LIFE CYCLE CONTRACTS: WHO BENEFITS FROM THEM?

Evgenia Zusman, Senior Associate, Analyst PPP and infrastructure practice, VEGAS LEX

LCC: legal basis

An LCC can take two forms either a contract between two private entities or a contract between the State and a private partner(s).

Russian law recognizes the concept of so-called “mixed contracts” (based on the principle of freedom of contract). Accordingly, a contract that covers different activities will not be challenged on the basis of that it fails to comply with the RF Civil Code (the “Code”) provided it is made between private entities, and the terms of the contract itself comply with the Code.

Key characteristics of life cycle contracts

It is possible to identify a number of key characteristics of LCCs:

- LCCs cover the following stages of the economic life of an infrastructure asset: design, construction, financing and maintenance;
- a private partner under the LCC model is responsible for all design and technical decisions, necessary for the implementation of the project and it assumes all of the technical and design concept risks;
- initially, funding under the LCC model involves the private partner (represented by a special purpose vehicle (SPV)), which is responsible for raising funding itself either in the form of debt funding from commercial banks and international financial institutions or by equity funding. Generally, this will cover the first stages of the “life” of the infrastructure asset (i.e. its design and construction);
- the public partner makes payments under the project only once the infrastructure asset is in use;
- one key driver of efficiency in the LCC contract is the payment structure by the state sector. Generally, payment is made either on a quarterly or annual basis. However, all payments at each stage in the development of the infrastructure asset are contingent on the private contractor satisfying performance targets. The LCC will specify these so-called key performance indicators (“KPIs”), clearly through appropriate contractual provisions. Typically, those targets relate to the quality of the work undertaken by the private sector contractor, as well as the time in which the work is performed. In the event that those KPIs are not achieved (or they are not achieved on time), the State can reduce the amount it pays the private contractor and impose charges in accordance with the contract;
- ownership of the infrastructure asset covered by the LCC model can be with either the State (or a company owned or controlled by the State) or the private sector contractor(s).

Advantages of LCCs for the State:

1) Social utility

The State continues to be involved with the process of ensuring that the economy delivers certain essential “public goods” (roads, hospitals, schools etc.). Under the LCC model it does this through paying the private sector to deliver these goods. In common with other models of PPP the LCC model is based on the assumption that the private sector will be more efficient at performing the provision of certain public goods than if the state sector performed this role itself.

2) Minimization of risks of poor quality design

The private party and not the State will produce design documentation for the project. The State shifts all design, construction and maintenance risks to the private partner and it defines only the major technical and functional characteristics of the LCC and controls the compliance with them at the operational stage.

3) Single constructor

One problem with a general public procurement model that engages different contractors for different roles is that the individual contractors sometimes have little incentive to co-operate. For example, in the context of the life cycle of an infrastructure asset the contractor engaged to perform design work might be paid irrespective of the impact that its poor work has later on construction and maintenance of the asset. One perceived advantage of the LCC model is that since the same contractor is engaged for all the constituent parts of the infrastructure asset’s life (i.e. design, construction and maintenance), there may be more effective management and less waste.

4) Payment obligations of the State under the LCC only become due once the infrastructure asset is in use.

5) Payment under the contract by installments

One advantage of the LCC model is that in contrast to the traditional public procurement model, the State does not need to allocate in the budget a consid-
erable amount of funds for construction of the infrastructure, because the payment is made only after the asset is in use.

6) The absence of unpredictable future expenditure for infrastructure.

One advantage of the LCC over the traditional procurement is the fact that after launching the infrastructure constructed under the LCC, the private partner is charged with its maintenance.

The advantages of LCCs for the private partner:

1) Revenue and profit

LCCs are generally high value contracts. They offer opportunities for companies to improve their turnover and profitability. The fact that a private contractor has obtained a high value contract with the State can be used as leverage to secure further investment and growth.

2) Freedom of choice of engineering and technical solutions

The LCC scheme presupposes that the private partner is responsible for the design documentation by itself. It follows that the contractor is free in its choice of engineering and technical solutions and independently develops the methods of attainment of functional parameters defined in the LCC.

3) The opportunity to raise funds on advantageous terms

The financial obligations of the State under the LCC sometimes enable the private partner to raise credit funds for project financing on more beneficial terms.

4) Reduced risk of customer insolvency

An LCC offers the contractor the advantage of a guaranteed income stream. In addition, since the contractor’s client is the State (or a private entity backed by the State) so the risks for the contractor of its customer becoming insolvent are smaller in comparison to some private sector customers.

5) Opportunity for construction and operation cost reduction due to high-quality design and application of advanced technologies.

As the private partner is chosen for all three stages of project implementation according to the results of one tender, he is entitled to offer his own project solutions optimizing the process of object construction and maintenance.

**Is it possible to implement LCCs in Russia?**

Two and more private entities may execute LCCs on the basis of the RF Civil Code. Although Russian law currently recognizes the ‘mixed contract’, there are no specific provisions in Russian law, which allow for the use of LCCs in form of a PPP. It is clear that certain amendments will be required to the existing legislation affecting PPP projects in Russia before LCCs can be effectively used.

There are currently two Federal laws, which apply directly to PPP projects performed in Russia:

a) the law on “On concession agreements” and;

b) the law on “On placement of orders to supply goods, carry out works and render services for meeting state and municipal needs”.

There are similarities between the concession agreement and LCCs. Assuming that the Federal law “On concession agreements” provides the legal basis for use of LCCs in Russia then a number of amendments would need to be made to the existing legislation:

- amendments providing for the conclusion of concession agreements relevant to infrastructure assets, for which usage the end consumer will not be charged;
- amendments allowing the State to assume entire cost of establishment and (or) renovation of infrastructure assets under the concession agreement;
- amendments which replace obligatory requirements on the private contractor to pay the State under a concession agreement;
- amendments, which remove the obligatory requirement to use model concession agreements for the conclusion of concession agreements etc.

**What sectors are LCCs applicable in?**

Experience shows that although the LCC model has wide application, it is of particular use in the transport sector.

This is owing to the fact, that the life cycle of the transport infrastructure is consistent with the interests of the parties to the LCC in terms of financing, schedule, pay back, construction and maintenance of such transport infrastructure assets. PPP projects in the sphere of transport infrastructure are commonly used in Russia. There are good reasons for believing that if appropriate changes are made to existing legislation, the LCC model might offer a positive step forward for PPP projects.

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