

# RUSSIA / EURASIA

## *Executive Guide*



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### Highlights

#### **New Year Will See New Transfer Pricing Law in Kazakhstan Go Into Effect**

REEG presents perspectives of the new law "On transfer pricing" (the "New Law"), which was adopted by the President of Kazakhstan in July 2008. The New Law will be in effect from January 1, 2009 and a main change ushered in by the New Law will be the introduction of the arm's length principle.  
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#### **An Overview of the Power Industry's Management in the Kyrgyz Republic**

Currently, the Kyrgyz Republic's power industry's potential capacities are not being fully utilized and it is experiencing certain financial, economic and management difficulties. The development of market relations in power industry might be a solution to this crisis. The proposed privatization of power companies and their assets is being offered as a solution to such problems as low power generation volumes, productivity losses, and unemployment.  
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#### **A Look at Recent Immigration Law Developments in Russia**

In recent months employers have witnessed many changes in the Russian Federation immigration laws. Most notable are the regulations surrounding employment and work permit procedures and the list of occupations exempt from the annual work permit quota. Although these changes are a step in the right direction for those seeking work authorization in Russia, they raise many questions as well.  
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#### **Ongoing Challenges Remain When Structuring Investments in Russia**

Structuring acquisitions and investments continues to be a challenge as Russian legislation does not yet offer the full range of tools with which Western investors are familiar. For example, a foreign investor in Russia will need to take into account the absence of tax consolidated groups, restrictions on deduction of certain business expenses, important rules related to corporate restructurings, the impossibility of achieving direct conversion of debt to equity, the absence of classic debt push down techniques, and currency control.  
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## Project Finance in Russia: Risks and Rewards

By Robert Jutson  
(Griffin Capital)

After decades of neglect, the Russian Federation government is allocating much of its wealth from commodity exports into long-postponed infrastructure projects. If spot oil remains down at \$65/bbl, the RF budget will barely break even.

But the recent turmoil in financial and commodity markets will force the RF government to reassess budgetary priorities, resulting in the indefinite postponement of many projects. Alternatively, the RF government and project sponsors may choose to adopt of Public Private Partnership (PPP) funding schemes.

### Overview

This past May, Prime Minister Putin announced that Rbs13trn would be spent on Russian infrastructure by 2015, with a third coming from the federal budget and the rest from “non-budgetary funds and companies”.

In addition to a handful of new towns each housing over 100,000 people, the plan calls for 17,000km of new roads, 3,000km of new railroads and more than 100 airport runways. It also calls for expanding annual port capacity by 400m tons of cargo.

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**In a world of risk, project finance is a useful technique for governments and commercial enterprise to fund large projects without risking their balance sheet or annual budget. Properly managed, it can enable a large project which might not otherwise be affordable.**

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Reliance on sophisticated PPP models, and the stability of the regulatory and judicial regime upon which they rest, will need to be tested before any of these projects can receive funding outside the RF budget. Until then, the government and the state controlled banks holding liquidity will pick the winners.

In the transportation sector, six large projects are already in the tender stage. These include the Moscow to St Petersburg motorway, which is said to be worth €1.5bn and involves 43km of toll roads under a 30-year concession. The management of a transparent procurement process will be essential to attract private sector capital.

Unfortunately for project planners, tenders have slipped for the 46.6km US\$9bn Western High-Speed

Diameter (WHSD) in St. Petersburg, whose estimated construction cost since it was launched in November 2006 has jumped by 470%.

This cost compares unfavorably with transparent procurement and recent launch of debt syndication of Germany’s A1 toll road between Bremen and Hamburg based on a 30-year concession.

Mushrooming costs will severely test procurement management for recently announced new towns featuring low-rise construction in Tartarstan and in Russia’s Veronezh region. There, Governor Vladimir Kulakov recently announced a tender for a 1,400-hectare housing project in the southern suburb of Veronezh, the second such project announced in three years.

In the public sector, Veronezh city authorities launched a \$240MM program aimed at upgrading the city’s water treatment facilities. The financing structure reflects the requirement of increased equity for projects worldwide.

Of the US\$240 million budgeted for the project, about 2/3 is coming from the RF (US\$40.8MM) and the World Bank (US\$122MM). The remaining 1/3 will be allocated from local and regional funds according to their budgetary and policy priorities.

With few exceptions, the minimum requirement of 1/3 equity may be a useful starting point for certain projects which seek funding on commercial terms.

Though there is an abundance of global liquidity sitting in money market accounts awaiting the bottom of the credit cycle, we expect the pricing and terms of commercial finance will continue to be scarce and costly through 2009. Terms will moderate as the balance of power between investors and issuers is restored to its long-term equilibrium level.

In this environment, only well conceived projects will receive funding on commercial terms. Competition between project sponsors for limited funds will also enhance the negotiating leverage of investor participants who will have great choice of projects. Adjusting to these financial realities will affect the plans of project sponsors in Russia and throughout the world.

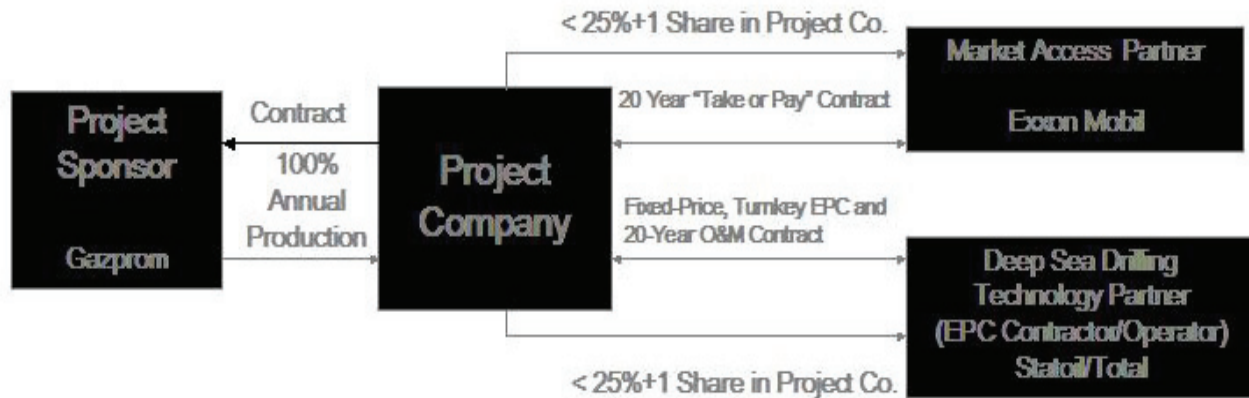
### EPC Risks and Project Cost Management

The nature of risks confronting planners of large Russian projects has changed dramatically since 1998, nowhere more so than in the energy sector.

In the transportation sector, the robust, long-term traffic and tariff projections of many projects raise the issue of liquidity. Such reassessment resulted in the cancellation of a toll road in the American state of Pennsylvania, where planners have witnessed a dramatic decrease in traffic volume.

Rouble denominated debt will be preferred, but is problematic for tenors much longer than the 10 years

## Shtokman Gasfield Development



interest swaps currently available. Although leading local players like Gazprombank and VTB are expected to bear some of the cost of these swap tails, it's been reported that the government has already agreed a euro tranche on WHSD.

Not to be underestimated is the risk of inflation. With declining hard currency flows from the export of oil and minerals, the demand from Russian banks for rouble liquidity will force the depreciation of the rouble against the Euro and the US Dollar, further exacerbating inflation.

Builders may have made tidy profits approaching 18% until recently, but Russia's inflation is now 16%, up from 8% only a year ago.

It is difficult to generalize how this it affects turnkey EPC contracts, but inflation is of particular concern for projects with long construction periods such as WHSD. The ability of EPC contractors to guarantee prices depends on their ability to enforce those obligations through their supply chain. That ability is thus problematic, exposing project sponsors to cost escalation.

Expectations of inflation are compounded by fears that the government's infrastructure program will itself accelerate what is already the highest rate of inflation in five years. EPC contractors are reluctant to bear the costs of inflation but will be forced to bear much of this exposure in a competitive tender.

Nowhere is this more true than when it comes to the cost of cement. Current production, at 50m to 60m tonnes per year, is still far below the Soviet record of 90m despite having recovered from its low of 25m at the beginning of this decade.

According to a recent regional government report, Voronezh-based developer StroyMontazh-2004 has revised the cost of construction of Voronezh's 1,170-ha Kashirsky District satellite town Gradoslav by \$851m to \$5.5bn.

Within 15 years the company intends to build more than 5.5 million square meters of housing and social infrastructure for 150,000 people. Construction will begin between 2009 and 2010. Experts expect further swelling of costs. Shortages of steel and labor are also major concerns of both EPC contractors and project sponsors. It's estimated that Russia will need 100m tonnes of building materials and tens of thousands of laborers merely to rebuild the area around the Black Sea resort of Sochi where Russia will host the 2014 Winter Olympics. Sochi will be the price taker for cement and regional labor and all other projects will have to compete for limited output resulting in budget busting prices.

Risk allocation is proving a point of contention as various tenders mature. The RF government seems reluctant to accept approval risk for timely granting of building permits and other licenses. Like most agencies, it is genuinely reluctant to accept the risk of delays arising from its actions – or inactions. It has reluctantly consented to international arbitration only for the financing transactions rather than for overall EPC and O&M contractual provisions. The timely availability of concessions and related grants remains a significant concern. Such risks are not unique to Russia - we have encountered similar problems with solar generating plants in Spain.

Calculating political risk remains at the heart of doing business in Russia. The involvement of funding agencies

*Continued on page 14*

## Russia *(from page 13)*

such as the IFC, EIB, EBRD and Vnesheconombank may provide some comfort, but the details of their involvement in project finance schemes may only be finalized once all other terms are agreed.

As pathfinders establish the procurement parameters for big projects, 2009 will prove critical for the development of the PPP model in Russia and the realization of its long-deferred infrastructure program.

### Risk Management and Project Finance

Project finance is a risk-management technique used to finance long-lived, capital-intensive projects. A well-conceived project can attract substantial funding by balancing risks and rewards among various participants.

When undertaking critical infrastructure development, project sponsors must identify and manage risks as effectively as they can, using the tools at their disposal.

These risks might include cost overruns, delays to completion, changing cost of inputs such as feedstock (oil, gas, cement, coking coal) and variable price of the output or finished product (electricity, LNG, steel or aluminum or public services such as toll roads and student housing).

Because every project is unique, there are many "Project Finance" structures, but they all have one common element: *the financing is based on the economics of the project and is not dependent on the credit support of the sponsor or the value of the physical assets involved.*

As a practical matter, this means the tolls or economic production of the project yield a predictable amount of cash or pre-sold product on a periodic basis.

This last point is important where projects are developed under government license or concession to develop or utilize a resource such as those governed by Russia's PSA regime.

Such rights or concessions cannot readily be assigned in Russia as collateral to third-party lenders. The value of the assets and rights granted by license are regarded as having limited value to lenders outside Russia.

The selective inclusion of strategic project participants is a traditional way to mitigate risk. This is why some projects such as the Shtokman gas field development operate as joint ventures. The proposed allocation of risk and shares is illustrated in the schematic diagram, which accompanies this article.

### When Does Project Finance Succeed?

Every successful project financing provides a satisfactory and economic allocation of project risk among the various participants.

The participants in a project financing generally include the project sponsor, lenders, suppliers of equipment and raw materials and a purchaser of the project output. The purchaser is often an affiliate of the project sponsor seeking direct access to a resource or product at a long-term fixed price.

In general, project sponsors seek to allocate risks among:

- A long-term production purchaser who agrees to buy product at a fixed price;
- A materials supplier who agrees to provide inputs (feedstock) at a fixed price;
- An EPC contractor who will build the project on a fixed-cost, turnkey basis;
- An export credit agency, multilateral, mono-line or other insurer;
- Other counter-parties (derivatives for hedging currency and interest rate); and
- A plant operator who will operate and maintain the project under an O&M contract.

In order to limit financial liability, most projects are undertaken through a special purpose entity such as a limited liability company established by the sponsor. The sponsor maintains control through ownership or management contracts or a combination of the two.

Regardless of how well conceived a project is, *the foundation of a successful project financing is ultimately a stable regulatory, tax and judicial regime.*

### Conclusion

In a world of risk, project finance is a useful technique for governments and commercial enterprise to fund large projects without risking their balance sheet or annual budget. Properly managed, it can enable a large project which might not otherwise be affordable.

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*This article was written by Robert Jutson, Managing Director, Griffin Capital and for further information, he may be contacted via email at: [rmj@griffincap.ch](mailto:rmj@griffincap.ch). Griffin Capital has advised on financings for MTV Ukraine, Investment Group VIKA, KazakhstanEnergo, Mobile Telecom of Russia, Dal Telecom International (Khabarovsk), Cable & Wireless Sakhalin, Moscow CableCom, the Tbilisi Marriott Hotel and NTVPlus. Griffin Capital is currently acquiring solar power generators in Germany and aerospace technology in the USA. Griffin Capital's website is: [www.griffincap.com](http://www.griffincap.com) and the general email address is: [partners@griffincap.ch](mailto:partners@griffincap.ch).*