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# LARGE SCALE INVESTMENTS IN RUSSIA'S INFRASTRUCTURE AND NATURAL RESOURCES SECTOR

In Russia there exists a considerable demand for large scale investment in infrastructure utilities and production of natural resources. It is a common understanding that these requirements can only be met with the help of foreign direct investment (FDI). Without the delivery of capital and know-how Russia would miss chances for growth of the whole economy and could loose export revenues. This article concentrates especially on the conditions that are prerequisites for attracting large scale FDI that are nowadays increasingly realized by setting up project finance structures.

Общеизвестно, что потребности России в крупномасштабных инвестициях в развитие инфраструктуры и добычу полезных ископаемых могут быть покрыты только с помощью прямых иностранных инвестиций. Без использования иностранных капиталов и ноу-хау Россия может упустить шанс развития всей экономики в целом и потерять доходы от экспорта. Рассматриваются условия, являющиеся предпосылками для привлечения крупномасштабных прямых иностранных инвестиций, которые в настоящее время все чаще реализуются через структуры проектного финансирования.

All around the world large scale investment units like power plants, roads or oil production units are increasingly set up as project finance structures.[*] Investors found a separate legal entity that than becomes responsible for all concerns of the intended project. The bulk of investment capital comes from bank syndicates that offer long term finance secured only by the expected cash flow of the project – without recourse to the sponsoring investor. Creating such stand alone project companies seems to yield economic benefits especially with large projects that create considerable cash flows. The separation and the intense contracting with all stakeholders of the project like banks, suppliers and uptakers guards against negative impacts on the sponsoring company in the case of financial problems of the pursued project and sets a strict basket for the behaviour of the project managers. From the latter point of view, project financing should also be an appropriate model for transition countries in which corporate governance structures are still evolving.[**] This article addresses the situation in Russia where a substantial amount of investment in large scale infrastructure projects and natural resources is required to sustain the high economic growth rates. It is expected that the country will not be able to cope with this situation without inviting foreign capital and expertise.

Thus, there seems to be a huge potential to apply project financing structures with foreign participation. However, Russia's project finance record remains small in comparison to other European transition countries, where the method is increasingly applied as basis for public-private partnerships (PPP) agreements for the provision of public infrastructure. The article addresses the situation in Russia and highlights the potential of foreign-led project finance structures for speeding up the country's technical renewal.

**Basic elements of project financing.** Separation of the project and non-recourse finance are the two main pillars of «text book» project finance. In practice, a special purpose vehicle (SPV) is founded to become the central organizational unit for all affairs of a project. Up to ca. 80 % of the whole financing comes from a small number of banks that form a lending syndicate. The remaining 20 % are formed by an

[*] See Esty (2004).
[**] See e.g. International Herald Tribune (2006).

equity investment of the sponsoring company.* As such, the debt and equity structure is highly concentrated, whereby the number of participants in the lending syndicate is according to empirical studies increasing with the level of legal insecurity.** The lenders mainly rely on the expected cash-flow of the project when deciding for financing since the project company or the project itself are – especially in field of infrastructure – highly indivisible and as such only of value as «going» concern. In the case of not reaching an operational level the bulk of the investments has to be considered as sunk cost. This refers also to the lifecycle character of many projects since the constructed units have a limited operation because of abrasion and technical development. They can also loose their natural basis when – in the case of e.g. production of oil – the well is about to deplete. Finally, project financing structures are from a legal point of view networks of long term contracts with which the involved partners signal their commitment. Thus, they require a stable legal and economic framework. If this is not available, political guarantees by the hosting states in combination with the participation of international development banks like World Bank or EBRD can be some kind of substitute. Due to their bargaining power the latter can exert pressure on hosting states to show adherence to original agreements.***

**Economical motivations for using project financing structures.** The increasing application of project financing structures around the globe indicates (net) benefits of such arrangements in comparison to traditional corporate financing.**** In the year 2006, more than 200 billion USD were raised for this type of financing.***** At first sight, project financing seems to be more costly to the investor since:

- the setting up of a separate project unit and the large amount of contracting incurs a lot of transaction costs;
- project loans are burdened with higher interest rates to compensate for the higher risk of the lenders.

However, the separation of the project cash flow from other cash flows of the sponsoring company…:

- avoids misuse and cross subsidization (agency cost motivation);
- preserves «precious» equity (debt overhang motivation);
- prevents that a loss-making or failing project threatens «healthy» parts of the sponsoring company (risk management motivation).

Thus, the company prevents a long capital lock-up, can invest in more projects parallelly and has the possibility to increase its return on investment. In addition, it is possible for the company to sell the project as a whole. The separation simultaneously increases the chance to attract finance for the project since the lenders can more easily monitor the business processes of project company. Further, their «loan investment» is protected from financial distress of the sponsoring company and they can liquidate the «project» more easily by selling it as whole to third parties without being involved in a time-consuming bankruptcy procedure of the whole (failing) mother company. Thus, from an economic point of view, project financing accelerates investment and could stimulate overall economic growth.*

**Russia's project finance record.** Up to now, project finance remains a rarely applied tool for financing large scale projects in Russia. However, there are some impressive examples in the oil & gas sector as well as in mining.** The most deeply studied project in this regard is the Sakhalin II Energy Project that was initially organized by a foreign consortium led by Dutch Shell and later over-

* It is also common that the sponsoring investors provide loans to the project company. Beside bank loans, there is in some countries like USA and GB a special market for project bonds. Banks have also started to securitize their project loans.

** See Esty / Megginson (2003).

*** See Hainz (2002). P.35.

**** On net benefits and motivations for project finance see Esty (2004).

***** See Financial Times (2007).

* This should not be understood in that way, that large investment projects per se stimulate development as the negative experiences with former trickle-down development projects in the 1970s suggest.

** See e.g. The Banker (2004).

taken by Russian Gazprom.* As such, the project is a textbook example for FDI in connection with project finance and the possible gains that foreign investment can have for the Russian economy: There has been at least an amount of 10 billion USD of capital that was brought to Russia and a transfer of know-how concerning offshore drilling and production of liquefied natural gas (LNG).** Together with other projects with foreign participation on Sakhalin Island, Sakhalin II significantly adds to the stabilization and increase of Russia's mineral base and increases government revenues.

The estimated amount of more than 200 bn. USD need of investment in the Russian oil & gas sector will increasingly call for a rising number of multi-billion USD project schemes since it gets more and more complicated to exploit the remaining wells that are in remote areas.*** Despite the currently high revenues Russia's domestic natural resources industry will not be able to meet the investment requirements in a foreseeable time. The effect could be a large amount of «opportunity costs» in terms of lost government revenues that could otherwise have been spend on e.g. public infrastructure. However, also in this area a lot can be gained from foreign investment: While there is a widely acknowledged need for investment in roads, bridges and public utilities, the supply side remains small and incapable to meet the requirements in quantitative and qualitative terms as the huge demand overhang for apartments in Russia suggests.**** Even if the state would increase his number of projects, the effect would be rather inflation than new facilities. To speed up the construction and renewal of infrastructure Russia would have to invite foreign construction companies and could use this possibility to draw on their technical and organisational experience. This refers also to the provision of public infrastructure by implementing project finance based public private partnerships (PPP). Such cooperative arrangements have been reinvented at the end of 1980ies and become more and more famous due to their prospective efficiency advantages in comparison to traditional public procurement. Furthermore, many governments in Western countries try use PPP as measure to reduce the amount of new public debt earmarked for the projects in question. Thus, PPP ideally uses the benefits of project finance structures concerning transparency and adds incentives to increase quality and efficiency in the provision of public goods. However, providing public goods in an economic viable way is often a contradiction in itself. In many cases the state remains the carrier of many highly incentivicing economic risks like the demand risk if he wants to maintain a certain level of supply for his citizens. Although, the markets have found contractive structures for such circumstances like e.g. availability payments. All in all, there is meanwhile a rich base of knowledge concerning cooperative infrastructure provision on which Russia could draw. However, for all there needs to be a political will to create convenient conditions such that the positive effects can materialize.

**Conditions for attracting large scale FDIS.** As project finance is «contract finance», there have to be stable regulations that govern private and public contracting.* In the field of natural resources to attract foreign capital it is necessary to offer entering investors the possibility to possess the majority ownership in new development projects. Only this gives incentive to invest considerable sums of money and to share know-how with partners. Concerning public infrastructure especially the reliability of the behaviour of public agencies is required to commit investors to spend money on often highly politi-

* On details see EBRD (1997) and EBRD (2005). The takeover is widely believed to be a significant step to renationalize large scale foreign-led projects in the oil & gas sector – See e.g. Liuhto (2007).

** The investment is supposed to be the largest single foreign investment in Russia and is directed towards the construction of the first LNG plant in Russia. See Bradshaw (2004), EBRD

*** See EBRD (2001a,b). The currently most striking example is the planned production on the Shtokman gas field for the supply of the new gas pipeline from Vyborg to Greifswald in Germany.

**** According to PMR Publications (2006) there are ca. 130.000 construction companies in Russia. The figure for the much smaller Poland is ca. 345.000.

* See e.g. Garibaldi et al. (2002).

cised infrastructure projects. More practically, the state should take care for solid project plans and tendering procedures. This would diminish ex post negotiations, which remain also in Western European countries a problem due to missing sets of rules for the solution of conflicts between project partners.

**Conclusion.** The increasing application of project financing structures indicates net benefits of this way to realize large scale investments in natural resources and public infrastructure in comparison to traditional corporate financing or public procurement, respectively. However, due to the high level of contracting, project finance needs stable conditions or at least stable guarantees that enable long-term planning. The high level of transparency of separately running project companies makes them also appealing under conditions of weak corporate governance strutures. From this point of view, project financing should also be an appropriate tool for transition countries like Russia where corporate governance structures are still developing. Russia itself offers tremendous potential for project finance due to its huge need for investment in natural resources and infrastructure. Without sophistication and extension of the infrastructure, economic growth will be lost and without more investment in natural resources, the mineral base will again shrink like it was the case in the 1990ies. If Russia wants to meet these tasks in due time, it could draw on the experience and capital from abroad. However, due to the ongoing debate about strategic industries, the room for foreign activity in the Russian economy gets smaller and smaller.

[*] On the future role of foreign firms in Russia see Liuhto (2006).

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