of shares as of 1 July 2006. They would be able to exercise their squeeze-out rights only upon the enactment of a law regulating obligatory civil liability insurance of independent evaluators so as to eventually protect evaluators from shareholders claims.

Notwithstanding the improvements mentioned above, a number of issues still need to be addressed. One of the FSFM's concerns is that a substantial part of Russian assets is being traded in foreign markets as depository receipts issued on shares of Russian companies and as shares of non-Russian holding companies with significant Russian subsidiaries. On 30 December 2006 a new law introducing changes to the Securities Law¹⁶ was enacted, bringing in the notion of a Russian depository receipt. The introduction of Russian depository receipts, while increasing the range of financial instruments in the Russian securities market, provides domestic investors with access to foreign capital markets and an opportunity to invest in companies with substantial Russian assets that are listed outside Russia.

Collective investment schemes

The existence of collective investment schemes is a good indicator of the development of the securities market in a given country. Whereas in several countries in the EBRD region there are no specific standards or requirements established in law to market or operate collective investment schemes, the assessment, in the case of Russia, revealed a high level of compliance with the relevant standards.¹⁷

The basic framework for collective investment schemes in Russia is composed of the federal *Law on Investment Funds* along with a number of resolutions issued by the regulator.¹⁸ Investment funds can be established in the form of joint-stock companies or non-corporate entities, such as unit investment funds. Collective investment schemes must be licensed by the FSFM. Licensing requirements include education, fitness, propriety, honesty, integrity, competence, experience and financial capacity.

The operators of these schemes are required to disclose their price on a regular basis and are subject to an ongoing obligation to disclose material information which might influence the value of a collective investment scheme. Payments of redemption proceeds must be made no later than 15 days from the date of redemption.¹⁹

The unlicensed operation of funds can result in administrative liability,²⁰ criminal liability²¹ and liquidation.²²

Pursuant to the federal *Law on Investment Funds*, the FSFM can order specific actions, for example, the suspension and revocation of licences, the suspension of an issue and the imposition of fines, in case of suspected

or actual breaches of the law. Operators are subject to segregation of assets requirements. Collective investment schemes assets are required to be held by a depositor – licensed by the FSFM – on behalf of the investors, but there are no requirements concerning the depositor's independence, which might give rise to concern and should be tackled as a matter of priority.

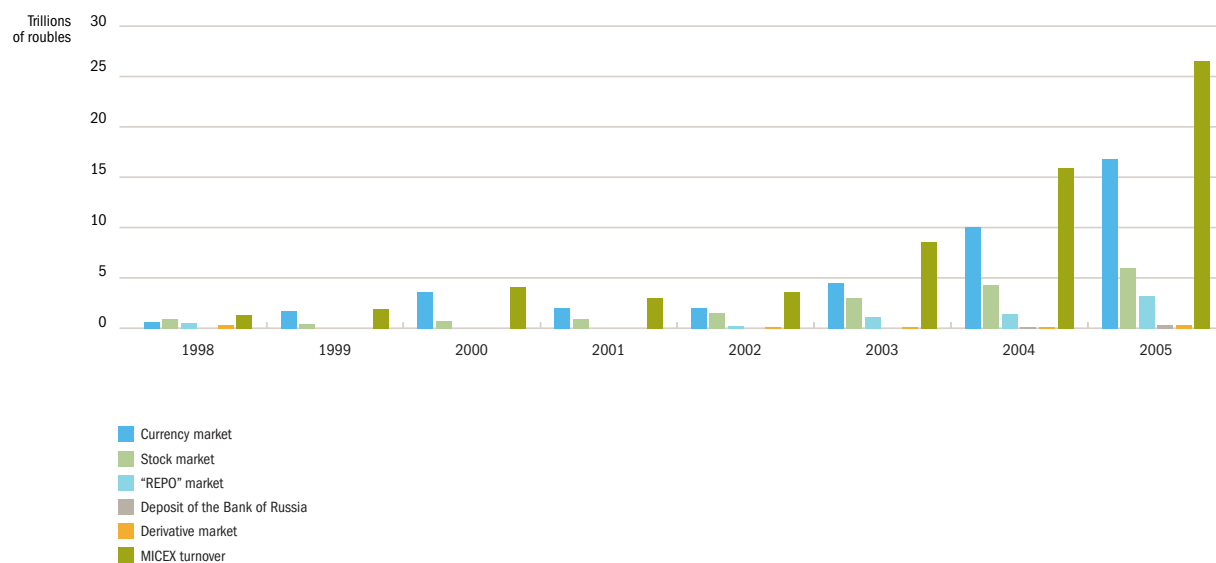
Market intermediaries

The fifth section of the EBRD questionnaire addressed the licensing criteria for market intermediaries, risk management and internal supervisory systems, minimum capital and capital adequacy requirements.

In Russia, all professional activities on the securities market must be carried out on the basis of a licence issued by the FSFM or other agencies empowered by the FSFM.²³ Minimum standards for licensing include: minimum capital; proper books and record keeping; internal control procedures; risk management requirements; and defined skills and experience of senior management, directors and controlling shareholders.²⁴ In the event that a market intermediary fails to meet ongoing requirements, the FSFM has the power to suspend²⁵ or revoke its licence, impose conditions or restrictions on its business operations, impose administrative sanctions²⁶ or defer the matter to the prosecutor for the start of criminal proceedings.²⁷

Licensed market intermediaries are required to inform the FSFM of their reorganisation or change of name or address but they do not have to inform the FSFM of eventual changes in the firm's ownership²⁸ or senior

Chart 2a MICEX annual trading volumes 1998-2005

Source: <http://www.micex.com>

management.²⁹ The law does not require professional participants to inform clients of potential conflicts of interest, but it does require them to inform clients when a conflict actually occurs. As a result, Russian legislation on market intermediaries was found to be in medium compliance with relevant international standards.

Secondary market

The licensing of securities exchanges, trading, clearing and settlement systems, along with issues such as price manipulation, insider trading, market abuse and prudent requirements for trading systems members were benchmarked against the IOSCO Principles applicable to secondary markets, which resulted in a rating of medium compliance.³⁰

The Moscow Interbank Currency Exchange (MICEX) is the largest financial exchange in Russia. Trading in non-government securities was launched in March 1997. Later that year, following the example of the MICEX, regional currency and stock exchanges in Samara, Rostov-on-Don, St Petersburg, Nizhny Novgorod and Yekaterinburg also launched trading in bonds and stocks.

Chart 2a clearly shows the increase of trading activities on the MICEX during the past few years. The increase is particularly remarkable for the stock exchange (see details in Chart 2c) and for currency market volumes. The increase in trading of derivatives is also significant (see Chart 2b overleaf) and it is interesting to see the drastic collapse of volume of trading after the 1998 crises (see Charts 2b and 2c overleaf).

All securities exchange, trading, clearing or settlement systems in Russia are subject to licensing by the FSFM. Among other requirements, the licensee's capital must meet the requirements set by the FSFM,³¹ comply with the descriptions of risk management systems and contribute to investors' compensation funds.³² Only brokers, dealers and managers (professional securities market participants) can directly participate in trading securities on the stock exchange.

In order to allow the FSFM to monitor the ongoing compliance of the system with the initial authorisation requirement, trading organisers must disclose information on their activities and operations to the FSFM on a regular

basis. The FSFM is entitled to exercise control over trading organisers and carry out inspections. In the event that trading organisers are not able to enforce their internal rules and regulations, they must report to the FSFM and the latter has the right to revoke the licence.

The major shortcomings registered in this section are, first, the inability of the regulator to compel market participants carrying large positions to reduce their exposures and, secondly, the lack of a comprehensive insider trading regulation.

As regards insider trading issues, while the Securities Law contains a notion of the concept of office information and prohibits trading based on it, this notion is limited and fines for using such information are insufficient. In order to improve market infrastructure and attract a wider range of market participants, Russia needs to adopt laws prohibiting insider trading.

Chart 2b MICEX derivatives volumes 1996-2005

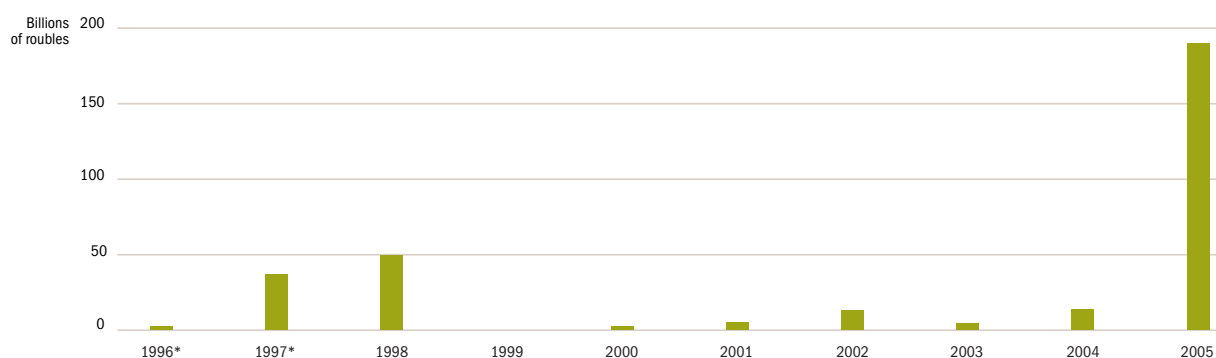
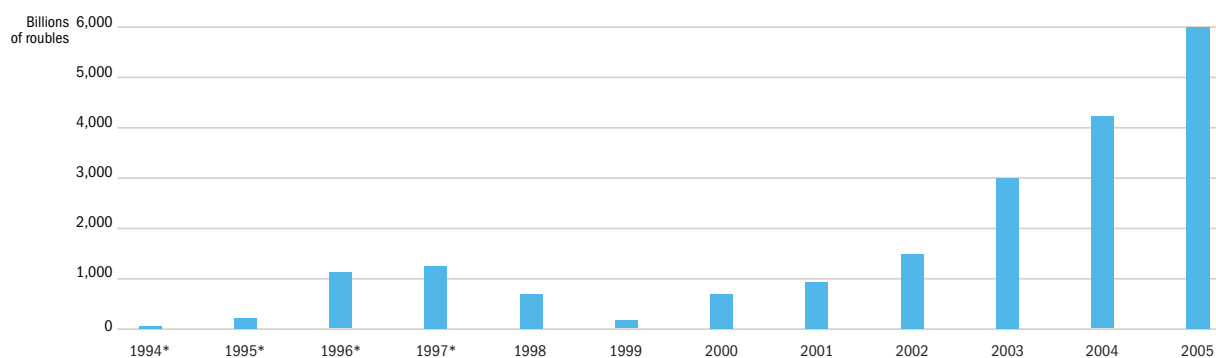


Chart 2c MICEX stock volumes 1994-2005



*Value expressed in 1998 denominated rubles (1000 non-denominated rubles = 1 denominated ruble)

Source: <http://www.micex.com>

Clearance and settlement

Standards on the surveillance and auditing of clearing systems are essentially entrusted to the Recommendations for Securities Settlements Systems which is published in the Joint Report from the Technical Committee of IOSCO and the Committee on Payment and Settlement Systems of the Bank for International Settlements (November 2001).³³

In Russia, the activities of clearing organisations are subject to FSFM supervision and control. According to the Securities Law, stock exchanges and trading organisers can also perform clearing activities (that is, match the account liabilities and claims of trade participants as a result of trades in securities), collect, verify and correct information on trades in securities, define the procedure for the settlement of trade participants' obligations, determine the net liabilities and net claims of trade participants and provide settlement of net liabilities and claims on a delivery-versus-payment basis.

Clearing systems must be licensed by the FSFM and applicants are required to comply with securities legislation requirements and with specific capital requirements. Changes to a clearing organisation's internal rules and procedures are subject to the prior approval of the FSFM. The main requirement for approval is the compliance of submitted documents with applicable legislation.

One of the legislative initiatives that has been discussed in Russia over the last few years is the idea of creating a central depository. It is believed that,

The main obstacle to the development of the Russian derivatives market is the legal uncertainty as to the availability of judicial protection for claims arising in connection with cash-settled derivatives transactions.

once established, it will guarantee a higher degree of protection of ownership rights to securities as compared to the current system, as well as provide for an efficient and simplified securities settlement system. As a result, the establishment of the central depository would add to the improvement of the market infrastructure and strengthen the competitiveness of the Russian stock market.

It is difficult to predict, however, when a central depository would be created in Russia, although the necessity of its establishment has been a topic of discussion for many years.

Anti-money laundering, financial instruments and investment service providers

The three final sections of the EBRD's analysis were dedicated to legislative awareness of the need to prevent and discourage money laundering operations, to open markets to more sophisticated financial products such as derivatives and to accommodate investment service providers as a separate class of securities professional. While the legislation on money laundering and investment service providers appeared to be generally in line with applicable international standards, significant flaws were registered in the section dedicated to financial instruments (see Chart 1).

Although the Russian derivatives market has grown considerably over the last few years (see Chart 2b), in comparison with world markets it remains small and quite limited in terms of available instruments. The main obstacle to the development of the Russian derivatives market is the

legal uncertainty as to the availability of judicial protection for claims arising in connection with cash-settled derivatives transactions.

This uncertainty results from a number of Russian court decisions taken since 1998, including from courts of high instance³⁴ and the Russian Constitutional Court.³⁵ The basis for these decisions refusing to grant judicial protection to claims arising out of derivatives transactions was the application of gambling provisions contained in the Russian Civil Code (that do not provide legal protection to gambling contracts) to derivatives transactions.

In order to eliminate the problem of unenforceability of derivatives contracts under Russian law, the legislature should exempt derivatives transactions from the gambling provisions of the Russian Civil Code. The federal law *On amendments to article 1062 of Part II of the Civil Code of the Russian Federation* has just been enacted³⁶ and it is difficult to predict how the law will be implemented. At this moment, the law does not seem to provide the certainty that market participants were hoping for.

It restricts the scope of eligible counterparties to derivatives transactions by providing that the gambling provisions of the Russian Civil Code would not apply only to those derivative transactions where at least one counterparty is an entity licensed to engage in banking or to act as a professional securities market participant, that is a licensed Russian entity. In addition, the new law does not cover the full range of derivatives

transactions and, as a result, excludes certain types of derivatives from the scope of legal protection.

The lack of judicial protection of claims arising in connection with cash-settled derivatives contracts has been the main impediment to the development of a derivatives market in Russia. However, there remain a number of other issues that, while unresolved, are also hampering its development. These include the uncertainty of application of close-out netting in case of insolvency proceedings under Russian law and the lack of certain types of collateral arrangements that are widely used in world markets.

Another area of increasing interest among investors and other market participants in Russia is the development of securitisation instruments. There have already been several successful securitisation transactions of future flow structured with an offshore issuer. There is significant further originator interest in securitisation, especially for export receivables-based deals and credit card and consumer loans receivables.

The Russian market would benefit considerably from developing a domestic legal framework for the securitisation of assets. At the moment Russia has no specific legislation governing the securitisation of assets, except for mortgages.³⁷ However, the creation of an appropriate legislative framework for asset-backed securities transactions in Russia would require significant amendments to a large number of existing laws.

These should include amendments to the Russian Civil Code to allow for the assignment of future claims, the introduction of a notion of trust management, amendments to tax laws to provide a neutral tax regime for securitisation deals, amendments to bankruptcy laws to provide for specific bankruptcy procedures for such securities issuers and to certain other laws.

Several legislative initiatives aimed at the creation of a legislative framework for asset-backed transactions are already under way. Developing a local securitisation market in Russia would ultimately provide Russian borrowers with wider access to long-term financing, reduced borrowing costs and an expanded range of companies that have access to bond financing.

Conclusion

There have been several improvements made to Russia's legislation on securities markets during the past few years. However, there is still much progress to be made in market supervision, clearance and prudential requirements for exchanges and intermediaries. The regulator should be subject to a code of conduct and

its activities should be more public, it should have investigatory and rule making powers and it should cooperate with regulators from other jurisdictions.

Russia also needs to implement the listing of particular requirements, strengthen minority shareholder protections, impose real-time trade confirmations and centralise securities depositories. Currently there are no regulatory powers to impose margin calls, reduce exposures to large share positions, or otherwise empower a market authority to take action against systemic risks.

Uncertainty in respect of legal protection of derivatives transactions has to be eliminated and netting and collateral legislation should be adopted so that more sophisticated financial instruments can be developed. Introducing legislative amendments that would allow the development of domestic asset-backed transactions would also be an important step.

The elimination of the above legislative impediments would provide financial market participants with the legal certainty and confidence that is absolutely necessary in order to bolster the development of Russia's financial market.

Notes

- ¹ This article is based on documentation from the EBRD's Securities Markets Legislation Assessment, 2005, conducted by the Bank with assistance from the law firm SALANS but expresses only the personal opinions of the authors and does not necessarily represent the views of the EBRD. The assessment was financed by the French government. Opinions expressed are based on current legislation as of 30 January 2007.
- ² The EBRD's countries of operations are: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Former Yugoslav Republic of Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Mongolia, Montenegro, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.
- ³ Specifically, IOSCO Principles 1, 2, 3, 4 and 5 (for more details see www.iosco.org).
- ⁴ Basically, IOSCO Principles 11, 12 and 13.
- ⁵ The main functions, powers and organisation of the FSFM's activity are set out in Russian Government Decree Number 206 "On the Federal Financial Markets Service" of 9 April 2004, and in the statute on the Federal Financial Markets Service of 30 June 2004, approved by Russian Governmental Decree Number 317 of 30 June 2004.
- ⁶ Article 51 of the Securities Law; Resolution of the FSFM "On the Adoption of Procedure for Licensing of Types of Professional Activities on the RF Securities Market" Number 05-3/pz-n of 16 March 2005.
- ⁷ Administrative sanctions are limited to 20-30 times the Russian minimum monthly wage (currently – 100 Roubles) while criminal liability is provided only for the disclosure of commercially sensitive information.
- ⁸ Federal Law "On the Securities Market" Number 39-FZ of 22 April 1996 (the Securities Law).
- ⁹ SROs are required to cooperate with the federal authority responsible for the securities market pursuant to, among others, paragraphs 2.2, 7.3.8 and 7.3.11 of the FSFM Resolution on "Approval of the Regulation on Self-Regulatory Organisations of Professional Securities Market Participants and Regulation on the Licensing of Self-Regulatory Organisations of Professional Securities Market Participants" Number 24 of 1 July 1997 (Resolution Number 24) and Order of the FSFM "On the Co-operation of the Federal Commission for the Securities Market with Self-Regulatory Organisations upon Conducting Inspections of Activities of Professional Securities Market Participants" Number 982-r of 17 September 1998.
- ¹⁰ Pursuant to paragraph 4.3 of Resolution Number 24 at least one-third of a collective body of an SRO shall consist of persons who are not: (i) members of that SRO, (ii) employed by that SRO, or (iii) professional securities market participants. The remaining members are representatives of members of that SRO pursuant to its charter. There should be no more than one representative from one member of the SRO on the board.
- ¹¹ The IOSCO Principles relevant for this section are numbers 14 and 15.
- ¹² Art. 25 of the Securities Law.
- ¹³ Art. 2.8.1 of the Regulation "On Disclosure of Information by Issuers of Securities" approved by FSFM Order Number 05-5/pz-n of 16 March 2005.

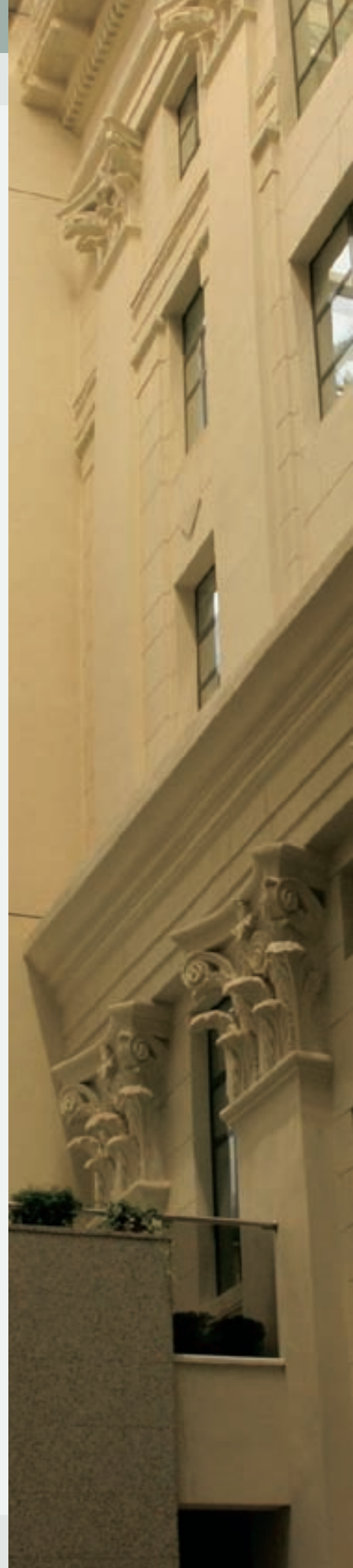
- ¹⁴ Art.9 of the FSFM Order "On Approval of Regulation on the Procedure of Issuance of the FSFM Permits for Placement and/or Trading of Securities of Russian Issuers outside of the Russian Federation" Number 06-5/pz-n of 12 January 2006.
- ¹⁵ Federal Law N7-FZ "On Amendments to the Federal Law "On Joint-Stock Companies" and to Certain Other Legislative Acts of the Russian Federation" of 5 January 2006.
- ¹⁶ Federal Law N282-FZ "On Amendments to the Federal Law "On the securities market" of 30 December 2006.
- ¹⁷ IOSCO Principles 17, 18, 19 and 20.
- ¹⁸ Law Number 156-FZ of 29 November 2001. Essentially, FSFM Resolution Number 28/ps of 31 July 2002; FCSM Resolution on "Additional Requirements for the Procedure of Establishment of Unit Investment Funds out of the Assets of Joint-Stock Companies" Number 44/ps of 6 November 2002; FCSM Resolution on "Approval of the Regulations on the Procedure and Terms of Establishing the Net Assets of Joint Stock Investment Funds" Number 05-21/pz-n of 15 June 2005; FCSM Resolution on "Approval of the Regulations on the Requirements to the Procedure and Terms of Disclosure of Information on the Activity of Joint Stock Investment Funds and Management Companies of Investment Funds, and on the content of the Information Subject to Disclosure" Number 05-23/pz-n of 22 June 2005.
- ¹⁹ Art. 25 of federal Law on investment funds Number 156-FZ of 29 November 2001.
- ²⁰ Art. 14.1 of the Russian Code on Administrative Offences.
- ²¹ Art. 171 of the Russian Criminal Code.
- ²² Art. 61 of the Russian Civil Code.
- ²³ Art. 39 of the Securities Law, as amended.
- ²⁴ FSFM Resolution "Standards of Adequacy of Equity of Professional Participants of the Securities Market" Number 03-22/ps of 23 April 2003, establishes compulsory standards of adequacy of equity for professional participants of the securities market carrying out different types of activities. The standards are the following: for dealing activity: 500,000 Roubles; for brokerage activity: 5,000,000 Roubles; for securities management activity: 5,000,000 Roubles; for clearing activity: 15,000,000 Roubles; for depository activity: 20,000,000 Roubles; for activity involving maintaining registers of securities holders: 30,000,000 Roubles (from 1 January 2005); for activity involving organising trading on the securities market: 30,000,000 Roubles.
- ²⁵ According to Order of the FSFM "On the Adoption of Procedure for Licensing of Types of Professional Activities on the Security Market" Number 05-3/pz-n of 16 March 2005, licensing authorities are entitled to suspend a license if professional security market participants violate the Russian legislation on securities repeatedly for one year.
- ²⁶ Art. 14.1 of the Russian Code on Administrative Offences provides that the conduct of entrepreneurial activities in violation of the license conditions shall result in the imposition of a fine for 300-400 times statutory minimum monthly wages.
- ²⁷ The Russian Criminal Code (Art. 169, 171) provides for criminal liability for the conduct of entrepreneurial activities in violation of the license conditions/requirements, if such offences result in adverse material consequences or involve the acquisition of income exceeding 250 times statutory minimum monthly wages. The criminal penalty is a fine of up to 300,000 Roubles or arrest and incarceration for up to six months.
- ²⁸ However, according to Resolution of the FSFM and the Ministry of Finance on the "Adoption of Regulations on the Reporting of Professional Securities Market Participants" Number 33, 109n of 11 December 2001, professional securities market participants (legal entities) shall submit to the FSFM their quarterly reports containing information on persons holding shares (participatory interests) in such legal entities.
- ²⁹ There is no direct obligation to give such notice. At the same time, Resolution of the FSFM and the Ministry of Finance "On the Adoption of Regulations on the Reporting of Professional Securities Market Participants" Number 33, 109n of 11 December 2001, provides that professional participants of the securities market (legal entities) shall submit to the FSFM their quarterly reports containing information on the management bodies (directors) of such legal entities.
- ³⁰ Essentially, IOSCO Principles 25, 26, 27, 28 and 29.
- ³¹ Resolution of the FCSM "On Standards of Adequacy of Equity of Professional Participants of the Securities Market" Number 03-22/ps of 23 April 2003.
- ³² Art. 17 of Federal Law "On the Protection of Rights and Lawful Interests of Investors on the Securities Market" Number 46-FZ of 5 March 1999, as amended.
- ³³ Available at <http://www.bis.org/publ/cps46.pdf>
- ³⁴ Decision of the Russian High Arbitration Court N5347/98 of 8 June 1999, and numerous decisions of the Federal Arbitration Court of the Moscow region.
- ³⁵ Decision of the Russian Constitutional Court "On terminating proceedings in respect of compliance with the Constitution of Atr.1062 of the Civil Code of the Russian Federation" N282-0 of 16 December 2002.
- ³⁶ Federal Law N5-FZ of 26 January 2007.
- ³⁷ Federal Law "On Mortgage-Backed Securities" N152-FZ of 11 November 2003.

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A close-up, slightly blurred photograph of a person's hands holding an open book. The person is wearing a light-colored, possibly white, long-sleeved shirt. The book's pages are filled with text, but it is out of focus. A semi-transparent dark grey rectangular box is overlaid on the upper half of the image, containing white text. The overall lighting is soft and somewhat dim, creating a focused and studious atmosphere.

**Russia's social and
economic development today:**
improving legislation to
support economic growth



Mikhail Kopeikin
Deputy Chief of Staff,
Russian Government

Over the past five years the Russian economy has grown rapidly, at an annual rate exceeding 6 per cent. Consistent government policy has resulted in macroeconomic stability, as reflected in, among other things, the strength of the rouble, the federal budget surplus and the growth of Russia's budget revenues. The government has also devoted considerable effort to focusing on legal issues: regulatory improvements and legislative reforms have progressed steadily over the past couple of years.

For 2006, GDP growth in Russia is forecast at 6.9 per cent (compared with 6.4 per cent in 2005), capital investment at 13.2 per cent (10.7 per cent), retail sales at 12.8 per cent (12.8 per cent), and real disposable income at 11.5 per cent (11.1 per cent). The country's gold and currency reserves, which stood at US\$ 298.5 billion on 15 December 2006, are rising.

A key factor is the diversification of investment across sectors. As a percentage of the overall total, the share of investment in the manufacturing industries increased from 15.9 to 16.8 per cent between 2002 and 2005, and the share of investment in transport and communications from 18.5 to 25.9 per cent. This is the result of the Russian government's selection of priority areas in its economic policy, which is targeting the development of sectors that have a high manufacturing content.

If steady economic growth leading to a significant increase in living standards is to be achieved, a low level of inflation is essential. The government pays special attention to ensuring macro

economic stability, and the steady growth of the main macroeconomic indicators is evidence of the success achieved in recent times. Inflation is regarded by the government as being among the most important problems to be kept under constant control.

Particular efforts were made in 2006 to slow the rise in consumer prices. A series of anti-inflationary measures were taken with the aim of achieving an inflation target of 9 per cent for the year. The intention in this context was to reduce consumer price inflation to 4-5 per cent by 2009.

An important aspect of stimulating economic growth is making tax policy more effective so that it exploits not only the fiscal but also the regulating functions of taxes. Analysis of international experience shows that Russia lags well behind advanced countries with regard to tax levels and the quality of tax administration. Over a number of years, the overall tax burden on business has decreased by 1-1.5 per cent a year, but this has proved insufficient to bring about a significant change in the situation.

It is against this backdrop that the government approved the main lines of its tax policy for 2007-09. The measures put forward to improve tax law provide for a reduction of more than 220 billion roubles in the tax burden on the economy during this period.

Attention is currently focusing on developing and improving economic mechanisms that will stimulate economic growth. These include refining public-private partnership approaches and schemes, establishing a state development corporation, stimulating high-tech exports and introducing concession mechanisms in the housing, utilities, roads and ports sectors.

Major steps are being taken to develop further a modern banking infrastructure to provide consumers with access to a whole range of banking services in line with international practice.

Given the size of its market, its geographical position, its potential for innovation and its natural resources, a strengthening and expansion of Russia's role on world markets

can be expected within the foreseeable future. If interested countries work together and exploit their inherent advantages, it should be possible to achieve impressive results capable of responding to today's challenges.

In order to keep up with this new expanded role the government has also devoted considerable effort to focusing on legal issues: regulatory improvements and legislative reforms have progressed steadily over the past couple of years.

A number of laws aimed to improve the investment climate in Russia further. One of the most important federal laws adopted in 2005 was the *Law on Concession Agreements*. This law creates a legal framework enabling private participation in the provision of public services and creating a legal framework for public-private partnerships in Russia. Consistent application of the new law by the federal, regional and municipal authorities, as well as by the courts, is necessary to ensure that it is successfully implemented.

The *Law on Special Economic Zones*, which took effect on 25 August 2005, is designed to stimulate investment in Russia – it provides for a special regime (including tax and custom duties exemptions) for entrepreneurial activities carried out in designated special economic zones.

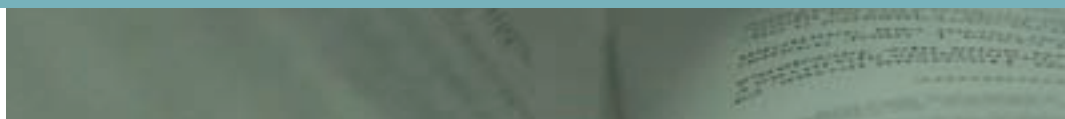
In particular, Part IV of the Civil Code was completed in 2006 as well as amendments to a tax-governing law. Perhaps the single most important development in the area of corporate law was the approval of amendments to the *Law on Joint-stock Companies*, enacted on 1 July 2006. A new federal law dated 3 January 2006 helped to remove various discrepancies between the Civil Code, the *Law on Insolvency (Bankruptcy)* and the *Law on Insolvency (Bankruptcy) of Credit Organisations*.

To improve mineral extraction tax computation and collection procedures, new legislation aims to resolve the highest-priority issues of the development of the oil industry. In particular, it aims to address the problem of reduced oil production rates at depleted oil fields and provide incentives for the development of new fields.

Judicial reforms continued to be among the government's top priorities and there have been significant positive steps to increase judicial independence, including increases in judges' salaries.

Successful implementation of the legal reforms has been adversely affected by the inconsistent application of laws by the federal, regional and municipal authorities and by the judiciary. Further efforts are needed in this area to achieve a change in the public perception regarding the stability of the business climate in Russia.

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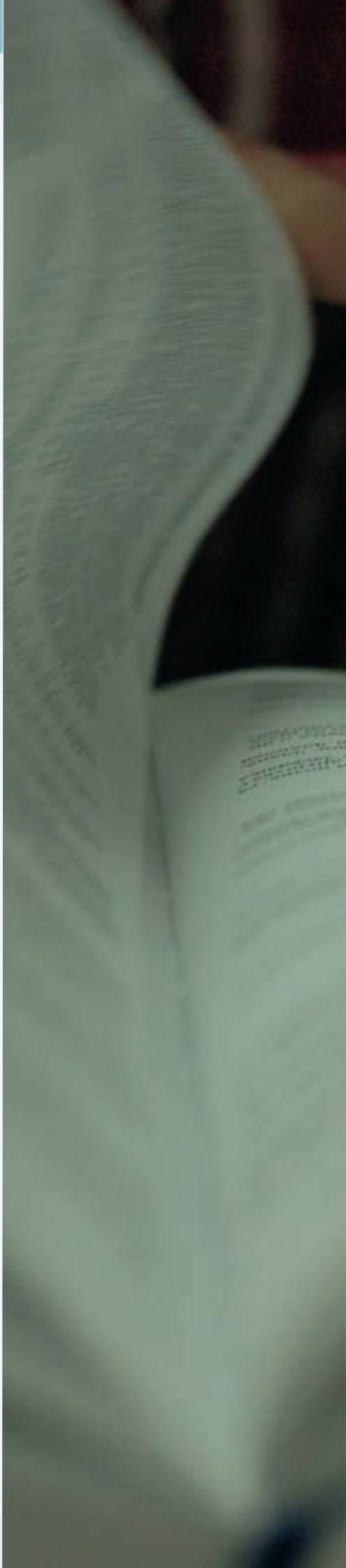
Notes

- ¹ Federal Act No. 151-FZ of 27 July 2006, Amending Section 26 Part Two of the RF Tax Code and Abrogating Certain Provisions of RF Laws and Regulations.

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The image features a close-up of a wooden gavel resting on a wooden block. The gavel is positioned vertically, with its head at the top. The background is a circular emblem with a scale of justice, symbolizing law and justice. The emblem is set against a dark, textured background. The overall color palette is warm, dominated by browns and oranges.

**The institutional training
of judges in Russia**



Vladimir Peysikov

Provost,
Russian Academy
of Justice

The Russian Academy of Justice, founded in 1999, provides higher and continuing education for the Russian court system and judiciary. To carry out its role properly, the academy needs its status and functions to be enshrined in legislation and requires to be properly funded by the state.

In both the former Soviet Union and in Russia the institutional training of judges has had quite a long history.

The All Union Institute of Continuing Professional Development for Employees in Justice was formed in 1970. The Law Academy of the Ministry of Justice of the USSR opened its doors in 1990 and in 1992 the Russian government founded the Russian Law Academy of the Ministry of Justice.

These institutions have been running continuing professional development programmes for judges alongside the retraining of other categories of students. Therefore their training has been unable to fully satisfy the needs of the court system for a scheme of judiciary training that meets modern requirements.

Historically, the Russian Supreme Court and Supreme Arbitrazh Court have not had their own educational or academic institutions to provide training, retraining or continuing professional development for judges and administrative employees in the courts. Neither have they engaged in fundamental, applied or academic research into the law-making or implementation activities of the courts.

In 1998 the Russian Ministry of Justice handed over financial, administrative and personnel management of the courts to the overall jurisdiction of the Courts Department of the Supreme Court. Subsequently the Russian Academy of Justice was established as a state-owned educational institution offering higher professional education.¹ The functions of its founding bodies were handed over by the federal government to the Supreme Court and the Supreme Arbitrazh Court.

The role of the academy

In accordance with its statutes, the Russian Academy of Justice deals with the following:

- continuing professional development and retraining of judges and administrative employees in general courts and arbitrazh courts and for employees in the Courts Department of the Supreme Court
- training of specialists for the court system under programmes of higher and secondary professional legal training

- training of postgraduates and doctoral candidates for the court system, under programmes of postgraduate professional education
- fundamental and applied academic research into the organisation of the court system and academic back up for the law-making and implementation activities of court authorities
- collaboration with legal, academic and educational institutions in Russia, the Commonwealth of Independent States (CIS), other states and international organisations, for the purpose of studying and applying foreign experience of rule-making, law implementation, academic activities and the training, retraining and continuing professional development of specialists
- publication of academic, study, teaching methodology, reference and other materials.

The academy, which was originally established to satisfy the personnel needs of the court system in Russia, has now become a genuinely unique institution of legal higher education without comparison in Russia or abroad.

A study of the underlying concepts and constitutive documents of the academy, carried out in 2000 by the Council of Europe, confirmed that its unique multi-function model fully satisfies the needs of the court system in Russia.

Prior to 1998 higher and intermediate educational institutions in Russia did not take specialists who already had a higher or intermediate legal education and offer them specialist training for further work in the court system. The result of this was, first, that approximately 50 per cent of

candidates for jobs as judges in Russia obtained unsatisfactory grades. Secondly, individuals who had passed the examinations and been appointed as judges were obliged, either independently or with the aid of their more experienced colleagues, to devote large amounts of their own time to gaining theoretical knowledge in substantive and procedural law and to studying the practical skills needed to conduct trials in courts, prepare procedural documents and so on.

The academy, which was originally established to satisfy the personnel needs of the court system in Russia, has now become a genuinely unique institution of legal higher education without comparison in Russia or abroad. Its specialists are in demand not only in the courts, but also in such areas as state administration, politics, economics, municipal administration and international relations, because the training offered in the academy is closely linked with real court practice.

The underlying concept of the academy is continuous specialised training starting at an early age and continuing throughout the professional lives of judges. That concept has dictated the academy's organisational structure. The academy has a law college, a law faculty that trains specialists for the court system and additional faculties for continuing professional development. It also has 21 academic departments and seven academic sections.

The academy has 10 branches, in Chelyabinsk, Irkutsk, Kazan, Khabarovsk, Krasnodar, Nizhnii Novgorod, Rostov-on-Don, St Petersburg, Tomsk and Voronezh. In any given year the academy and its branches offer

continuing professional development and retraining to more than 6,000 judges and administrative employees of the courts. More than 13,000 students in the academy are studying law as their main subject.

As projected in the plan for continuing professional development for judges in federal and military courts and for court administrative staff and managers of personnel departments in administrations or sections of the Russian Court Department, the number of professional staff trained at the academy is rapidly increasing (see Chart 1).

The significant increase in the number of trainees in 2005 is due to the TACIS programme "Training for Judges and Administrators in Courts of the Russian Federation".² In the north-west, central, Rostov and north Caucasus branches of the academy as well as in Moscow, there have been 43 seminars for judges and 20 seminars for court administrators. The total number of people who have been trained under this TACIS project is 2,174.

The total number of law students at the academy has increased rapidly over the last few years to reach 9,390 in 2005 (see Chart 2).

The total number of people in postgraduate study or attached to the academy as doctoral candidates is currently 575. The academy currently has a total of 1,783 employees.

The establishment of the academy has highlighted the importance of investigating, from the academic point of view, the following issues: improving the professionalism of judges, various aspects of the amending of legislation and improving academic, procedural, information technology and personnel support for the work of the courts.

Chart 1 Number of professional staff trained at the Russian Academy of Justice

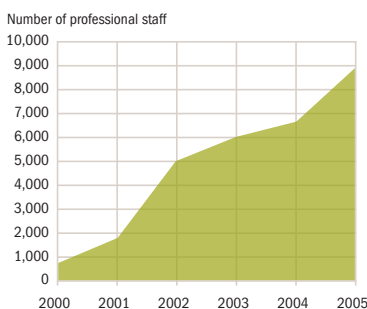
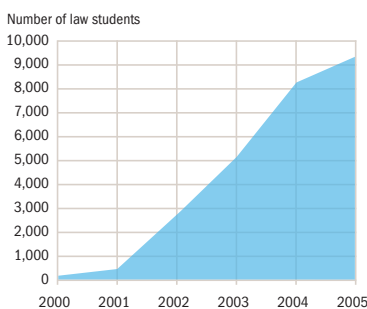


Chart 2 Number of law students at the Russian Academy of Justice



Source: Russian Academy of Justice 2006

Reforming the judicial training system

There is an acute need for federal laws to incorporate legal standards requiring candidates for the judiciary to undergo a compulsory year of preliminary training in the academy. The academy should employ the most experienced employees that the court system can offer as tutors for this training.

In order to reform the judicial training system it will also be necessary to draft regulations laying down procedures for the selection of candidates that are based primarily on professional criteria related to legal training but also take into account the moral outlooks of the judges.

Regular, mandatory and highly professional training of sitting judges has become particularly important recently because courts tend to refer to a long list of sources including:

- the Russian Constitution
- generally recognised principles of international law
- decisions of the European Court of Human Rights (following Russia's recognition of the court's jurisdiction)
- constantly changing federal legislation
- regulatory acts adopted by constituent entities of the Russian Federation in accordance with the constitution and with federal legislation.

At present, however, federal judges only have the opportunity to update their skills once every ten years.

The concept underlying the legislative framework of the system for forming the judiciary should provide for:

- transparency at all levels
- detailed legal regulation of all its component relations, by means of federal legislation
- obstacles to penetration or corruption of the judiciary by undesirable persons

- more efficient organisation of the competitive selection of judges
- more efficient organisation of judicial training.

The drafting and implementation of this concept assumed greater urgency following the decision by the Sixth All-Russian Congress of Judges to: "reinforce the court system with highly qualified personnel by training candidates for the judiciary in federal courts and court administrators for one to two years in the Russian Academy of Justice, through mandatory continuing professional development for judges in federal courts (once every three years), including training for judges in constitutional or statutory courts and for magistrates, under civil law contracts between the constituent entities of the Russian Federation and the Russian Academy of Justice."

Improvements to the selection procedure for judges in accordance with generally recognised principles and standards of international law, the Russian Constitution and federal laws, could, it is thought, be brought about on the following conditions:

- by including in the state-approved curriculum a differentiation within the legal studies speciality such that training could take place on the basis of individual study plans; in particular, this would mean the introduction of an additional qualification entitled "court-trained lawyer"
- by instituting a position to be known as candidate judge, which would involve the application of proper conditions for the selection of future judges, all-round character formation and creating an organisational framework for appropriate training
- by drafting additional legal, moral and psychological criteria which a candidate judge would have to satisfy
- by carrying out preliminary training of candidate judges before their appointment using procedures which facilitate the assessment

of a person's suitability for work as a judge, for example, business games, resolving specific legal, psychological and moral situations, participation in discussions, drafting the core content of speeches, other forms of training and a proper assessment of his or her individual qualities.

Implementation of the above conditions would only be possible through legislative regulation, in particular by including the following provisions in the *Law on the Status of Judges in the Russian Federation*:

- a person with citizenship of another state cannot apply for the post of judge and exercise a judge's powers
- information provided by candidate judges is to be vetted by law enforcement, customs and fiscal bodies
- the creation within the Courts Department of the Russian Supreme Court of a psychological assessment service whose task would be: first, to identify by tests and other procedures the psychological qualities of candidate judges which would enhance their work as a judge, or qualities which might be a hindrance to such work, for instance intellectual immaturity or impatience; secondly, to carry out regular psychological testing of judges who are directly affected by the implementation of justice or who display improper conduct whether in service or in non-work circumstances; and lastly to assist qualified collegial bodies of judges when considering matters related to the appointment of a judge or the assessment of improper conduct which might be grounds for disciplinary or other action
- the provision of tangible guarantees in relation to the training and subsequent appointment of candidate judges by taking into account Russian tradition and experience and the prevailing practice in a number of foreign countries

- the obligation for judges to engage in continuing professional development not less than once every three years.

In contrast to foreign legislation, which regulates the judicial selection, training and appointment process in detail, only the core aspects of existing procedures for the selection, training and appointment of judges are included in federal legislation and regulations. Some existing procedures are not incorporated in legislation while other procedures are regulated by secondary legislation which, in practice, leads to different interpretations of established regulations. Because of this, it is essential for federal legislation to be explicit about the powers of all the agencies, structures and institutions involved in the selection of candidate judges.

All costs of training candidate judges must be borne by the state through the allocation of the necessary budgetary support. For example, a Joint Resolution of the Plenums of the Supreme Court and the Supreme Arbitrazh Tribunal of the Russian Federation, Numbers 16, 17 of 12 November 2001 'On Submission to the State Duma of the Russian Federal Assembly of a draft Federal Law On Amendments and Additions to the Law of the Russian Federation "On the Status of Judges in the Russian Federation"' first proposed regulations of an entirely novel nature, including the proposal that candidate judges should be appointed only after special professional training of at least one year and that this professional training should be entrusted to the academy.

This is in line with the European Charter on the Status of Judges which lays down the European standards on this issue.

In particular, paragraph 2.3 provides for mandatory professional retraining of candidate judges, requiring "by means of appropriate training at the expense of the State", the preparation of the chosen candidates for the effective exercise of judicial duties. [emphasis added] However the relevant draft legislation has still not been considered and as a result applicants for posts as judges in Russia currently receive no professional training, in spite of the acute need for it.

The effectiveness of the justice system depends on how successfully this matter is dealt with. However, official acceptance of the need for pre-appointment training will not resolve all these problems and a rational method of selecting candidate judges will be essential. Only when such a procedure has yielded results can it be adopted as the basis for a legal standard.

The training of candidate judges should take place during the last stage of their selection, after they have passed a qualifying examination, been vetted and obtained a recommendation from the relevant examining college.

Rearranging the above suggested chronology would be inadvisable since a candidate who, for example, has not passed the preliminary selection, is not likely to proceed to the next stage in the process. Allocations from the federal budget for the training of a candidate who has failed the preliminary selection would be unjustified. It follows from this that the professional training of a candidate must only be carried out at the last stage of selection, before his or her official appointment.

The creation of a unified European legal and judicial system should facilitate the participation of judicial training institutions:

- in establishing that system and in creating a court culture based on unified approaches to the dispensing of justice by European judges, taking into account particular national features of legal procedure and court systems
- in providing, both during training and continuing professional development, training in European law and familiarisation with European institutions
- in providing training programmes for the study of European collaboration by the judiciary in the application of international law, and
- in carrying out exchanges of experience in training the judiciary and implementing continuous professional training of judges.

To this end, the academy must implement international projects involving conferences and seminars, research into comparative law, joint publications of academic and practical manuals for judges and the organisation of training schemes abroad for teachers and academic staff.

In the period 2000-05 the academy, jointly with its foreign partners, arranged 76 international conferences and seminars. The academy has also entered into 21 contracts for collaboration with foreign partners.

The training of candidate judges should take place during the last stage of their selection, after they have passed a qualifying examination, been vetted and obtained a recommendation from the relevant examining college.

Chart 3 What Russian judges think: Training needs at the individual level

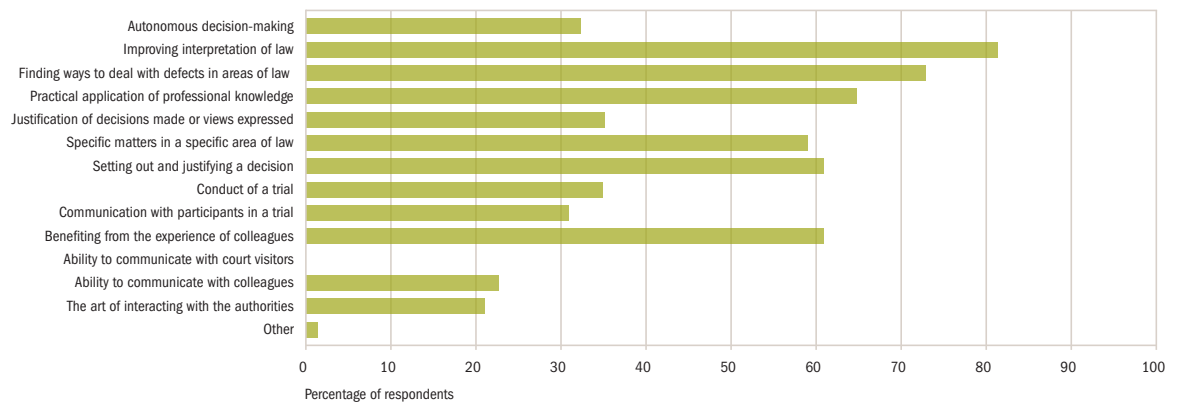
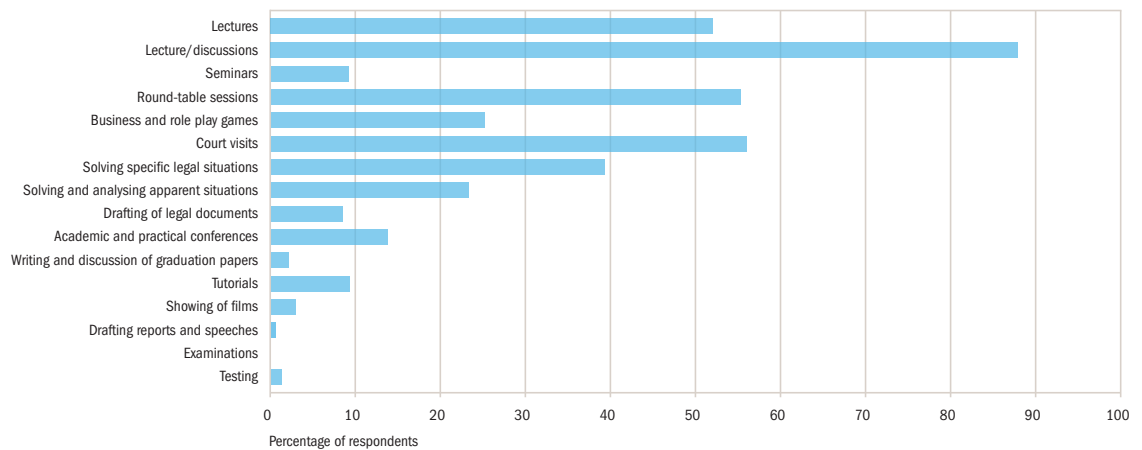


Chart 4 What Russian judges think: Preferred learning methods



Source: Russian Academy of Justice 2003

Results of a survey on judicial training

The academy is conducting research among judges in order to improve the training process. The results are of interest not only to the organisers of the training process, but to judges themselves. The following charts illustrate some results from one of the most recent research projects.

The questionnaire asked respondents to name the priority objectives of continuing professional development for judges. The majority of respondents mentioned objectives such as: the study of new legislation, obtaining recommendations from legislative draftsmen concerning practical

implementation, the study of court practice, defects in specific areas of law and ways of dealing with them, improvements to skills used when interpreting the law, the skills of adopting and formulating decisions in specific categories of cases and sharing experience with colleagues.

When asked about their personal needs, the majority of respondents mentioned the need to develop skills of interpretation of law, finding ways to deal with defects in legislation, the application of professional knowledge in practice, the setting out and arguing of a decision and benefiting from the experience of colleagues in obtaining information on specific questions in a specific area of law (see Chart 3).

Concerning learning methods, the majority of respondents were satisfied with lecture/discussions, round-table sessions and visits to sessions of the Russian Supreme Court and Moscow courts and solving specific legal problems (see Chart 4).

The analysis of proposals for improvements to the continuing professional development training process shows that trainees feel the need for more practical sessions; analysis of court practice in lectures; more opportunities to share experience; more lessons involving judges from the Russian Supreme Court; lessons involving visits to courts; lessons on ethics and personal psychology; important materials to be supplied

Chart 5 What Russian judges think: Possible improvements to the training process

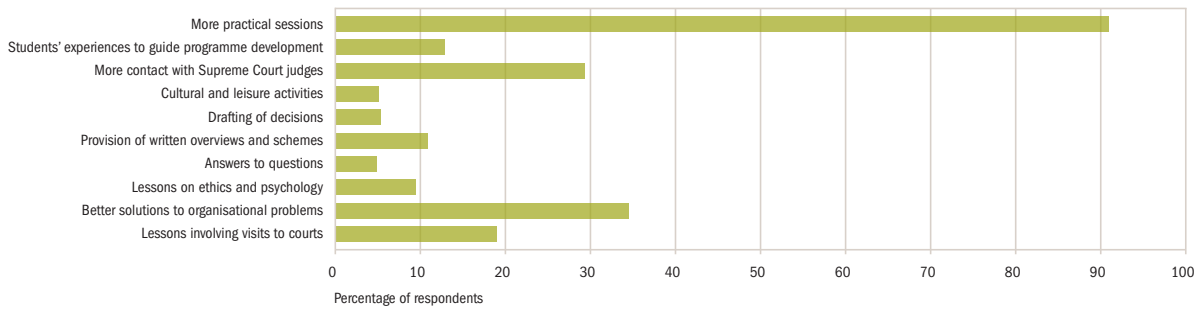
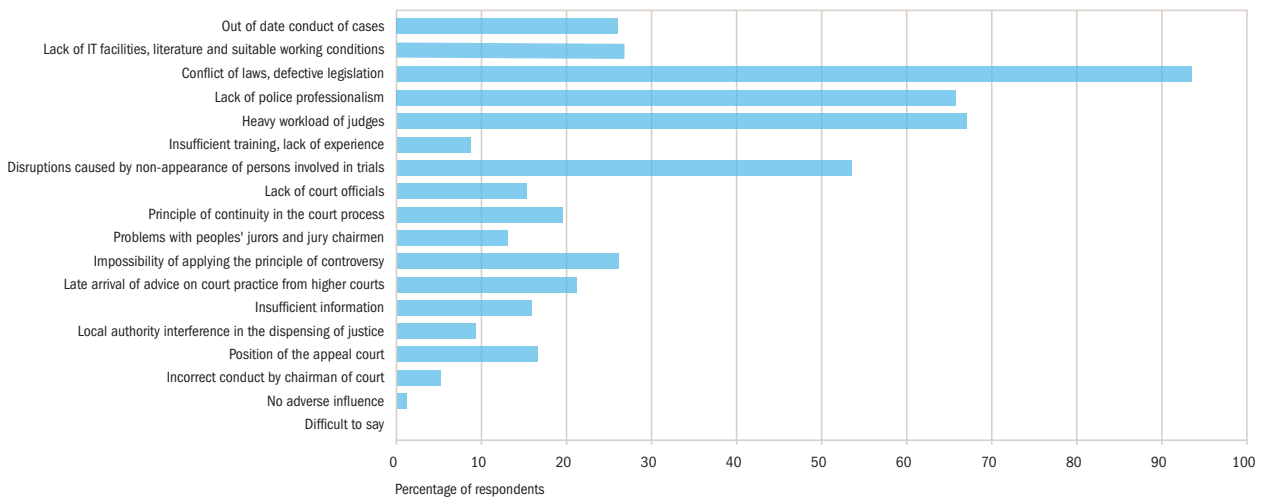


Chart 6 What Russian judges think: Factors adversely affecting in-court performance



Source: Russian Academy of Justice 2003

in a written form that is usable in their work; and better administration for the training process itself (lesson timetables, organisation of accommodation, food and transport and so on – see Chart 5).

Regarding factors adversely affecting their own professional activities, the majority of respondents mentioned conflict of laws and defective legislation, the heavy workload, the low level of professionalism of employees in law enforcement and disruptions to court sessions due to the non-appearance of persons involved in trials (see Chart 6).

Analysis of the questionnaire responses

The data suggest that there is a need for improvements in judicial work both in the context of continuing professional development programmes and in a wider context.

Judges feel a clear need for additional opportunities to communicate within the professional community of court system employees. They are short of information about the current state of court practice and they also do not communicate enough with colleagues both in courts of the same level and in higher courts. The organisation of such additional opportunities is a priority area of work with judges.

When formulating teaching plans for the forthcoming academic year it is essential that more attention be paid to questions of improving the interpretation of laws and ways of dealing with defects in various areas of the law and to solving specific legal problems.

As regards the wishes of judges in relation to the organisation of the court process and their own problem-solving activities, a number of basic areas for possible future activities can be identified.

They include information technology support for judges, including printed publications, an internet-based information service, familiarity with internet resources and the optimisation

of communications between judges at various levels. Careful attention should be devoted to opportunities for building such communications in the context of the continuing professional development system for judges, viewing it not only as a way of organising training but as a form of structuring improved communication within the judiciary going forward.

Respondents noted that they use participation in continuing professional development events as a way of communicating with their colleagues. It makes sense for the academy to become involved in this process so as to ensure more efficient communication, to provide the subject matter for that communication and to manage it.

Many respondents approved of certain types of training such as round-table sessions. It is worth encouraging a greater level of participation in this type of training and also in the organisation of such sessions, proposing topics for discussion, speakers and so on. This will make it possible both to satisfy requests from the judiciary and to identify its most active members.

From the point of view of forming a unified information environment that would allow judges to obtain the information they need for their professional activities efficiently and to support the process of professional communication, a significant step would be the creation of a web site which would supply up-to-date information about changes to legislation and the particular features of its application, provide judges with communication opportunities in the shape of forums or opportunities to publish articles by the most authoritative members of the community and, in general, act as a tool of constructive communication for the judiciary and the students of the academy.

Such a web site could, at the same time, become an effective tool for influencing the professional development of judges by suggesting topics for discussion and by publishing articles about the position

of the judge in society, the demands society makes on judges and the socio-economic, political and cultural changes to which judges have to react.

Time management and establishing priorities must be improved. According to the data, respondents are devoting much of their personal time to issues of time management and systematisation. This assistance has been specifically asked for and is urgent. Courses and training sessions on time management and experience-sharing on improving the efficiency of professional activities are effective means of tackling these issues.

Conclusion

Even with all the undoubted successes achieved by the academy in training personnel for the court system and in training sitting judges, there are difficulties and unresolved problems which make it impossible for the academy to carry out its functions in full.

In the first place, the status and functions of the academy are not enshrined in legislation. Secondly, funding from the state budget is insufficient and does not allow the academy to expand its physical presence either in Moscow or in the regions. For example, the Federal Special Programme "Development of the Court System in Russia" for 2002-06 did not make provisions for the funding of training for judges. There is no plan to allocate funds for that purpose in the budget for the same programme in 2007-11 either.

The assertion that "up to now there is no resolution, and in the absence of sufficient funds there is no prospect of a resolution, to the problem of providing a sufficient quantity and a high professional level of training for those who have been called on to apply the law correctly – the judges"³ seems perfectly valid given the present day situation in the Russian judicial training system.

Notes

- ¹ Russian Presidential Decree Number 528 of 11 May 1999, "On the Russian Academy of Justice", and Russian Government Resolution Number 1199 of 28 October 1999, "On the Russian Academy of Justice" led to the foundation of the Russian Academy of Justice.
- ² TACIS is an assistance programme implemented by the European Commission to help the 12 member states of the Commonwealth of Independent States in their transition to democratic market-oriented economies.
- ³ V. P. Verin. Concerning certain problems in bringing into force the new code of criminal procedure of the Russian Federation. In: "Court Reform: Conclusions, Priorities, Prospects. Conference Materials." Academic Reports Series, Number 47. Moscow, Moscow Social Fund, 1997, p. 85.

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Abbreviations

BOO	Build-own-operate
BOOT	Build-own-operate-transfer
BOT	Build-operate-transfer
CEE	Central and eastern Europe
CIS	Commonwealth of Independent States
DBFO	Design-build-finance-operate
DBFT	Design-build-finance-transfer
DESA	Department of Economic and Social Affairs
EBRD, the Bank	European Bank for Reconstruction and Development
EIB	European Investment Bank
EPEC	European PPP Expertise Centre
EU	European Union
FYR Macedonia	Former Yugoslav Republic of Macedonia
GDP	Gross domestic product
IOSCO	International Organisation of Securities Commissions
IPO	Initial Public Offering
LIS	Legal Indicator Survey
MDG	Millennium Development Goals
MEDT	Ministry of Economic Development and Trade
MEI	Municipal and environmental infrastructure
MICEX	Moscow Interbank Currency Exchange
PFI	Private finance initiative
PPP	Public-private partnership
TTF	Treasury task force
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law

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