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ENV/EPOC/EAP/MIN(2005)8



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**ENVIRONMENT DIRECTORATE
ENVIRONMENT POLICY COMMITTEE
TASK FORCE FOR THE IMPLEMENTATION OF THE ENVIRONMENTAL ACTION
PROGRAMME FOR CENTRAL AND EASTERN EUROPE, CAUCASUS AND CENTRAL ASIA**

Private Business Development in the Russian Water Sector

**Financing water supply and sanitation in EECCA
Conference of EECCA Ministers of Economy/Finance, Environment and Water and their partners from
the OECD**

17-18 November 2005, Yerevan, Armenia

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PRIVATE BUSINESS DEVELOPMENT IN THE RUSSIAN WATER SECTOR

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INTRODUCTION

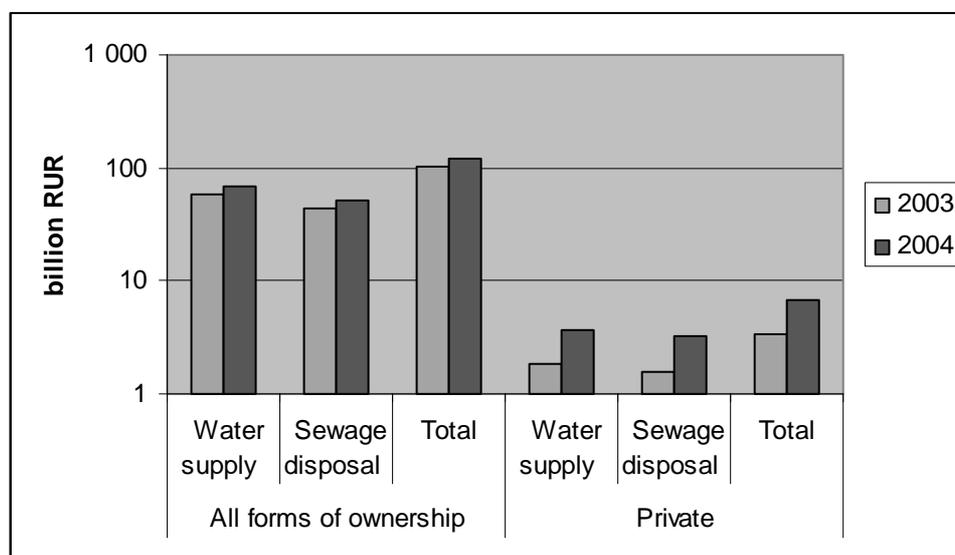
In recent years domestic private sector actors from the EECCA region have started to play a role in the water supply and sanitation sector (WSS) of a few EECCA countries. The most notable example is that of the Russian Federation, where several large private operators have been set-up, each with the objective of taking-up considerable market-share in Russia. More than 20 mostly large and medium size municipalities in the Russian Federation now have privately operated water systems. This report analyses private business development trends in the Russian water supply and sanitation sector over the last two years and tries to identify the key challenges and opportunities that this new situation is creating. It investigates whether the model of private sector involvement that is in use in the Russian Federation is sustainable in the long term and what it can contribute to the reform process.

THE RUSSIAN WATER MARKET AND PPP

Currently domestic private companies provide WSS services for some **11%** of the urban population and operate in at least 20 cities in the Russian Federation (see table 2 in the annex)¹. Most of these cities have a population of more than 250,000. The annual operating income of private operators more than doubled between 2003 and 2004 and now reaches RUR 6.9 billion, or about **6%** of the total operating income of state, municipally and privately owned water utilities in the Russian Federation (RUR 120 billion or USD 4.21 billion). In 2004 the growth of the municipal water supply and sanitation sector revenues was at 18%, significantly less than that of privately operated water utilities at 202% (see table 1 in annex 1).

¹ These figures do not include cities and share of population served by regional companies or companies operating *fully privatized* infrastructure facilities. Total market share of private companies could be roughly estimated as 16%-19% of total urban population.

Figure 1: Market share of private operators in the Russian water supply and sanitation sector



Source: Federal Statistical Agency

While the *financial performance* of the municipal water supply and sanitation sector was still negative in 2004², the trend is towards an improvement, largely supported by the water tariffs for households increasing faster (at 28%) than production costs for this consumer group (at 26%, see annex, table 1)). In large cities with a population of 200,000 and more, most water utilities enjoyed operating profits, while in smaller towns and in rural areas (settlements with populations of less than 5,000) most water utilities incurred losses.

The entry of private businesses into the Russian WSS sector dates from 2003 when many large businesses declared their wish and preparedness to meet the challenge of supplying Russian end-users with electric power, heat, and water supply services. This was a politically motivated declaration made on the eve of the presidential election when the regime was particularly interested in sharing, with business, the responsibility for a sector in difficult condition. Still this declaration had great strategic importance as it signified big business' growing awareness of the potential benefits of the WSS sector as a new market with stable demand, significant cash flows, and limited competition.

This process was characterized by:

- The fast (in half a year) appearance of 5-6 companies positioning themselves as national communal (utility) services operators;
- The active expansion of the companies' business in various Russian regions with the intent to obtain control over power, heat, water and wastewater supply facilities, initially mostly for political rather than economic reasons;

² In this case the financial performance is defined as operating revenues minus operating costs across all water utilities.

- The signing of about 20 short-term utility leases (without investment commitments) and detection of many objective and subjective obstacles to private businesses' entry to the public services market;
- The clear dominance of the Russian Communal Systems Joint-Stock Company (JSC) during the initial period, when it managed to set-up daughter companies and/or open branch offices in 24 Russian regions in one year.

The past year has brought many changes in the government/business relations in the public service sector, the most notable of which are:

1. Major improvements of the sector-related legislation through enactment of laws "On Principles of Utility Tariff Regulation" (December 2004), "On Concession Agreements" (July 2005), and the new "Housing Code of the Russian Federation" (December 2004). The laws are expected to significantly improve the investment climate in the sector, and in the WSS sector in particular. However, the real effect of this legislation will become tangible no sooner than next year.
2. The position of the big Russian private companies, which two years ago were so eager to develop the market for public services, has become more financially oriented and less politically loaded. Particularly notable changes are evident in the most prominent private operator - Russian Communal Systems JSC - which has reduced its presence in the field to only 13 regions.
3. A new important trend towards long-term lease contracts, including investment commitments has emerged (such contracts may be easily converted into concession agreements). Already more than 10 contracts of this type have been concluded in the WSS sector.
4. In the past year municipalities, for the first time, offered their WSS facilities for private operation through public tenders.
5. Alongside big companies marketing themselves as national public service operators, Russian regions are also seeing the emergence of regional private operators that usually are affiliated either to regional power producers or powerful regional politicians.
6. In many countries, engagement of foreign operators for water servicing is common practice, unlike in Russia where they have not met with success yet and are now less active.

These points are discussed in more detail in the following.

LEGAL TRENDS

Two recent legal developments should help to improve the situation for a durable involvement of the private sector in operating water supply and sanitation infrastructure in the Russian Federation.

A new law on “Fundamentals of Utility Providers Tariff Regulation” (Federal Law nr.210-FZ), is coming into force on 1st of January 2006. It is expected that this law would help to reduce the tariff risk for utilities by making the change of tariffs more predictable, as it requires tariff setting authorities to take the full cost of operating and maintaining water systems into account and to set tariffs for a specified duration. The law also requires the involvement of the public in the process of tariff setting, and associates this to obligatory affordability assessments for household tariffs, which should help to improve the acceptance of tariff increases in the population. It also introduces a water utility performance monitoring system based on performance indicators, including the publishing of the data.

In order to set a better legal basis for the involvement of private operators in the WSS sector, the legislator has also adopted a federal law on “Concession Agreements” (Federal law nr.115-FZ adopted in July 2005). This law includes provisions regulating the fundamental guarantees of the rights and legal interests of the concessionaire, aimed at protecting his investments against expropriation, including unfavourable changes in taxation and/or regulatory framework. The law also stipulates that concession contracts need to be awarded in open competitions.

The package of laws on housing and communal services sector approved in the fall of 2004 has established a private sector participation system, based on the “French” model, and concluded several years of intensive debates in the Russian Federation, which also considered the “German” model (corporatisation of water utilities including transfer of ownership of WSS infrastructure to the utility, but with a controlling share remaining with the municipality) and the “UK” model (full divestiture of WSS infrastructure with regulatory oversight). The debate came to this conclusion, because it was perceived that the “French” model allows for a stronger role for the private sector and more competition than in the “German” model, while not requiring the same, sophisticated regulatory capacity to be installed at the central government level as in the “UK” model.

CONTRACTS

While at the outset, most PPPs were short term leases, about half of them have been transformed into long term leases over the past year. Between 2003 and 2004 more than 10 contracts for terms between 15 and 49 years were concluded, with the total serviced population covered by them approaching seven million.

This is, of course, a strategically important outcome, which will encourage the inflow of private investments into the water sector.

It should be remembered that in the early years of private operation of water services in Russia, preference was given to short-term leases, typically lasting no more than 11 months. The main reason for this were “technical barriers”, which made signing of long-term leases impossible: Russian law provides for mandatory registration of such leases which, in turn, supposes mandatory assessment and registration of leased property. However, in Russia there was no practice to assess and register municipal property when it was put under operating control. Therefore, due to the underdevelopment of the municipal property registers as well as of the property appraisal markets, procedures for utility assessment and registration proved to be both time and money-consuming. For this reason, private operators concerned with getting fast access to the market chose to conclude short-term leases (not subject to mandatory registration).

However, apart from this, there were also other factors that explain the careful approach of both investors and public authorities to long-term contracts:

Public authorities were mostly concerned with the risk of losing property of assets, since the Russian Civil Code allows the lessee, after fulfilment of investment commitments, to claim ownership in newly built or modernised facilities.

Private investors are also exposed to risks associated with long-term contracts, mainly through uncertainty over tariffs where it is unclear whether contractual arrangements over tariffs may prevail over the authority of administrations to set tariffs.

As a consequence, long term leases that have been concluded in the last year are legally very fragile, which is why many are rather declarative and resemble memoranda of understanding more than actual contracts. However, it cannot be denied that these contracts have a great political value.

The new concession law confronts market actors with an interesting dilemma. The reason for this is that contracts that are based on the new concession law will allow to palliate most existing problems with long term contracts. However, such contracts can be placed only through a tender, while a lease may be concluded under a non-competitive procedure. Contracting parties will have to choose between less competition associated to high risks during execution of a contract on the one hand, and competitive selection of the operator, associated to smaller follow-on risks, on the other. Most likely both options will be in demand.

INDUSTRY STRUCTURE

The past year witnessed major restructuring processes in the industry. Some companies market themselves as national water operators, which is to say they express their interest in the development of the water supply operations in various Russian regions. All these companies are backed by financially strong shareholders.

This group of water operators includes:

- **Russian Communal Systems (RCS)** – a company running water businesses in six Russian cities with a total population of some two million;
- **Eurasian Water Partnership** – a company running water businesses in two Russian cities with a total population of more than two million;
- **Novogor-Prikamje** – a company running water businesses in two Russian cities with a total population of some one and a half million;
- **Rosvodocanal** – a company running water businesses in two Russian cities with a total population of more than one million.

Three companies from this group have been operating in the utility market since 1994, while Eurasian Water Partnership was created only last autumn. Two other business entities that initially intended to enter the Russian water supply and sanitation market did not show any activity so far.

Alongside with the stepping up of the involvement of big businesses in the utility market, the water sector witnessed several new trends in the last year as a consequence of the ongoing corporatisation of water utilities.

The first trend lies in the fast emergence of regional private operators in the utility sector. Usually these are affiliated either to powerful regional politicians or to regional power producers. A good illustration is the case of Krasnoyarsk City where the Krasnoyarsk Communal Company, created as a privately-owned entity, was contracted for management of utility and housing property for the city (population, one million), including water and sewage facilities. The company is loyal to the interests of Mr. Khloponin, the *governor* of Krasnoyarsk Region, and co-owner of Norilsk Nickel. The company is headed by the *former vice-governor* of the region.

The dynamism of regional energy companies in the utility market may be exemplified by many Russian cities. For example, their initiatives in Barnaul (Altaj Kray's capital city with a population over 500 000) and in *Leningrad Oblast* are particularly noteworthy. In these areas, regional power producers and national operators joined their efforts and created cooperative ventures for utility services management. In Barnaul, such a venture was founded by Rosvodocanal, a national operator, and Barnaulenergo, a regional energy company, for management of the city's water sector. In Leningrad Region, top managers from Lenenergo, a regional energy company, and Novogor Company established a cooperative venture for managing a low-voltage network belonging to rural municipalities of the region. This trend may be deemed positive and indicative of the growing interest in the utility sector of regional business elites alongside Moscow-based business majors. The contractual arrangements in these cases follow the same pattern as for the national operators, where the infrastructure remains in public (municipal)

ownership and is managed by private companies on a contractual basis. Market share of private regional operators could be estimated as 3-5%.

The second trend is the conversion of municipal water enterprises into joint-stock companies who own the WSS infrastructure, with the equity entirely belonging to municipal or regional governments. The case of Yuzhno-Sakhalinsk, Primorsky Krai (Vladivostok) and Stavropol may serve as examples of this model of corporatisation. In these cases the ownership of WSS infrastructure operated by former municipal/state water utilities has been transferred to newly created private companies as an equity contribution, in fact following the “German” model. The trend towards using this model appears to be progressing steadily. Big private operators disapprove such practice as they believe that local administrators use it as an instrument for hidden privatisation of public property. Around 2-3% of WSS are provided through privatized infrastructure.

COMPETITION

When interviewed, major private operators point out that the huge size of the Russian market for water services is going to limit competition at least in the medium term. As the supply of potential projects is far larger than the current demand of private operators for projects, intensive competition is likely to be limited to a few high profile deals. Today private operators have to compete mostly with local administrations, which may be tempted to keep cash flows from water supply and sanitation under their control.

Unlike Russian private operators that have been rather successful on the water market, international operators' have so far largely failed to establish themselves on the market. In the past year they have won no contracts for water facility management. Repeated attempts by Veolia, a French operator, to obtain operating control over the water and sewage sector in Podolsk City and other towns in the Moscow Region have been unsuccessful. This has been the case for all other foreign operators. The primary reason is the low transparency of deal making. Until now, the better part of leases, including long-term, were concluded under a non-competitive procedure. The current practice of non-public negotiations has resulted in a certain priority given to domestic operators. This priority is a result of Russian operators' better knowledge of the intricacies of the water sector and the decision making mechanisms rather than the result of corruption practices (although this risk should not be fully ruled out in circumstances of low transparency).

International private operators will be better placed to participate in the market, when significant investment will be attracted into the sector, as they have a competitive advantage in accessing low-cost capital. Therefore it is important for them to keep operating in the Russian water services market despite the low success rate to date, so as gain knowledge of the market and to be ready to step in when the opportunity arises.

Only two Russian cities (Omsk and Berezniki) have so far set-up a competitive bidding process to award contracts for the operation of their water services. Both of these tenders have been contested. The tender in Omsk has been criticised for having been manipulated, with only one of the bidders having the necessary credibility to receive serious consideration by the municipal authorities. The tender in Berezniki resulted in two strong bids being put forward, but the award of the contract to one of them has been challenged since then in court and the bid evaluation criteria have been criticised for being too subjective. With the recent adoption of the Russian Concession Law, which requires the competitive bidding for

concession contracts the number of tenders is likely to increase, building-up the needed experience and capacity to organise such tenders more effectively in the future. As mentioned earlier, the lack of serious bidders might however reduce the effectiveness of this approach.

INVESTMENT

Only now that long-term contracting has become actual practice it is reasonable to expect the inflow of private investments into the water sector. A year ago, when contracts were made mostly for a short term, the question did not arise. However, even today real private investments are rare. It is clear from available reports on utility sector investments, that today such investments are financed from operator's own funds, either from tariffs, *i.e.* profit, amortisation and capital repair charges, or from equity capital.

What this situation suggests is that the sector is not yet attractive for private investment, both due to its currently low profitability, and to the significant financial risks that are associated to such operations.

Private operators are therefore calling for government guarantees to insulate their business from some of these risks, as well as access to low interest loans, and the possibility to use future operating incomes as collateral for bank loans, which currently is not acceptable by Russian commercial banks. They are also demanding improvements in the institutional set-up that would allow them to reduce risks, such as more predictable tariff-setting procedures, and more control over the collection of payments through more effective enforcement mechanisms, including the allowance of disconnection of users.

ANNEX

Table 1. Main performance indicators of water companies in 2003-2004

	All forms of ownership			State owned			Municipally owned			Private		
	Water supply	Sewage disposal	Total	Water supply	Sewage disposal	Total	Water supply	Sewage disposal	Total	Water supply	Sewage disposal	Total
Operating income, RUR thousands												
2003	57 744 235	44 372 839	102 117 074	14 714 520	12 059 103	26 773 624	39 978 741	29 617 254	69 595 994	1 845 367	1 552 078	3 397 444
2004	68 002 955	52 103 634	120 106 589	17 511 683	13 579 240	31 090 923	45 571 485	34 367 223	79 938 708	3 644 158	3 222 729	6 866 887
Increased by	10 258 720	7 730 795	17 989 515	2 797 163	1 520 137	4 317 300	5 592 744	4 749 969	10 342 713	1 798 792	1 670 651	3 469 443
Growth rate	118%	117%	118%	119%	113%	116%	114%	116%	115%	197%	208%	202%
Income from retail services, RUR thousands												
2003	26 467 915	21 583 541	48 051 456	6 455 328	6 103 558	12 558 886	18 537 823	14 387 502	32 925 325	937 111	712 120	1 649 231
2004	34 532 948	27 820 568	62 353 516	8 769 012	7 364 511	16 133 524	23 187 132	8 477 400	41 664 532	1 855 192	1 493 076	3 348 268
Increased by	8 065 033	6 237 027	14 302 059	2 313 684	1 260 953	3 574 638	4 649 310	4 089 898	8 739 207	918 081	780 955	1 699 036
Growth rate	130%	129%	130%	136%	121%	128%	125%	128%	127%	198%	210%	203%
Operating costs, RUR thousands												
2003	65 192 384	46 330 241	111 522 625	15 968 005	11 951 771	27 919 775	45 052 275	31 145 882	76 198 157	2 541 813	1 806 852	4 348 665
2004	74 234 471	54 039 785	128 274 256	18 809 901	13 750 133	32 560 034	49 269 470	35 605 384	84 874 853	4 465 295	3 547 337	8 012 632
Increased by	9 042 086	7 709 544	16 751 631	2 841 897	1 798 362	4 640 259	4 217 195	4 459 501	8 676 696	1 923 482	1 740 485	3 663 967
Growth rate	114%	117%	115%	118%	115%	117%	109%	114%	111%	176%	196%	184%
Financial performance, RUR thousands												
2003	-7 448 149	-1 957 402	-9 405 551	-1 253 484	107 333	-1 146 152	-5 073 534	-1 528 629	-6 602 163	-696 446	-254 774	-951 221
2004	-6 231 516	-1 936 151	-8 167 667	-1 298 218	-170 893	-1 469 111	-3 697 985	-1 238 161	-4 936 146	-821 137	-324 608	-1 145 745
Increased by	1 216 634	21 251	1 237 885	-44 734	-278 226	-322 960	1 375 549	290 468	1 666 017	124 691	-69 834	-194 524
Growth rate	84%	99%	87%	104%	-159%	128%	73%	81%	75%	118%	127%	120%
Debt receivable, RUR thousands												
2003	28 472 642	21 047 000	49 519 642	5 821 375	5 129 593	10 950 968	21 376 728	14 941 020	36 317 747	738 215	521 993	1 260 208
2004	27 875 024	21 006 191	48 881 215	5 138 927	4 383 715	9 522 642	20 743 763	15 092 041	35 835 804	1 444 850	1 155 500	2 600 351
Increased by	-597 618	-40 809	-638 426	-682 449	-745 878	-1 428 327	-632 965	151 021	-481 944	706 635	633 507	1 340 142
Growth rate	98%	100%	99%	88%	85%	87%	97%	101%	99%	196%	221%	206%
Debt payable, RUR thousands+A29.												
2003	28 638 130	21 316 949	49 955 078	4 857 185	4 017 194	8 874 379	22 769 866	16 308 128	39 077 994	347 464	361 055	708 519
2004	28 134 244	20 990 059	49 124 303	4 835 777	3 870 306	8 706 083	21 290 564	15 638 202	36 928 765	1 331 969	1 142 654	2 474 622
Increased by	-503 886	-326 889	-830 775	-21 408	-146 888	-168 296	-1 479 302	-669 927	-2 149 229	984 505	781 599	1 766 104
Growth rate	98%	98%	98%	100%	96%	98%	94%	96%	95%	383%	316%	349%

Table 2: Water supply and sanitation projects with participation of private operators in the Russian Federation

City	Private operator	Shareholders of the company	Year of entrance	Type of the contract	Term of the agreement	Volume of obligations	Tender	Population of city
Perm	LLC «NewUrban Infrastructure of Prikamye»	CJSC «New Urban Infrastructure»	2003	Long-term Lease + The Investment contract	49 years	Not less than 750 mln. Rub. for 2005-2009 years	No	1 009,4 thousand persons
Berezniki	LLC «New Urban Infrastructure of Prikamye»	CJSC «New Urban Infrastructure»	2005	Long-term Lease + The Investment contract	25 years	Refusal of participation in the project of the World Bank	Yes	250 thousand persons
Omsk	JSC «Omsk Vodokanal»	LLC «Eurasian Water Partnership»	2004	Long-term Lease + The Investment contract	25 years (with an opportunity of prolongation till 49 years)	4.3 bln. Rub. for 10 years, 450 mln. Rub. for 2005-2006 years	Yes	2 058,5 thousand persons
Rostov-on-Don	LLC «Rostov water partnership»	LLC «Eurasian water partnership» and others	2005	The Investment contract	n/a	1,2 bln. Rub., from which 0,8 bln. Rub. are already invested	No	1 070,2 thousand persons
Kirov	JSC «The Kirov Utility Systems »	JSC «Russian Utility Systems »	2003	Long-term Lease + The Investment contract	15 years	20 mln. USD, on 2006 year it is planned 46,6 mln. Rub.	No	502,9 thousand persons
Tambov	JSC «The Tambov Utility Systems »	JSC « Russian Utility Systems »	2003	Long-term Lease + The Investment contract	25 years	Refusal of participation in the project of the World Bank	No	294,3 thousand persons
Tomsk	JSC «Tomsk Utility Systems »	JSC « Russian Utility Systems »	2003	Long-term Lease + The Investment contract	49 years	n/a ²	No	487,7 thousand persons
Blagoveshchensk	JSC «The Amur Utility Systems »	JSC « Russian Utility Systems »	2003	Long-term Lease + The Investment contract	10 years	n/a	No	223,7 thousand persons
Volgograd	JSC «The Volgograd Utility Systems »	JSC « Russian Utility Systems »	2003	Short-term Lease	11 months	Not significant	No	1 012,8 thousand persons
Kachkanar	JSC «Sverdlovsk Utility Systems »	JSC « Russian Utility Systems »	2003	Short-term Lease	11 months	Not significant	No	47,4 thousand persons
Petrozavodsk	JSC «Petrozavodsk Utility Systems »	JSC « Russian Utility Systems »	2005	Long-term Lease + The Investment contract	20 years	n/a	No	266,2 thousand persons
Orenburg	LLC «Orenburg Vodokanal»	LLC «Rosvodokanal»	2003	Long-term Lease	20 years	n/a	No	548,8 thousand persons
Barnaul	LLC «The Barnaul Vodokanal»	LLC «Altaivodokanal», debenture trust LLC «Rosvodokanal» JSC «Barnaulpower»	2005	Short-term Lease	11 months	Not significant	No	662,2 thousand persons
Krasnoyarsk	«The Krasnoyarsk Utility »	n/a	2005	n/a	n/a		No	912,8 thousand persons

Notes: 1. This Table does not include information about some other Russian cities where private companies operate successfully (such as, for example, Syzran, Otradny and Moscow) because of lack of needed information.

2 In 2006 JSC « Russian Utility Systems » will discuss attraction of 70 - 100 mln. USD loans for project financing. Under the forecast, in five years' prospect the volume of loans attracted by JSC « Russian Utility Systems » can increase up to 400 - 500 mln. USD.