



EAP Task Force



FRAMEWORK CONDITIONS FOR PRIVATE SECTOR PARTICIPATION IN WATER INFRASTRUCTURE IN RUSSIA¹

This document provides an assessment of the framework conditions for private sector participation in the water and sanitation sector of Russia, based on the OECD *Checklist for Public Action*. It builds on answers to the *Checklist*-based Questionnaire, publicly available material (listed at the end of the document), and interviews with various stakeholders, including private operators, held during three missions jointly carried out by the OECD and the EAP Taskforce to Moscow in June 2009, January 2010 and June 2010. Early versions of the draft were presented and discussed at the Regional Meeting on private sector participation in water and sanitation in EECCA (Moscow, 28-29 January 2010) and at the 2nd National Policy Dialogue Meeting on Water and Sanitation Policy in Russia (Moscow, 3 June 2010). The document provides an overview of recent developments on private sector participation in water and sanitation and highlights three areas for consideration by the government: the institutional framework under development; the accountability mechanisms; and the financial sustainability of projects.

Private sector participation in the water sector of Russia is in a period of stagnation. From 2003 to 2006, private actors actively entered the provision of water services on the basis of lease contracts granted through direct negotiations. A new legislative framework is now promoting the concession model granted on the basis of competitive tenders. However, no major contracts have been developed in the water sector following implementation of the law. This may reflect a wait and see attitude from the private sector at a time of important changes in the legislative framework. This may also reflect difficulties on the part of responsible authorities to implement the new legislation. Overall, the blockage justifies a careful consideration of the framework conditions for private sector participation in the water and sanitation sector. While, some of the constraints to private sector involvement can undoubtedly be found outside the water sector, this paper focuses on water-specific issues and policies.

A number of initiatives are developing, under the leadership of institutions such as Vnesheconombank, EBRD, UNECE, World Bank, that aim to support a better understanding of the risks and opportunities associated with private sector participation and to build capacities among the different Russian

¹ The document was prepared by Céline Kauffmann of the OECD Secretariat with inputs from Alexandre Martoussevitch (OECD/EAP Task Force secretariat). The views expressed in this paper do not necessarily represent those of the OECD or its Member governments. Contacts: Céline Kauffmann (celine.kauffmann@oecd.org) and Alexandre Martoussevitch (alexandre.martoussevitch@oecd.org).

stakeholders.² In this context, the OECD, together with Russian institutions (Vnesheconombank –VEB - and the Ministry of Economic Development) and international partners (EBRD and the World Bank), is conducting a more targeted effort that focuses on the water sector. It builds on the recently published OECD *Checklist for Public Action*, which aims to support governments' efforts to build a shared understanding of framework conditions necessary to attract beneficial private sector participation in the water sector. It involves developing an assessment of current conditions for private sector participation in Russia and supporting policy dialogue among key stakeholders. To this effect, a Regional Meeting on Private Sector Participation in Water Supply and Sanitation was held in Moscow on 28-29 January 2010 and a Policy Dialogue Meeting on Water and Sanitation Policy in Russia was hosted by VEB on 3 June 2010.

1. Recent developments with private sector participation in Russia

Active penetration of private business into Russia's water sector dates back to 2003 when the government sent a clear political signal that it would open the sector to private business. Before that, participation of the private sector in water and sanitation was only sporadic, starting with the full divestiture of Novokuznetsk City Vodokanal in 1991, the BOT arrangements for the South Butovo and the Zelenograd wastewater treatment plants (deals signed in 1996 and 1998 respectively, with the international group Wassertechnik Essen - WTE) and the management contract for the Syzran Vodokanal signed in 2001. From 2003, the opening of the water sector generated strong expectations on the part of government and the wider public that the private sector would bring in the necessary investments and the technical and managerial capacities to improve efficiency and quality of services.

It is indeed estimated that water infrastructure and facilities in Russia are in dire need of maintenance: according to the Institute for Urban Economics (2009), some 40% of the 532,000 km water supply pipes and 35% of the 179,000 km sewerage networks are in need of replacement. Over the last 5-6 years the accumulated depreciation of fixed assets in water and sanitation has been growing, reaching on average 55.3% in 2006, compared to 51% in 2003, and exceeding the critical level of 60% in many municipalities. Consequently, according to the draft Clear Water Programme, the share of totally depreciated assets amounted to 22.6% in 2006, compared to 19.5% in 2003.

As a consequence, the key performance indicators of the sector remain weak and stagnating: the share of leaks and unregistered water consumption amounted to 18–20% in 2004-2008 and showed no sign of decrease. The number of breakdowns in water supply networks reaches 35-38 failures per 100 km of networks a year, while the similar index for sewerage networks grew over the last 5 years to 25 failures/100 km/year in 2006. Quality of water supply and sanitation services has still large room for improvement: only 52% of tap water samples fully comply with national standards for drinking water, some 55-60% only of water undergoes water treatment and less than half of wastewater is treated to the appropriate standard.

The resulting needs for infrastructure investment are colossal. As mentioned in a recent publication by Rosvodokanal³, the Chairman of the Duma announced that \$459 billion (15 trillion Rubles) was needed to complete necessary upgrades, refurbishment and new construction for water and sanitation infrastructure in Russia by 2020.

² The International Conference on Public-Private Partnerships: "New Opportunities for infrastructure Development in Transition Economies" of 21-22 October 2008 in Moscow is a good example of these current efforts: www.veb.ru/en/PPP/pppconfi

³ Tomasz Zagdan (2009). Market Insight: Water sector outlook for Russia: www.rosvodokanal.ru/en/press-center/aboutus/index.php?id4=1176

Over 2003-2006, a number of large private companies positioned themselves as national operators of water services, including Russian Communal Systems, Complex Energy Systems, Novogor, Evraziyskiy, Regional Utility Investments, Rosvodokanal. It is estimated that some 20 agreements were concluded in the water and sanitation sector, covering 15% of the country population or 20% of the total urban population⁴.

Table 1. Major private water operators in Russia, after consolidation of the sector

Companies	Activities	Type of contract
<p><u>Evrasiyskiy:</u> Created in 2004. Since 2006, VEB has been a 20% shareholder and provides funds for investment. www.evrasiyskiy.ru</p>	<p>Evrasiyskiy operates in 3 regions:</p> <ul style="list-style-type: none"> - Rostov-on-the Don and in the south-west of Rostov Oblast, since 2005 (1.1 million people) - Sochi vodokanal (via Yugvodokanal) (330,000 people) - Program of rehabilitation and development of the water supply and sanitation facilities of the water supply and sanitation system in some cities and towns of the Azov-Black Sea seashore. 	<ul style="list-style-type: none"> - Rostov-on-the Don: lease combined with a long-term investment programme (25 years – no tender). - Sochi: long-term lease. - Krasnodarskiy Krai: concession.
<p><u>Rosvodokanal:</u> From 2007, owned by Alfa-Bank consortium (90%) and Deutsche Bank (10%). www.rosvodokanal.ru</p>	<p>Rosvodokanal water companies operate in 7 regions of Russia and in Ukraine, covering 7.5 million people:</p> <ul style="list-style-type: none"> - Barnaul Vodokanal, since 2005; - Kaluga Oblast Vodokanal, since 2006; - Krasnodar Vodokanal, since 2005; - Omsk vodokanal, since Dec 2004; - Orenburg Vodokanal, since October 2003; - Tver Vodokanal, since 2006; - Tyumen Vodokanal, since 2005. 	<p>Long-term lease agreements:</p> <ul style="list-style-type: none"> - Barnaul (25 years – no tender) - Kaluga (25 years – no tender) - Krasnodar (25 years - competitive bidding). - Omsk (25 years - competitive bidding). - Orenburg (20 years – no tender) - Tver (25 years - competitive bidding). - Tyumen (25 years).
<p><u>Russian Utility Systems:</u> Multi-utility operator founded in May 2003. Currently owned by “Renova” - one of the largest private financial industrial group in Russia. www.roscomsysru</p>	<p>The company provides water and sanitation services in 5 regions for over 2 million consumers:</p> <ul style="list-style-type: none"> - Amur Oblast (Amur Utility Systems) since August 2003; - Kirov Oblast (Kirov Utility Systems) since September 2004; - Perm Krai (Novogor-Prikamie, LLC) since December 2003: operates in Perm since 2005, in Berezniki and Krasnokamsk since 2006; - Republic of Karelia (Petrozavodsk Utility Systems) since September 2005; - Tambov Oblast (Tambov Utility Systems) since July 2003 	<p>Long-term lease agreements:</p> <ul style="list-style-type: none"> - Berezniki (30 years, competitive bidding), - Blagoveshchensk (10 years – no tender), - Kirov (15 years – no tender), - Perm (49 years – no tender), - Petrozavodsk (20 years – no tender), - Tambov (25 years – no tender).

Source: Based on information from the Institute for Urban Economics (2009), OECD (2005), UK Trade and Investment (2009) and the World Bank PPI database.

After 2006, however, the trend stalled and a consolidation occurred: of the 6 to 8 operators that initially entered the market, only 3 major ones remained as national operators (Table 1) along with smaller scale localised private actors. In 2008, only one contract was signed in Volgograd, which was later challenged in

⁴ OECD (2010a). Private sector participation in water supply and sanitation in Eastern Europe, Caucasus and Central Asia: Status paper.

court and cancelled. In December 2009, a concession was signed for the transregional water supply networks of the Krasnodarskiy Krai (province) and in September 2009 the Samara Water Supply Municipal Enterprise announced a bid for a long-term lease contract.

In addition, there are mixed signals on the success of foreign water companies to take advantage of the new opportunity for private sector participation. In some instances, traditional international water companies have been led to reduce their activity in Russia. As such an example, Veolia Water made several attempts to take water supply systems in some cities and towns of Central Russia for lease but after unsuccessful completion of these projects almost suspended its operations in Russia.⁵ Generally, foreign investors' participation in Russia's infrastructures and utilities has remained limited even during the period (until 2008) of strong FDI inflows to Russia.⁶ Although not directly concerned by the 2008 Law on Strategic Sectors, which imposes government's prior approval procedures for new FDI in 42 sectors, foreign participation in the water sector will continue to be affected by the general investment climate and developments in the FDI policy framework. However, early 2010, Remondis Aqua Gumby and Co won a long term contract for the city of Arzamas.

2. The institutional framework under development

The OECD Checklist for Public Action: enhancing the enabling institutional environment

The government has the essential responsibilities of establishing adequate policy and regulatory frameworks, institutions and contractual arrangements and overseeing their functioning (**Principles 5 & 17**). In addition, water is a segmented sector, with oversight responsibilities for resource management and service provision often split horizontally between different Ministries, and vertically across national, regional and local authorities. This may raise important capacity challenges and also generate issues of consistency across government levels. Careful allocation of roles and responsibilities is needed across different authorities, taking into account existing capacity gaps, and based on resources allocated in line with duties and distributed in a predictable way (**principle 10**), as well as building common understanding across levels of government on the objectives, means and resources for water provision (**principle 11**).

Principle 5. Enabling environment. A sound and enabling environment for infrastructure investment, which implies high standards of public and corporate governance, transparency and the rule of law, including protection of property and contractual rights, is essential to attract the participation of the private sector.

Principle 10. Empower authorities responsible for privately-operated infrastructure projects. Authorities responsible for privately-operated infrastructure projects should have the capacity to manage the commercial processes involved and to partner on an equal basis with their private sector counterparts.

Principle 11. Clear and broadly understood objectives and strategies. Strategies for private sector participation in infrastructure need to be understood, and objectives shared, throughout all levels of government and in all relevant parts of the public administration.

Principle 17. Competent, well resourced and independent regulatory bodies. Regulation of infrastructure services needs to be entrusted to specialised public authorities that are competent, well-resourced and shielded from undue influence by the parties to infrastructure contracts.

Source: OECD (2009). Private sector participation in water infrastructure. OECD Checklist for Public Action.

A developing legislative framework

Private sector participation in the water sector of Russia (and more generally in the municipal utility sector) initially developed on an ad-hoc basis, within the existing incomplete legal framework and based

⁵ A number of international private operators, including SAUR, SUEZ, Veolia Water, Severn Trent, nevertheless remain involved in water projects in Russia through consultancy assignments from multilateral and bilateral donors.

⁶ OECD (2008a).

on rudimentary contractual arrangements that did not define clearly the rights and obligations of partners according to EBRD (2008). To remedy some of the shortcomings of the legislative framework, Russia is in the process of reviewing and amending its federal laws governing private sector participation, including the concession law.

Federal Law n°115-FZ “On Concession Agreements” of July 2005 (“Concession Law”)

In the first years of private sector participation (from 2003 to 2006), private actors entered the water sector on the basis of lease contracts (with no competitive bidding, duration that could go up to 49, but with initial arrangements that were short term - typically 11 months – to avoid official registration and leave time for asset registration). The developing legislative framework is now promoting the concession model. However, only a limited number of contracts have been developed in the water sector following implementation of the law. As of mid-October 2009, the Federal Service for State Registration had registered a total of 8 concession agreements in the water and sanitation sector, typically, in medium-size cities and small towns.

The Concession Law raises important difficulties that the legislators are currently trying to address through a number of amendments. These amendments have already been agreed by Government and were submitted to parliament for a second reading early June 2010:

- The law was tailored mostly to the transport sector and does not fit well with the water sector. Standard sector-specific concession agreements were developed and approved by government for all infrastructure sectors, including toll roads and utility infrastructure. Amendments are under preparation to improve these standard model contracts and supplement the law itself with a number of sector-specific provisions.
- There is important uncertainty regarding the conversion of old leases into new concession agreements: leases were granted without bidding processes which have become compulsory with the new regulation; the leases had investment provisions that made the private sector the owner of the new infrastructure developments (new facilities and so called “separable improvements” of existing fixed assets) while the concession law does not allow private ownership of assets. The amendments to the concession law will provide for the procedure for converting long-term lease contracts into concession agreements.
- New legislation has established that any contract (lease, management contract etc.) that anticipates transfer of public assets to private management, or possession, shall be concluded with a party selected through a competitive public tender. In practice, however, competition is constrained by the limited number of players and tender conditions have been severely criticised in some specific instances. Barriers to entry include unclear property rights, uncertainty and regulatory risks and complex and cumbersome administrative procedures, all of which favour incumbent operators and those with inside knowledge or connections. Competition issues are further developed in section 3.
- Asset registration is compulsory before a municipality enters in a contract longer than a year with a private partner. This process is, however, taking longer than expected owing to limited capacity at municipal level and poor knowledge of existing vodokanal fixed assets. Capacity issues are further discussed below.

Other relevant legislations

Several other legislations have important consequences for private sector participation in water infrastructure, including Federal Law n°7-FZ “On Environment Protection”; Federal Law n°210-FZ “On General Principles of Utility Organizations Tariff Regulation” (discussed in section 4), Federal Law 184

“On technical regulation”, Water Code and Civil Code, regional PPP laws, Federal Law n°281-FZ “On information disclosure” and procurement law, etc.

The concession model is not the only form of private sector participation authorized by law. Under the Civil Code, any kind of contractual arrangements with the private sector can be developed (up to 49 years for leases and to 5 years for management contracts). The question of a separate law governing public private partnerships is periodically raised at the federal level.

In effect, special laws on public private partnerships have already been adopted in several subjects of the Russian Federation such as: Republics of Altai, Dagestan, Kalmykia, Tomsk Oblast and city of St.-Petersburg. In particular, the St. Petersburg law “*On Participation of St. Petersburg in Public Private Partnerships*” forms the legal basis for implementation of public private partnership projects in various legal forms without limiting them to concession agreements. These sub-national PPP laws have emerged in a relative legal vacuum at the federal level and may expose concessionaires to a risk of revision of their contractual agreements (or even their annulment) if they fail to comply with forthcoming federal legislation.

Federal Law 184 “On technical regulation” sets out the general requirements for certification of technical devices. Its implementation requires the development of accompanying technical regulations that will define the technical standards for drinking water, wastewater collection and treatment. These regulations are expected to facilitate the setting of objectives and technical requirements in investment plans, to support the development of performance indicators for monitoring purposes and to provide a sounder base for tariffs setting. The draft regulations on drinking water and on wastewater collection and treatment were submitted to parliament in March 2006. However, as of January 2010, they had not yet passed their first reading.

In parallel, a water policy framework is under development. The State Water Strategy to 2020 was approved in 2009. A State Clean Water Programme for 2010-2020 is under development, which should provide guidance on broad development objectives for the water sector (see table 2 for key goals based on 2008 draft). The Programme aims to upgrade the quality of water services through improvement of sector regulation, creation of a competitive environment, promotion of socially responsible businesses and support to innovations. However, until the completion of the programme (at an undefined time) and its translation into concrete policies, some underline the lack of clarity of long-term government policy for the water sector.

Table 2. Key goals of the Clean Water Programme, 2008 draft

Goals to achieve	2010	2017
Population with access to centralized water supply (%)	78.2%	90
Water losses in the centralized water supply network (%)	18.5%	15%
Population consuming drinking water of good quality (%)	71.3%	83.2%
Share of wastewater that meets requirements (%)	40.3%	68.3%
Share of spending on capital investment in expenditure of water utilities (%)	15%	40%

Source: Rosvodokanal, www.rosvodokanal.ru/en/press-center/aboutus/index.php?id4=1176.

Property rights

Unclear property rights remain an important issue in Russia and an important impediment to private sector participation in water infrastructure. Registration of publicly-owned assets, a prerequisite to involving the private sector by law, is far from completed yet. The process itself is difficult, long and costly: it is done by municipalities according to territorial criteria and not at water system level with the consequence that a network may be registered in (thousand of) pieces. In addition, some parts of the water systems may have been registered as movable assets to overcome the delay incurred by the registration process (unlike contracts with fixed assets, contracts with movable assets are not subject to State registration), which, in the longer run, may generate some difficulties as such assets do not associate land property rights.

There appears to be a lack of incentives for municipalities to register their assets properly, even when resources allow them to do so. Some also question the capacity of small municipalities to carry out this task. Evidence is scattered in this area. Rostov-on-the Don presents an example of a city that carried out its own inventory and consequently was successful in establishing a long-term lease contract with a private operator. In Omsk and Perm Cities, the private operators undertook the inventory.

In addition to the issues related to asset registration, EBRD (2008) notes that, under current legislation, the ownership of fixed assets constructed by a private company also raises important questions. With the Civil Code allowing the lessee to claim ownership of newly built facilities and “separable improvements” of existing fixed assets, public authorities were concerned to lose property of essential services assets and compromise infrastructure integrity. In addition, interviews suggested that there might not be common understanding and clear definition of the “separability” of assets. To address the risks, the Concession law envisages that the assets to be contracted, rehabilitated or modernised under the concession agreement remain from the beginning property of the tendering authority. The status of pieces of networks acquired by the private sector under previous legislation remains, however, unclear.

Fragmentation of the regulatory and policy framework

Developing a high-quality regulatory framework remains a challenge. Under current legislation, the regulatory framework is highly fragmented. The Institute for Urban Economics (2009) reports a three-tier system of tariff regulation (the Federal Tariff Service – tariff regulation agencies of subjects of federation – local governments) which may ultimately confuse and dilute the responsibility for tariffs decisions. As an example of fragmentation, one of the interviewees mentioned that supplying water in Rostov Oblast is subject to the oversight of more than 40 regulators and supervisors, including various parts of the federal and regional governments which were said to have overlapping responsibilities and often set contradictory requirements.

More generally, private sector participation in the water and sanitation sector is a new field. The roles and responsibilities across the authorities responsible for regulating and overseeing private activities have not been clearly defined yet. According to Rosvodokanal⁷, regulatory agencies are also faced with limited resources to carry out their oversight activities. Consequently, they are deemed to have little control over discharge of untreated wastewaters and to apply the environmental regulation selectively and in a discretionary manner. This results in continuing pollution of the environment and raises important opportunities for corruption and substantial risks for private operators of water and sanitation systems.

The current municipal reform, launched by law 181FZ “On general principles of local self-governance”, may have compounded the problem by de facto encouraging the splitting of former big municipalities into

⁷ Tomasz Zagdan (2009). Market Insight: Water sector outlook for Russia: www.rosvodokanal.ru/en/press-center/aboutus/index.php?id4=1176

smaller entities, exacerbating the pressure on limited fiscal and management capacity at municipal level. In addition, responsibilities for a water system are split across the many municipalities that own it. There is limited experience to date in Russia of coordination mechanisms that could help overcome the fragmentation of responsibilities, such as inter-municipal bodies for instance. One example is a water operator providing services in several small settlements around Kaluga. An amendment to the concession law that would have allowed the pooling of responsible authorities in a concession agreement was rejected as posing legal issues.

Capacity development

Capacity at municipal level is often mentioned as a major constraining factor. This concerns their financial and management capacity, but also the ability of municipalities to plan and implement policies over the longer run.

By law, municipalities have the ultimate responsibility for developing long-term investment programmes for municipal infrastructure (including water and sanitation infrastructure), setting the goals and objectives of service delivery. They are the main level responsible for regulating the activities of the private sector (including until 2010 through tariff setting – see section 4). However, many municipalities lack the basic capacity and incentives to conduct the asset registration process that would underpin such policy setting. They also lack time and staff to undertake careful “due diligence” process of projects, or resources to outsource it.

Consequently, there is only limited information on the consumer base for water services and on the state of underlying infrastructure. Neither has the involvement of the private sector led so far to a systematic assessment of a viable pipeline of projects (which have been undertaken on an ad hoc basis by municipalities) or systematic assessment of value for money at project level. Outside the financing mechanisms put in place by IFIs (e.g. EBRD), the State Investment Fund is the only mechanism with a formal methodology to assess project sustainability.

To strengthen local capacities and reduce transaction costs, common understanding among partners of the implications of involving the private sector in the development of water infrastructure could be strengthened and standardised tools to underpin the due diligence process and contractual arrangements with private partners could be developed. As concluding remarks for the International Conference on PPP organised in Moscow in October 2008, UNECE and Vnesheconombank (VEB) agreed to explore the creation of a PPP Unit to support a systemic approach to capacity development in the public sector and provide a platform for the sharing of good practices. This led to the establishment of a PPP Centre within VEB to accelerate the development of PPP projects and help strengthen related capacities. The Centre sees itself as playing an advisory and a facilitator role⁸ through carrying out the following tasks:

- “Advising public bodies on issues related to PPP projects procurement, organizing PPP procurement process on their behalf;
- Facilitating PPP market development activities through ensuring information support for a PPP projects market, inclusive of maintaining a database of PPP projects (...), summarizing and disseminating the experience of PPP projects procurement.”

The establishment of a network of regional Centres for PPP is under consideration as the next step in the building of capacity. As of early 2010, 10 Russian regions had expressed their interest for the creation of such a PPP centre.

⁸ www.veb.ru/en/PPP

3. Rooting the partnerships in strong accountability mechanisms

The OECD Checklist for Public Action: making the co-operation between the public and private sectors work in the public interest

Contractual arrangements with the private sector for water infrastructure are typically long-term and as such not likely to cover all aspects of the complex relationship between the private sector and the public sector. Many past difficulties have also arisen from dispute over the real state of water systems and the quality of baseline data.

While no contract can be comprehensive enough to eliminate all elements of uncertainty, mechanisms exist that may help reduce the uncertainty that comes with long-term incomplete contracts or deal with its consequences. They include: adopting performance-based contractual arrangements (**principle 16**), strengthening competitive pressure (**principle 7-15**), strong political commitment in the fight against corruption (**principle 6**) and promoting information sharing (**principle 14**). Past experiences have shown that partnerships should not be viewed as simply a bilateral relationship between the public and the private sector as they generate strong interest from consumers and communities. Greater involvement of civil society (NGOs, consumer groups) may contribute to developing a feeling of ownership on the part of the users and the communities, to better protection of consumer rights and to monitoring service provision (**principle 9**).

Principle 6. Fight against corruption. Infrastructure projects should be free from corruption at all levels and in all project phases. Public authorities should take effective measures to ensure public and private sector integrity and accountability and establish appropriate procedures to deter, detect and sanction corruption.

Principle 7. Create a competitive environment. The benefits of private sector participation in infrastructure are enhanced by efforts to create a competitive environment, including by subjecting activities to appropriate commercial pressures, dismantling unnecessary barriers to entry and implementing and enforcing adequate competition laws.

Principle 9. Consultation with stakeholders. Public authorities should ensure adequate consultation with end-users and other stakeholders including prior to the initiation of an infrastructure project.

Principle 15. Fair, non-discriminatory and transparent awarding of contracts. The awarding of infrastructure contracts or concessions should be designed to guarantee procedural fairness, non-discrimination and transparency.

Principle 16. Output/performance based contracts. The formal agreement between authorities and private sector participants should be specified in terms of verifiable infrastructure services to be provided to the public on the basis of output or performance based specifications. It should contain provision regarding responsibilities and risk allocation in the case of unforeseen events.

Source: OECD (2009). Private sector participation in water infrastructure. OECD Checklist for Public Action.

Performance-based arrangements

Current legislation grants municipalities the right to monitor the implementation of investment and operational programmes in communal infrastructure; including in water and sanitation (methodology for monitoring was adopted by decree 48 of the Ministry of Regional Development in April 2008). However, municipalities are little equipped to carry out this task. There is limited culture of performance-based contractual arrangements and monitoring tools – such as performance indicators – are inexistent (so far, the only experience of performance indicators was undertaken by the City of Perm). This is compounded by the fact that the technical regulations, which would set service standards and technical specifications from water abstraction to discharge, are still not approved. In an effort to improve information, the government has announced the development of a database that will include data on cost structure, investment and operational programmes of vodokanals and most likely indicators of service quality. This was made possible by the adoption of the law on declassification of data on vodokanals performance in 2008.

Effective monitoring usually involves a system that rewards the company when the performance is in line with the objectives and penalises it when it substantially underperforms. Current contractual practices in Russia do not, however, provide for the procedure to follow when a party breaches its obligations. In addition, contracts do not usually foresee mechanisms to resolve the disputes that may arise between the partners.

Culture of performance based assessment is also very limited within the public sector. In 2004, the Russian Government developed an agenda aimed at introducing principles and procedures of performance-based management and budgeting. This agenda included the introduction of a system of objective and performance-based sector-specific and inter-sector planning; the development of key measurable efficiency and effectiveness indicators of the executive authorities; the introduction of target-setting technologies and procedures ensuring the connection of targets to concrete actors who should implement them; the introduction and the development of managerial accounting, an internal audit system, regular risk evaluation, management of subordinate organisations. The identification of performance outcomes and their measurement turned out, however, to be a more difficult task than it originally appeared.⁹

Create a competitive environment

Tender conditions for water projects have been severely criticised in some instances. In particular, the results of tenders in Berezniki and Volgograd were challenged in court for lack of transparency¹⁰. While in Berezniki no violation of law and tender rules was found, the court cancelled the tender in Volgograd. The tender in Omsk has been criticised for having been manipulated¹¹.

Significant measures were undertaken in 2008 to improve the competition legislation, introduce new amendments to Federal Law 135 “on Protection of Competition” and elaborate new provisions (“second anti-monopoly package”). They notably include the introduction of disqualification of officials (to reduce the opportunities for anticompetitive behaviour of authorities¹²) and mandatory competitive tender for transactions of State property. Ordinance 67, issued by the Federal Antimonopoly Service (FAS), prescribed procedures for organising tenders by local and state authorities when transferring the property rights on public utilities objects, including in relation to communal infrastructure. In line with a reinforced mandate, the structure of FAS was changed (with the establishment of an Anti-cartel Department) and staff was increased.

At the same time, competition may be limited by important administrative barriers to entrepreneurship, such as the specific requirements for cities above 350,000 inhabitants regarding access to network information, which requires a clearance that can only be granted to Russian citizens and makes it difficult for foreign companies to compete along domestic players. As underlined by UK Trade and Investment (2009), success hinges crucially on knowing and understanding local requirements and conditions and is largely facilitated by combining efforts with a local partner (familiar with the Russian State standards GOSTs, sanitary norms SanPiNs, construction norms and rules SNIps, and other norms used to obtain work permits, equipment certification, as well as to fill the complex tax documentation). This is consistent with the main findings of OECD (2009), which shows the high incidence of concentrated sectors in Russia, compared to OECD countries, and a trend of industry consolidation and vertical integration of supply chains.

Ultimately, the number of players (hence the intensity of competition) also depends on the attractiveness of the sector, i.e. the risks perceived by the private operators and the financial sustainability of projects (see section below) and the capacity of responsible authorities to launch adequate tenders.

⁹ OECD (forthcoming).

¹⁰ OECD (2010a). Private sector participation in water supply and sanitation in Eastern Europe, Caucasus and Central Asia: Status paper.

¹¹ OECD (2005).

¹² As shown by the statistics reported by the Federal Antimonopoly Service (FAS), more than half of violations of anti-trust law are committed by various levels of the Russian Government (53% in 2007, of which 80% by the regional and municipal authorities).

Fight against corruption

An anti-corruption Council headed by President Medvedev was established and the National Plan on Counteracting Corruption approved in July 2008. A Federal Law on Counteracting Corruption has been adopted that aims at strengthening control over politicians and senior bureaucrats through requirements to publicise income and assets of family members and measures to prevent and manage conflicts of interest.

The set of anti-corruption laws passed at the end of 2008 aimed at giving a legal definition to corruption and strengthening penalties against it. The legislation seeks to make it harder for state officials to conceal ill-gotten gains by mandating that top and medium-level government officers disclose their income and assets. It also aims to limit the discretionary powers of administration by mandating the Ministry of Justice to monitor legal practice and propose legislative improvements designed to eliminate “corruption-generating” legal provisions.

Avoiding unrealistic expectations in terms of what the private sector can achieve and inappropriate contractual arrangements and timeline are also essential steps in the fight against corruption as they may help limit the opportunities for ex-post renegotiations. For example, the expectation that the private sector could develop appropriate wastewater treatment facilities in Perm within 2-3 years proved unrealistic and led to a substantial fine levied by the environmental authority (while no sanctions were envisaged under the lease agreement).

Consultation with stakeholders

The successful implementation of reforms relies heavily on the transparency and accountability mechanisms put in place by the Government. Generally, the amendments to the legislative framework and the development of a water policy have led to broad consultation with the business community and representatives from civil society and academia. Working groups have been established to discuss and draft the amendments to the various laws. Some key private operators and experts, however, note the lack of transparency in the consultation process for the development of the State Clean Water Programme.

Developing an informed and representative participation of population can ultimately contribute to a better monitoring of service provision and higher adequacy with needs (as ultimately, users pay the price of lower-quality services). The Federal Law on Access to Information on the Activity of Government Authorities and Bodies of Local Self-Government adopted at the beginning of 2009 aims at ensuring individuals and organisations an access to any information on the activity of government authorities and local self-government bodies, apart from state secrets.¹³ As of today, however, participation mechanisms at local level remain largely underdeveloped.

4. Ensuring financial sustainability of projects

The OECD Checklist for Public Action: Deciding on private provision of infrastructure services

The choice between different modes of service provision is a means to an end: ensuring access to sustainable and affordable services. It should follow an initial consensus on the service provision desired by society, an assessment of where and how private partners can add value and determination of the modalities of their participation. Quantitative tools exist, which combined with qualitative analysis, can help governments better define the costs (including contingent liabilities) and benefits associated with private sector participation and can support policy dialogue.

Principle 1. Informed and calculated choice. The choice by public authorities between public and private provision should be based on cost-benefit analysis taking into account all alternative modes of delivery, the full system of infrastructure provision, and the projected financial and non-financial costs and benefits over the project lifecycle.

¹³

OECD (forthcoming).

Principle 2. Financial sustainability of infrastructure projects. No infrastructure project, regardless of the degree of private involvement, should be embarked upon without assessing the degree to which its costs can be recovered from end-users and, in case of shortfalls, what other sources of finance can be mobilised.

Principle 4. Preserve fiscal discipline and transparency. Fiscal discipline and transparency must be safeguarded, and the potential public finance implications of sharing responsibilities for infrastructure with the private sector fully understood.

Source: OECD (2009). Private sector participation in water infrastructure. OECD Checklist for Public Action.

Access to finance

For private partners, access to long-term commercial financing in Russia remains a challenge. This is especially valid for the water sector: financing is mainly short-term (up to 5 years) and relatively expensive (mid-2009, interest rates were around 23% per annum, with inflation relatively high - at 14% in 2008¹⁴). Longer term loans are only provided by IFIs (EBRD is active in this field). In addition, under current Russian law, it is difficult to pledge utility assets as collateral for financing. This is compounded by the uncertainties surrounding property rights. It is not possible either to use future cash flows as collateral for bank loans, although investors have tended to overcome the obstacle through the establishment of special-purpose companies leasing and operating the assets, the shares of which were used as collateral.

The Government has recently taken several measures to support increased financing for the refurbishment of infrastructure. The establishment of an Infrastructure Fund, issuance of infrastructure bonds and the possibility that federal government provides guarantees to private investors are under discussion as part of the programme on housing and utilities. In addition, an Investment Fund (initially some €2 billion)¹⁵ was established, which allocates funds on a competitive basis for the implementation of investment projects of federal and regional importance involving a partnership with the private sector. Only very large projects (total project costs of over RUB 5 billion) may apply for financing and the procedure for project preparation for review by the Investment Fund is deemed costly and time consuming (UNECE mentions an average of 2.5 years to consider an application). Two water operators have received financing from the Investment Fund. Evraziyskiy, through its affiliate company Rostov Water, obtained financing for its projects in the city of Rostov-on-the Don and in the south-west of Rostov Oblast for RUB 6,660 million and for the regional investment project Clear Don in the amount of RUB 1,055 million. Russian Communal Systems (RKS) has also drawn from the Investment Fund for a project in Petrozavodsk. The Investment Fund is, however, lagging behind schedule in terms of disbursing the financing.

Tariffs

Observers deem the potential market for private operators in Russia large. Rosvodokanal identifies the breaking point in cities with a population above 500,000¹⁶. Evraziyskiy and the Center for PPPs of the Vnesheconombank set it lower, at 300,000 inhabitants. There are already more than 10 cities in Russia with population above a million. In addition, Russia is doing relatively well in terms of bill collection rates.

Tariffs level and regulation remain, however, important contentious issues. By law, municipalities have been given the authority to regulate water and wastewater tariffs within the limits of the tariff ceilings set by the constituent entities of the Russian Federation (except when the operator provides services for several municipalities, in which case regulation is conducted at regional level). This is however likely to

¹⁴ Annual percentage change in average consumer prices, according to IMF World Economic Outlook database.

¹⁵ Article 120, Federal Law No. 189-FZ dated 26 December 2005 "On Federal Budget for 2006"

¹⁶ Global Water Intel (2008).

change shortly since the “Main Directions of Tariff and Pricing Policy in the Infrastructure Sector” approved by the Government in December 2009 and a number of later orders envisage delegating tariff and standards regulatory powers in the utility sector to regional level.

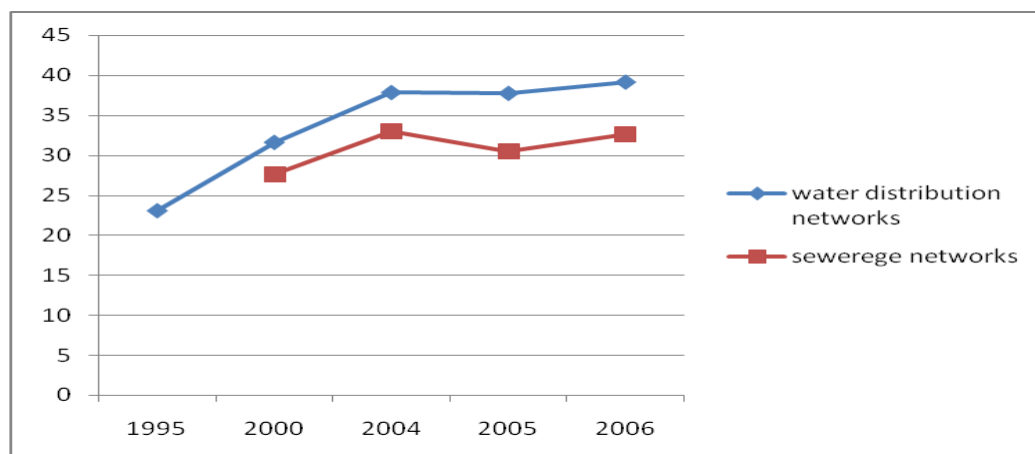
Tariffs are supposed to be established on the basis of operational plans and mid-term investment plans developed by the operator and agreed with respective municipality. To depoliticise tariff discussions between regulators and utilities, formal assessments of affordability have been made compulsory by Federal Law n°210-FZ “On General Principles of Utility Organizations Tariff Regulation” of December 2004. However, the law was not supported by the development of corresponding methodologies and capacities of most small municipalities to develop such methodologies on their own have been limited.

Until 2010, the Federal Tariff Service was responsible for setting tariffs increase limit. From 2009, the rule that entitled the Federal Government to impose caps on tariff growth was changed and the right transferred to the regional level. The Federal Government however reserves the right to set tariff ceilings for exceptional reasons. In this context, private partners may perceive the discretionary adjustment of tariffs as a potentially important risk. It is however noteworthy that the government has not yet used this prerogative - even in the present time of crisis.

Tariffs are set in accordance with the “Methodological recommendations for financial substantiation of water supply and wastewater prices”, approved by decree #302 of the Ministry of Regional Development of the Russian Federation dated 28 December 2000 (EBRD, 2008). This methodology does not allow taking into account a return on investment and in many instances, tariffs remain too low to cover capital costs. Although under current law municipalities are allowed to set long-term tariffs (3-5 years), in practice, tariffs are subject to annual revisions, which constitutes a disincentive for operators to improve efficiency as gains are immediately passed on to consumers. For this and other reasons, overall incentives to invest in the sector are limited, translating into rapid depreciation of assets.

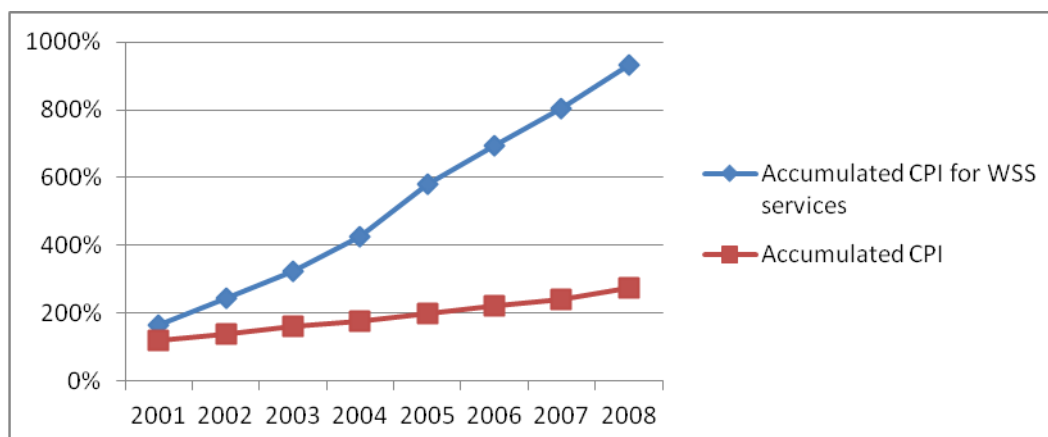
Figures 1 and 2 suggest that accumulated depreciation of fixed assets in water and sanitation has been growing in Russia despite the fact that water tariffs have increased more rapidly than the inflation rate (as measured by the consumer price index – CPI) and level of cost recovery has improved.

Figure 1. Water and sewerage networks requiring urgent replacement (as % of total length of networks)



Source: OECD/EAP Task Force (forthcoming).

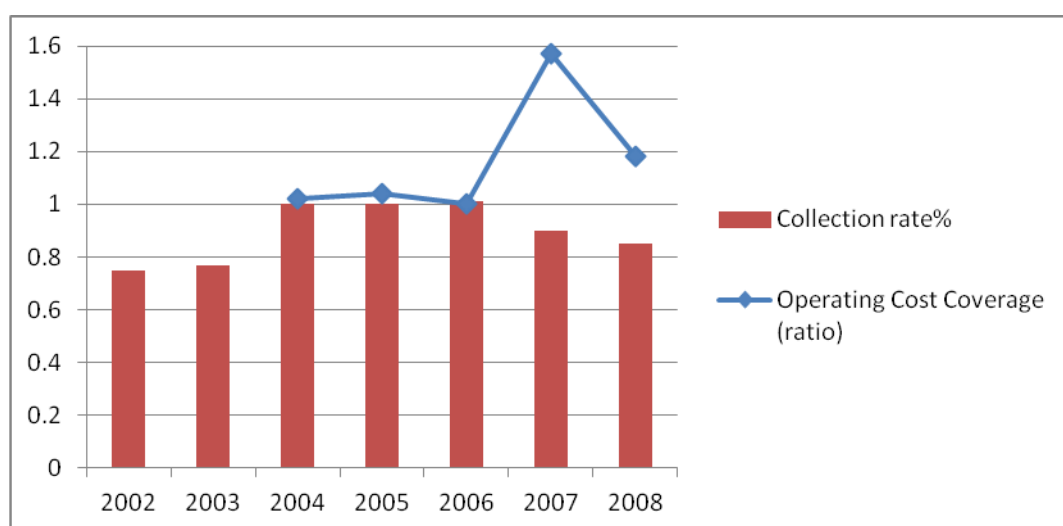
Figure 2. CPI versus accumulated CPI for water and sanitation (WSS) services in Russia



Note: The accumulated index is equal to 100% for the base year 2000.

Source: OECD/EAP Task Force (forthcoming).

Figure 3. Collection rate and operating cost coverage in Russia



Source: OECD/EAP Task Force (forthcoming).

To overcome the shortcomings of previous legislations, a new tariff methodology, based on Regulatory Asset Base, was approved in June 2008 by the Federal Tariff Service Decree # 231-e “On establishment of methodological guidelines for tariff regulation according to the return on investment method”. But while such methodology is being piloted in electricity distribution, it has not been introduced yet in the municipal utilities sector. The determination of a “fair” rate of return on investment is also raising a number of issues, including the possibility of important discretion in the definition of “fairness”. The Ministry of Economic Development is currently working on defining rules for the determination of the rate of return. In addition, guaranteeing a given rate of return on capital may create incentives to over-invest or invest inefficiently (in costly technology, for instance). Box 1 discusses alternative mechanisms of tariff regulation.

Meanwhile, in a limited number of instances, the parties have been adopting “notional” tariffs scheme in the contract, allowing for a long-term determination of tariffs. This practice was however flagged by EBRD (2008) as potentially risky for the private partner. It would indeed be difficult to implement

effective sanctions against a municipality for the violation of contractual arrangements on tariffs as courts would most likely give priority to the applicable tariff legislation rather than to the terms of the contract. In order to provide long-term perspective on tariffs to private partners, the amendments to the Concession Law will allow the setting of tariff regulation parameters within the concession agreement provided these are agreed with the regulator.

Box 1. Tariff regulation

Two alternative mechanisms for regulating prices exist. In price-cap regulation, the regulator sets maximum prices on the services, often with automatic adjustments to account for (substantial) changes in costs – if such changes happen due to factors outside the control of the concessionaire (e.g. the minimal wage rate or regulated prices for some key inputs, like electricity, have been increased, etc.) and to account for expected feasible improvements in efficiency within the control of the concessionaire, and a pre-set review date. In rate of return regulation, the regulator assigns a value to certain assets necessary to perform regulated services, sets a rate of return on those assets (often the market-determined rate of return on assets with similar risk characteristics) and sets prices that will allow sufficient revenue to cover both return on capital as well as costs that the regulator allows the concessionaire to pass through. With rate of return regulation, the investors have an incentive to invest as their operating and investment costs are covered. However, unless the regulator has access to a well-developed accounting system to audit the costs, the firm might be led to overestimate the costs to justify higher prices. Price cap regulation provides for strong incentives to reduce costs. However, the efficiency of investment in a price-cap regime hinges on the ability of regulators to assess “independently” what would constitute optimal capital equipment for the infrastructure provider. In addition, recent empirical evidence has shown that price cap regulation was more likely to lead to contract renegotiations.

In reality most regulatory mechanisms are hybrid systems between rate of return and price cap regulations in order to balance the incentives for efficiency, investments, rent-extraction and fairness. Armenia has been implementing an innovative approach by using the long-term tariff profile as a key criterion in the selection of bidders to water and sanitation projects.

Source: OECD (2009a) and Gagik Khachatryan (forthcoming).

5. Going forward

Substantial changes in the policy and regulatory framework that governs private sector participation in water and sanitation are underway or expected in the near future. They aim to address some of the current risks faced by the private sector in their participation in the development and management of water and sanitation infrastructure. They may constitute major steps in the transition of the sector to financial sustainability and efficiency and ultimately contribute to the two overarching country priorities stated by President Medvedev of modernisation and increased efficiency.

In that perspective, the present assessment is drawing the attention on the need to:

Reduce political, regulatory and legal risks for private sector participation through:

- Establishing a clear vision on the role of private sector participation in the development and management of water and sanitation infrastructure, as well as clear and realistic mid-term targets to be achieved by private operators. One possibility would be to clarify these issues in a sector policy document adopted at the federal level and/or a Strategy for sector modernisation and development.
- Addressing eventual inconsistencies in the legislative framework, including between different levels of government – between the concession legislation passed by a number of subjects of the federation and the Federal Concession Law for instance.
- Supporting the establishment of clear property rights over the longer run and clarifying what can be considered as “separable” vs. “inseparable” assets, as well as “movable” vs. “immovable” assets.

- Clarifying tariff regulation – both in terms of the allocation of responsibilities for tariff setting and of the methodology underpinning tariff determination – as it creates important uncertainty for private operators.

- Improving the environmental regulation, by establishing technically and economically feasible standards for wastewater treatment and quality of discharges into water bodies, as well as strong incentives for improving environmental performance of the WSS sector.

Improve accountability of public and private partners to end-users through:

- Granting contracts through well-devised and transparent competitive tenders with appropriate selection criteria, focusing on the price and quality of water and sanitation services; and making more systematic recourse to performance-based contractual arrangements, along the lines of Rosvodokanal's recent initiative supported by EBRD and successful experience in Armenia (OECD, 2008b).

- Supporting transparency and accountability of water operators and public authorities in charge of water and sanitation through greater (informed) involvement of users (this could be done through field surveys conducted by regulators or the development of hot lines for instance).

Develop capacity and a level playing field through:

- Understanding and remedying the bottlenecks that impede the development of new tenders in the water sector and encouraging the entry of new competitors, including by addressing discriminatory barriers.

- Supporting capacity building of responsible authorities through the development of standardised tools and methodologies (to conduct the due diligence process or assess the value for money of projects for instance). In this respect, useful lessons can be learnt from the experience of countries that have set up PPP units to ensure that the necessary competencies are available and clustered within government (OECD, 2010b).

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