WILL INVESTMENT PROJECTS BE IMPLEMENTED UNDER THE BUDGET DEFICIT?

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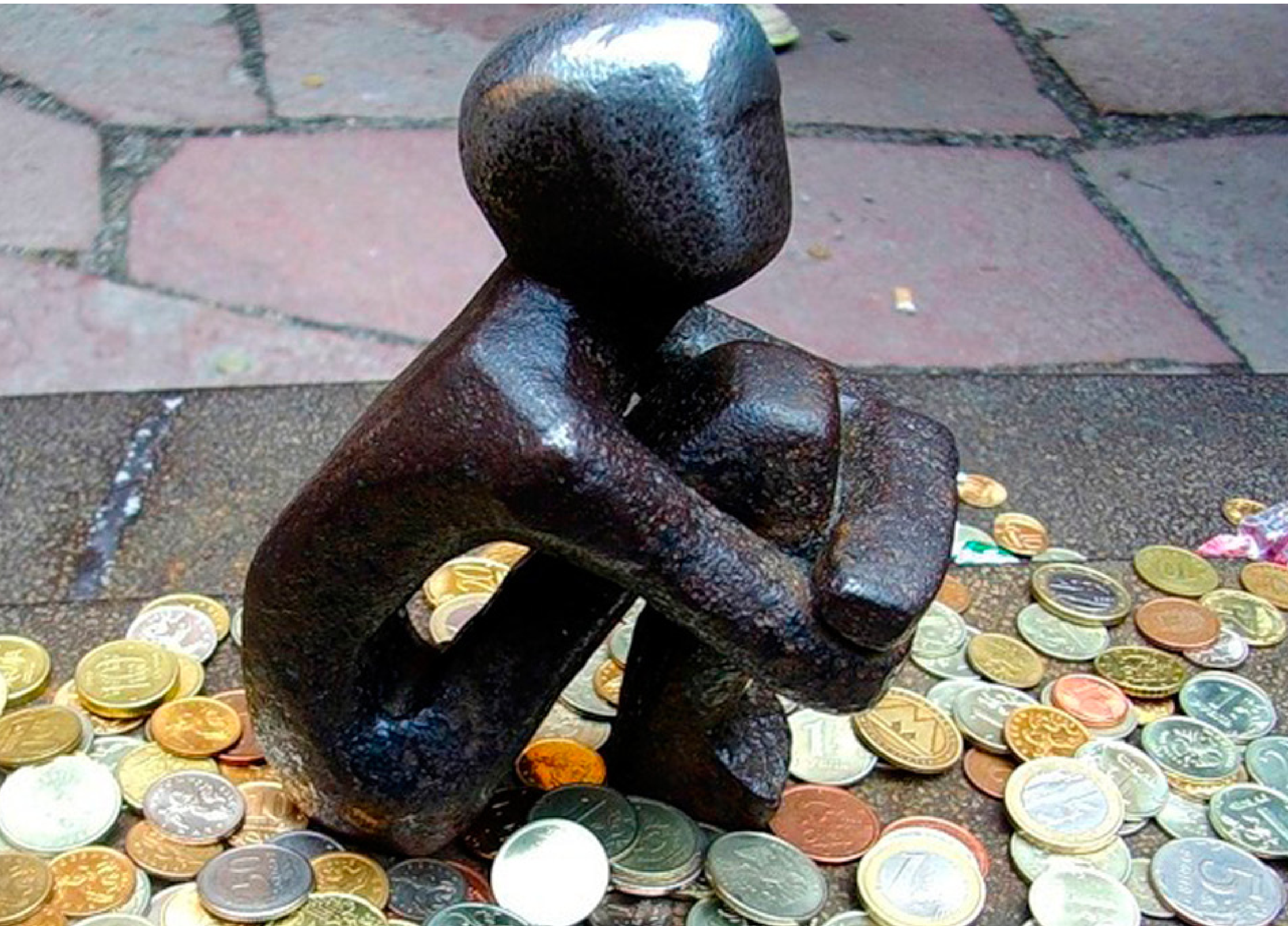
SEPTEMBER 2011



WILL INVESTMENT PROJECTS BE IMPLEMENTED UNDER THE BUDGET DEFICIT

Budget cuts restrain the growth of the amount of investment projects. However, private businesses are in need of development, which is influenced by external market factors. Should private companies wait for the state support in the form of direct funding, or do they need to start looking for other ways to address infrastructure constraints? We will focus on these questions in the review.

Held in Irkutsk, the VII Baikal International Economic Forum[1] provides market participants with an opportunity to assess the prospects of public investment in infrastructure development to secure the plans of industrial companies for economic growth. For the purpose of this analysis, it is sufficient enough to research news and publications of different agencies.

The news analysis from the forum confirms the general downward trend in public investment, which jeopardizes the plans for the economic development of regions in terms of commercial projects. The statement, made by the Deputy Minister of Economic Development on a limited state budget in the presence of existing infrastructure constrains of the industry, especially in Siberia and the Far East, suggests that only individual investment projects from the private sector can be realized in the coming years. This means that companies need to look for alternatives to public funding sources to solve problems of the associated, "captive" infrastructure development.

The Ministry of Economic Development offers 228 billion Rubles additionally for the development of the Far East and Transbaikal.

"Consequently, the Deputy Minister of Economic Development, Oleg Fomichev says that currently there is insufficient money in the public budget to fund all the projects in Russia that are declared under the Investment Fund and the Federal Target Programs. He noted that while preparing the budget now and in future they will select projects with the highest priority; and if there is no private investor, the Government will not allocate the money. According to Fomichev, this work will be conducted in the framework of the Federal Target Programs, and under the state programs, as the total amount of the investments is too high."

http://sibir.ria.ru/economy/20110912/82139345.html
(RIA Novosti)

Lack of active budget investment into the public infrastructure development, including funding from the Investment Fund, is supported by the official materials from the Ministry of Finance, which gradually prepares the state to increase the tax burden to address the needs (despite the fact that the actual stabilization of the economy after the crisis has not happened yet). The growth of social obligations of the state forces us to prepare for the increase of the budget expenditures and changes in the government debt policies.

The growing budget deficit over the next few years will be offset by an increasing public debt, as evidenced by the Ministry of Finance in the document called «Main areas of the public debt policy»[2]. The aims and objectives of the public debt policy for the period of 2012-2014 are formed on the base of "… the rapid growth of budget expenditures, which creates the prospect of its sustainable deficit and does not allow to return to the practice of accumulating the sovereign wealth funds…"

In spite of the progressive demand from the private investment projects, prospects for enhancing public investment in infrastructure development seem to be very doubtful. A separate area of infrastructure development is the expansion of the railway network in Siberia and the Far East[3]. Rail demand forecasting forces JSC "Russian Railways" to seek financing through the use of infrastructure bonds. However, the perspective for the state borrowings to reach the railroad infrastructure objectives looks disappointing. This is the impact of the same priority in the state fiscal policy, aimed at increasing the public debt in order to cover the current deficit. The potential of the investment borrowings might create a competition in the finance market and adversely affect market conditions. The Ministry of Finance and the Government of the Russian Federation cannot allow this to happen while solving the problem of the public budget deficit

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[1] Held in connection with the most pressing demand for infrastructure from major mining and manufacturing facilities.
[2] References to the "Main areas of the public debt policy in 2012-2014" (Ministry of Finance of the Russian Federation).
[3] http://ria.ru/economy/20110912/435798261.html (RIA Novosti).

The first Vice President of JSC «RZD» Vadim Morozov forecasts that the loss amount for the Russian economy from underdevelopment of the rail system only by 2020 could reach 240 billion rubles. This problem could not be solved by borrowing from the state. The Russian finance market could not help as well. Managing Director of the European Bank for Reconstruction and Development Kanako Sekine estimates that the amount of required investment in infrastructure by 2020 will be more than a trillion dollars. Experts advise that Russia needs to attract the largest foreign financial institutions into the infrastructure projects.

http://www.rg.ru/2011/02/04/investicii-site.html

"Russian Railways" requests additional state loan in the amount of 400 billion rubles. The Ministry of Economic Development and the Ministry of Finance opposed the idea of infrastructure bonds, lobbied by the railways authorities. In late July, "Russian Railways" addressed the Government and offered the idea of the state infrastructure bonds. The Prime Minister Vladimir Putin supported the initiative and asked for a month to study the matter. The spokesman Dmitry Peskov states that the idea is still being considered by the Government.

But as reported, the Ministry of Economic Development has already refused to support the idea (Vedomosti acquired a copy of the report).

"Russian Railways" complains about the lack of funding - quoted the Ministry of Economic Development from the circulation by "Russian Railways" - the monopoly asks the state for 400 billion rubles till 2015 for the infrastructure development. "Russian Railways" suggests loaning the money from the state by issuing state infrastructure bonds, and then turning the attracted funds into the capital stock. The money "Russian Railways" plans to invest into major repairs of the tracks, construction of the side tracks, elimination of the "bottle necks" and other projects, as stated by the representative of "Russian Railroads". He also states that the money is not intended for the capital stock: government will invest these funds in the infrastructure projects of "Russian Railways" directly.

According to the report of the Ministry of Economic Development, the idea of infrastructure bonds contradicts the fundamental principles of the Budget Code. Director of a Department at the Ministry of Economic Development Ivan Debris comments on the idea introduced by "Russian Railways": "Practice proves that the idea is unrealistic: there is the principle of integrity of the cash booking - the sacred budgetary process». He could not state any precedents. "It cannot be done" – confirms a clerk at the Ministry of Finance. He says: "State bonds are issued only for financing the state deficit".

http://www.vedomosti.ru/companies/news/1349464/gosdolg_radi_rzhd#ixzz1Y1kS1COZ

The pension fund system could not be considered as a source for additional funding, as it is experiencing some pressure as well, due to the increase in social payments. Some experts forecast a budget deficit of the pension system and the need for such an unpopular decision as to raise the eligible retirement age in Russia. With such background, it is impossible to count on a long term infrastructure investment from the pension funds, especially taking into consideration the significant period of time (10-15 years) for the payback in the infrastructure projects.

Evgenyi Gurvich, expert's opinion.

The fiscal policy has very low quality: a clear sign of the deterioration of the fiscal policy is a change in the composition of public expenditure. The main result is in the abrupt increase of the expenditure on social policy. The rejection of social obligations after they have been adopted is practically impossible. Thus, the government is driven into a trap: the allocation of additional funds for economic development is limited by the social obligations. The increase in some areas, such as defense sector, is expected. They already announced the development of the state arming. In these circumstances it is required to reduce costs in other areas.

http://www.vedomosti.ru/newspaper/article/261234/u_byudzhetnoj_politiki_ochen_nizkoe_kachestvo#ixzz1Uc22LjDF
http://www.rg.ru/2011/06/23/gurvich-site.html

One of the most important sources of infrastructure investment (after the state budget and the Investment Fund) is Vnesheconombank. World Bank activity in supporting the financial system of the country during the last crisis, as well as its work with the «bad» debt and investment in infrastructure projects was a good source of funding, aimed at eliminating market risks, which were not controlled by the private business. However, the public budget deficit affects the ability of the bank. In his interview to the newspaper «Vedomosti», the Chairman of Vnesheconombank Vladimir Dmitriev clearly and unambiguously pointed out that the state would no longer fund the bank. At the same time the bank itself is unable to attract deposits (due to the nature of activities defined by the law); and therefore the attempts of any companies, especially private ones, to get a loan from Vnesheconombank on terms, different from market, are illusive: "when we are seen as a quasi-fiscal tool for getting the rates that are lower than the market ones, it is a clear misunderstanding of our resource base»[4].

Thus, if Vnesheconombank becomes an active participant in infrastructure investments, the bank will provide the funding only by market value, including the revenue covering of Vnesheconombank risks as a banking institution.

«We are starting an independent life», - says Vladimir Dmitriev, the Chairman of the Bank for Development and Foreign Economic Affairs (Vnesheconombank). Vnesheconombank has adjusted its strategy. The State Corporation promises to live without funding from the budget, but is ready to triple its loan portfolio. Vladimir Dmitriev, the Chairman of the bank, shares the information about bank's new life.

http://www.vedomosti.ru/newspaper/article/267414/my_nachinaem_samostoyatelnuyu_zhizn_vladimir_dmitriev#ixzz1Y1xx3YR7

Based on current growing regional state debt, the regional budgets cannot be a source of funding for infrastructure and development[5]. The main increase in government borrowings by the regions within last two or three years was influenced by the necessity to cover the budget deficit; and the funds have not been

[4] http://www.vedomosti.ru/newspaper/article/267414/my_nachinaem_samostoyatelnuyu_zhizn_vladimir_dmitriev#ixzz1Y1xx3YR7 (Vedomosti).
[5] http://www.kommersant.ru/doc/1772723 (Kommersant).

used for the infrastructure development. That means that it is not practical to talk about new borrowings or the use of the current revenues to the budgets of the Russian Federation to invest in infrastructure. The largest part of the budget revenues will be used to recover already existing debts; and a possible recession in the global financial markets in general can create great difficulties for the regional authorities. The state budget of the Russian Federation cannot be relied upon, as it showed in 2008-2009: the reserve fund has been emptied and was not replenished, and the federal budget tries to solve its own problems to cover the deficit.

By 2014, the Government of Russia will try to reduce the amount of regional borrowings by more than six times. In particular, starting in 2012 the budget loans for construction, re-construction, major repairs, renovation and maintenance of the public roads will be stopped. The regions should become more active in the loan market.

http://www.itar-tass.com/c1/200214.html
http://top.rbc.ru/economics/08/08/2011/609389.shtml
http://www.vedomosti.ru/finance/news/1336010/otpravili_na_rynok#ixzz1UUPELP53

Regions raised the bar for the national loan up to trillions of rubles. The Chukchi already have more state debts than the Muscovites. Over the past three years, the debt burden has increased in 75 out of 83 Russian regions, concurrently, it increased more than ten times in 15 regions. The Ministry of Finance acknowledges only seven regions that decreased the state debt in comparison to the pre-crisis period (mid 2008). The experts conclude that the regions are now less ready for the crisis than three years ago. National debt of the regions by July 1, 2008 amounted to 505 billion rubles; by July 1, 2011 - 1.1 trillion rubles (twice as much).

http://www.kommersant.ru/doc/1772723

The only possible tool for the infrastructure development is foreign investment and the money from commercial banks and institutional investors: nongovernmental pension funds, insurance companies, investment infrastructure funds. It is impossible to attract these funds by the old methods, such as the dialog with the government… Private money requires a market approach.

Active involvement in infrastructure financing through the corporate financial instruments is hardly possible:

- Private companies have strong fears to be loaned up because of the consequent risk that they experienced in 2008.
- The current situation in international financial markets does not contribute to investors' confidence.
- Investments in infrastructure require special risk management and control over liquidity.

In this regard, infrastructure bonds, as one of the few applicable corporate financial tools, should be project-bounded, ensuring that the holders have a closer mechanism to interact with the funded infrastructure project.

As a result, we conclude that there are two options for the business and competitive growth of the private companies in the market:

- reactive behavior - waiting for the government decisions, including the elimination of budget constraints after 2014, and waiting for increase of the investment programs after the establishment of the state infrastructure;
- or proactive behavior – solving problems associated with the development of the associated infrastructure by attracting private investment and optimizing the tax base to compensate the cost of infrastructure development by reducing tax liabilities.

Can private funds wait for two or three years or is it time to act? It is an open question, which the owners will decide for themselves. In the end, the activities of private companies can be successful in those cases, where instead of direct government funding for the infrastructure development they use a form of public support to ensure the inflow of involvement out of nongovernmental sources.

CONTACTS

ALBERT EGANYAN
Managing Partner
Head of PPP and Infrastructure Practice
eganyan@vegaslex.ru

DENIS SHTIRBY
Senior Associate
PPP & Infrastructure Practice
shtirbu@vegaslex.ru

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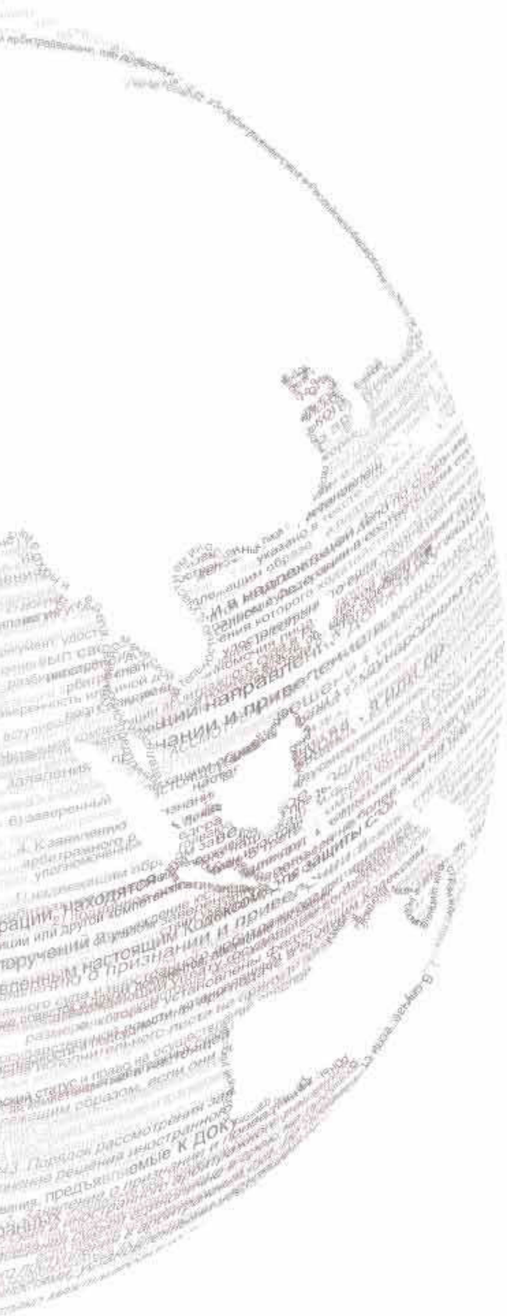

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MOSCOW
tel. +7 (495) 933 08 00
fax +7 (495) 933 08 02
vegaslex@vegaslex.ru

VOLGOGRAD
tel. +7 (8442) 26 63 12/13/14/15
fax +7 (8442) 26 63 16
volgograd@vegaslex.ru

KRASNODAR
tel. +7 (861) 274 74 08
fax +7 (861) 274 74 09
krasnodar@vegaslex.ru