DISTRIBUTION OF DEMAND RELATED RISKS IN ROAD CONCESSIONS IN RUSSIA

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ABSTRACT

The analysis of global and Russian experience of concession agreements in the transport sector shows the high dependence of successful projects on efficient allocation of demand risk between a grantor and a project company. The article describes major factors affecting demand risk distribution regarding Russian road concessions, contains conclusions and assumptions of the author on current and future trends related to the studied components of concession projects, particularly on the transition from the projects with real tolling to availability fees.

Keywords: concession, transportation, transport, roads, risk, demand, risk distribution, concession project.

Background. *The successful implementation of public-private partnership depends on many factors, including rational and efficient allocation of risks between parties. Taking into account the accumulated international and Russian experience, the risk of demand for services provided during the operation of the object of a concession agreement (an agreement on a public-private partnership) becomes particularly important among project risks. In road concessions demand risk can be realized through a lack of traffic on toll roads.*

Objective. *The objective of the author is to study past, present, and future conditions of implementation of road concessions and PPP agreements with regard to demand related risk and to reveal prevailing trends.*

Methods. *The author uses general scientific methods, comparative analysis, evaluation approach, legal and content analysis.*

Results. *According to some experts, demand risk in the public-private partnership in respect of toll roads is one of the most important, as well as one of the most difficult to be managed [1]. In addition, a quantitative calculation and allocation of demand related risk in the transportation sector is a more difficult task in comparison to other industries, such as power energy sector, since the vast majority of consumers (users) are natural persons [2, p. 370].*

The traditional approach to risk allocation in construction projects is based on several postulates formulated by an acknowledged lawyer in the field of construction M. Abrahamson:

– The risk must be borne by the party that controls it better;

– The risk must be borne by the party which may transfer it to another person, for example through insurance, while such a transfer is the most cost-effective way;

– The prevailing economic benefits of controlling the risk go to the party to which the risk is assigned;

– The risk laying on this party is in line with objectives of efficiency, including planning, motivation and innovation;

– If the risk is realized, the responsible party bears the risk of loss in the first place, and it should be recognized as impractical or inappropriate imposition of such losses on the other party [3, p. 24].

According to one of the recognized international experts in the field of project financing J. Delmon, «proper allocation of risk between the parties (when the risk is borne by the party, which is able to manage it better and minimize the risk) allows to reduce the total cost of the project and helps to establish more constructive business relationship between the parties. If the risk is wrongly assigned to one party, then, at best, it increases the likelihood of a dispute in the course of the project, and at worst – the project fails» [2, p. 40].

As rightly pointed by J. Delmon, the traditional approach to risk allocation reveals a significant difficulty in implementation: it assumes that all persons involved assess the risk absolutely objectively, that each person has all the information necessary for such an evaluation and interprets this information correctly, and that all persons assess the risk in the same way. Unfortunately, these assumptions are not true [2, p. 50].

Political factors and requirements of funders have a great influence on risk's assessment. This means that the optimum, in terms of the traditional approach, risk allocation in the project can be changed under the influence of public entities and donors involved in the project. For example, at the request of a sponsoring organization a certain risk can be transferred to a more financially wealthy party, even if such a distribution, in general rule is ineffective. The ability of the project to attract necessary debt financing (e.g. «bankability») actually means the distribution of project risks, which provides sufficiently comfort conditions to creditors to make a decision on financing the project.

Depending on the method of return on investment, concession projects in the field of road construction can be divided into two groups: concession with direct collection of fees and concession with fee paying by the grantor.

Initial Russian practices

Analysis of the very first text of the Federal Law «On Concession Agreements» shows that initially the federal legislator suggested the possibility of implementation of the concessions only with direct collection of fees (e.g. «real-toll concessions»). This can be judged according to the following stipulation contained in the law, «the grantor has a right to take up a part of costs for creation and (or) reconstruction of the object of the concession agreement, for the use (operation) of the object of the concession agreement» [4, part 13, art. 3]. Hence, the concessionaire has to bear another part of operation costs alone. In the spirit of the law, this means that return on investment and gaining the rate of profit was only possible with sufficient traffic density and the risk of lack of demand from users of the toll road was borne by the concessionaire. The action of this legal provision naturally limited interest from behalf of investors in the transport sector to those objects that by virtue of their geographical position could be deemed to get sufficient

load (those located in regions with a high level of effective demand, significant daily traffic associated with moving to and from work etc.). At the same time, projects in respect of roads, the loading of which was less obvious (because of low solvency of the population, the large number of alternative free roads, etc.), had low chances of attracting significant private investment.

With regard to world practice, in the case of imposing demand related risk on a project company, some guarantees might be provided for. For example, the project company may require from the grantor a set of guarantees of demand (via relevant compensation payable in the event that actual demand will be lower than forecasted demand). Also, the project company may be provided with the so-called shadow payments (e.g. «shadow tolls»), where users do not pay the fare, and the grantor transfers to the concessionaire directly fare paid by each user. This scheme is applicable to countries where tolls paid by users are considered as politically or socially unacceptable [2, p. 370].

The first concessions at **the federal level** *in Russia were concluded in 2009, they were agreements on the construction of a new exit to the Moscow Ring Road from the federal highway «M-1 «Belarus» Moscow–Minsk» and the construction of the head section of M-11 highway «Moscow–Saint-Petersburg» (15-58 km of that road). Both of these projects did not include public support (funding from the grantor) at the operational stage. Return on investment in them was performed due to the road user's fees (toll payments), the amount of which was determined by the concessionaire independently, but within the limits established by the concession agreement. Worth to note that maximum fares on toll sections created and (or) reconstructed on the basis of concession agreements, is determined by the decision on the conclusion of the concession agreement and may not exceed the limit established by the Government of the Russian Federation [5, paragraphs 4.3 and 5 of the art. 40].*

The first major road project at **the regional level** *was the construction of the road «Western High-Speed Diameter» in St. Petersburg. The project involved state support at the operational stage in the form of providing a minimum guaranteed yield, which under the terms of tender documentation was very restrictive and covered not all the needs of the private investor. In particular, the terms of the agreement, proposed by the city, assumed debt service coverage ratio (DSCR) at a level no higher than 1.0 [6, paragraphs 1.7.1.2 of the Annex № 1].*

It is to note regarding the above context that the analysis of international practices shows that funding organizations require the risks assumed by the project company to be limited and properly managed. The project, capable of attracting the necessary debt financing (e.g. «bankable project»), must have a clear financial, economic and technical plan, and risk distribution plan, corresponding to the nature of the project and the interests of creditors. Due to the fact that the borrower in the projects of public-private partnership is a project company and regress to shareholders of a company is generally limited, one of the main claims of the creditors to risk distribution is that the risks assigned to the project company could subsequently be passed on to other participants in the project (for example, construction risks can be transferred to the general contractor) [2, p. 97]. With regard to the risk of demand for road concessions borne by the concessionaire and in order to assess the risk related to demand, funders, as a general rule, order independent forecasts of traffic intensity to check for appropriate calculations provided by the grantor or the concessionaire.

Tender for the right to sign a concession agreement for design, construction and operation of the highway «Western High Speed Diameter» in St. Petersburg did not take place, despite the fact that the number of participants having passed the stage of pre-selection (prequalification) was significant. That can be explained through the fact that the draft concession agreement was only granted to participants at the latest stage of competitive selection, so participants had no opportunity to evaluate all the conditions of the project at the pre-qualification stage. The conditions proposed by the public party of the agreement caused changes of the attitude of investors to participation in the project, and not the last role was played by the proposed procedure for demand risk distribution.

Taking into account low competition that the two above mentioned federal projects also witnessed, it is possible to conclude that it was conditioned by one and the same reason that public partner actually left the contestants in situation when they had to face the risks at their own. In the absence of experience in implementing similar projects in Russia the uncertainties about total income from toll collection was a significant risk that the investors were not willing to assume.

Forecasting of the demand

In world practices, the main tool for identifying promising traffic is forecasting (including by modeling) of the traffic. Forecasts of traffic intensity on toll roads are the basis for the calculation of future income of the investment project [7, p. 36], while drawing up these forecasts is a difficult complex task that often causes a significant discrepancy between forecast and actual demand. According to some experts, traffic intensity forecast is one of the main weak elements of public-private partnership in the transportation sector. Such predictions have proven historically their low reliability, which is often critically dependent on demographic changes, changes in consumer preferences, competition level, increased costs and the desire of users to pay the fare [2, p. 374].

The study of traffic intensity on toll roads, conducted by Standard and Poor's in 2005, showed that the average deviation of the actual traffic from the predicted traffic is of 20-30% [8, p.3]. According to the results of the study of traffic intensity on toll roads in Spain, it was revealed that actual traffic during first few years of operation of the toll road was below the forecasted values on average by 35 p.p. [1, pp. 101, 102].

The discrepancy of actual traffic or passenger traffic to the traffic inherent in the initial financial model of the project is a challenge for many foreign projects of public-private partnerships in the transportation sector, as evidenced by the following examples:

– The actual volume of passenger traffic on the railway line Bangkok's BTS Skytrain (Thailand) for the first year of operation amounted to one quarter of the predicted value (570 000 people per day). As of 2009, passenger traffic was 450 000 people a day. As a result income gained by a concessionaire

does not allow to adequately service the debt on loans obtained in the investment phase of the project [9, p. 33];

– Highway Dulles Greenway in Virginia attracted only one-third of the projected daily traffic. Even after reducing the fares by 40 per cent Dulles Greenway was able to obtain only two thirds of its forecasted traffic intensity [10, p.10].

Risk allocation: alternative routes and guarantees

As rightly points J. Delmon, the traditional approach to risk distribution or, in other words, risk allocation, based on the principle of efficiency, is an ideal target model. In practice, the party with a stronger commercial or negotiating position, as a rule, transfers the risks that it does not want to carry to a «weaker» party, and such redistribution is not always consistent with the principle of effectiveness. Inefficient risk allocation has a negative impact on the project as a whole, including the interests of the «strong» party [2, p.125]. The validity of this approach is confirmed by the experience of the first Russian concession tenders in the road sector. The desire of the «strong» party (the grantor) to assign the risk of demand for the investor has resulted, in the case of federal projects in the lower competition among tender participants, and consequently in obtaining less lucrative offers of investors by the grantor, and in the case of the «Western High-Speed Diameter» that resulted in the recognition of the tender as a failed one.

In 2007, the Federal Law № 257-FZ «On the roads and the traffic in the Russian Federation and on Amending Certain Legislative Acts of the Russian Federation» was adopted, which prescribed to ensure the availability of alternative free route, and thus made it more difficult to attract private investment in concession road projects with real toll. Analysis of practice of toll roads has shown that users' demand is highly dependent on tariff's size. Rate increase leads to an outflow of traffic to alternative free routes. Meanwhile, in the world practice toll roads are often built in the absence of a real alternative.

Frejus tunnel, connecting Bardonecchia in Italy and Modane in France, has a length of 12,895 m. Of these, 6,360 m are in Italy and 6,535 m are in France. The French section of the tunnel is controlled by SFTRF, and Italian – by SITAF [e.g. 11]. The tunnel has no real free alternative.

Storebæltsforbindelsen (Great Belt) is a suspension bridge in Denmark, crossing the strait of the same name and connecting the islands of Funen and of Zealand. Great Belt Bridge has a length of 18 km. Car traffic on the bridge is fourlaning [e.g. 12]. The bridge also has virtually no free alternative.

According to information from publicly available sources, it is not always that a free alternative route is foreseen during the construction of toll roads in China [e.g. 13].

In view of the transfer of considerable demand related risks to the concessionaire in road projects, and hence the risks of impossibility of return on investment and of achieving the planned rate of profit, the state took certain steps aimed at reviving the competition of investors for participation in such projects.

The concession agreements providing for direct collection of fees began to include clauses on additional guarantees for the concessionaire from behalf of the grantor (guarantee of non-expansion of alternative routes, guarantee of creation of driveways and intersections to ensure the influx of local traffic from adjacent areas, the adoption of the conditional («off balance sheet») obligations of the grantor, as, for example, compensation in the event of «special circumstances», provision of the guaranteed minimum yield). Some of those guarantees entailed or, upon the occurrence of certain conditions, could lead to additional significant expenditures. Certain types of guarantees actually meant a redistribution of demand risk between the parties. Thus, ensuring the guaranteed minimum return on the project means a transfer of a part of the risk of insufficient demand for roads to the state. N. V. Raskov says: «If the demand in high-speed road is not sufficient to ensure the return on money spent and make a profit, then the grantor will cover losses from the budget. So, for all the mistakes, errors or even deliberate damage made during planning, construction and operation of a PPP project, the taxpayer will pay» [14, p.172].

Typical requirements of banks to cover demand related risk are provisions for either direct support (operating subsidies in the form of fixed payments or payments that depend on traffic, construction of access roads and interchanges to the highway, guarantee of minimum traffic / revenue etc.), or indirect support (restriction of competition, for example ban on construction of roads with parallel routes, prohibition on the introduction of tolls on access and connecting routes, prohibition on changing legislation which may affect demand indicators and others) from behalf of the public partner. A number of major Russian public-private partnership projects in the field of transport infrastructure have been able to achieve financial close by the use of guaranteed minimum yield mechanism, i.e., by public partner's reimbursing from the budget the difference between proceeds of the concessionaire and planned return of the project taking into account the return on investment and obtaining the rate of profit.

As a guarantee, potentially causing accusations in terms of restriction of competition, we can cite conditions of exclusivity (e.g. «exclusivity clause») that can be included in the agreement of implementation of PPP projects. For example, the agreement on creation, renovation and operation on the basis of a public-private partnership of objects belonging to the assets of the airport «Pulkovo», provided for exclusive right of a private partner to provide airport services and carry out construction works at the airport «Pulkovo» and city of St. Petersburg's obligations not to carry out activities aimed at creation and development of another commercial civil aviation airport in St. Petersburg. In addition, St. Petersburg was obliged to conclude and maintain in force during the term of the agreement a cooperation agreement with Leningrad region (adjacent region – editorial note), in accordance with which the Government of Leningrad Region had to assume similar commitments. According to the position of Federal antimonopoly service (FAS), these contractual terms contain signs of non-compliance with competition law. FAS on April 27, 2010 stated that the transaction could lead to restriction of competition by prohibiting the construction of other airports in the region [15].

Balancing of risks and guarantees is a decisive factor for the final implementation of the projects. Thus in 2011, the project to build the road «Western

High-Speed Diameter» gets a «second life» after adoption of a decision that the project should be implemented on the basis of an agreement on public-private partnership under the laws of St. Petersburg. Terms and conditions of the tender documentation provided investors with sufficient freedom in taking the risk of demand. The upper limit of financial criteria, reflecting the level of financial support from the public partner (income guarantee) during the operational phase, was absent. In addition, the southern section of the road «Western High-Speed Diameter», the construction of which under the terms of the tender held earlier was proposed to assign to the concessionaire, was transferred to the private partner already after been built and operated with existing traffic, and the details of traffic were provided to tender participants in advance. It's safe to say that these factors have contributed significantly to the dynamic implementation and completion of tender procedures, as well as to conclusion of an agreement on the implementation of the project.

Payment of grantor as availability payment

An important milestone in the creation of legal preconditions for the use of different options for demand related risks allocation in road concessions in Russia were amendments to the Federal Law «On Concession Agreements» of the year 2012, providing for the possibility of payment of the so-called fee of the grantor to the concessionaire. Nevertheless the concept of «payment of grantor» should be recognized not entirely successful, as its content and legal status are not defined in the Federal Law «On Concession Agreements» or other regulations. Analysis of the rules of the Federal Law «On Concession Agreements» governing payment of the grantor, reveals some features of this tool.

Firstly, the decision on payment of fees by the grantor can be made in case that the establishment of payment of the grantor of the concession agreement is defined as one of tender criteria [16, part 2.1, art. 24]. Therefore, as a general rule, payment of the grantor is a fixed value, determined on the basis of the winner's bid.

Secondly, the payment of the grantor is separated from the costs of creation and (or) reconstruction of the object of the concession agreement therefore may not only cover part of the costs of the concessionaire for creation and (or) reconstruction of the object of the concession agreement, but also to ensure profitability of the concession project [16, part 2.1. art. 24, paragraph 9 part 2 art. 10, paragraph 3 part 2.1 art. 15].

Thirdly, the grantor has a right to increase the size of payment of the grantor as one of the measures aimed at ensuring return on investment of the concessionaire and obtaining gross revenue (revenue from the sale of manufactured goods, works and services at regulated prices (tariffs) in the amount not less than the volume originally defined by the concession agreement) [16, part 1 art. 20]. A possibility to reduce the payment of the grantor is not provided for by the law.

The analysis of these features allows us to conclude that the payment of the grantor may be qualified as «availability fee» (e.g. «availability payment») within the same meaning that was developed in the world practice of implementation of concession projects. Some legal uncertainty with the content of this notion is eliminated by law enforcement practice. Studying conditions of concession tenders shows that an increasing number of projects is structured and implemented with the use of «availability fee» that is, public partner periodic payments to ensure the performance of the road under the agreement.

The introduction of payment of the grantor has made possible the realization of projects in which return on investment and required rate of return are provided entirely by the payment of operating payment to the investor at the expense of budget funds. This model is suitable for objects with insufficient traffic intensity, as well as for any project where private funding is impossible or difficult in the case of imposing demand risk on the concessionaire.

The year 2014 can be considered as the beginning of the era of concession agreements with the payment of the grantor. Tender for the right to sign a concession agreement for construction and operation of high-speed highway M-11 «Moscow–Saint Petersburg» at the site from 543 km to 684 km attracted three participants, which ensured a high level of competition, and thus an opportunity for the public party to select the private partner on the basis of more favorable conditions for the realization of the project. Bids of contestants insignificantly differed on the proposed numerical values within the criteria of the tender. In tenders for two other major concession projects (financing, construction and operation on a fee basis of third and fourth launch complexes of Central Ring Road in Moscow region) five bids from international consortia were received at the stage of preliminary selection. It is necessary to recognize that as the excellent indicator, given the economic and international situation.

Grantor payment can be also analyzed as tools increasing sustainability of the projects regarding current economic conditions. According to available public data, we can notice emerging stagnation or decline in traffic intensity on most toll roads of the Russian Federation («Western High Speed Diameter», «New access to Moscow Ring Road from the highway M-1» Belarus», paid sections of M-4 «Don»), and on toll roads in Europe [e.g. 17-20]. The economic downturn in many countries has a significant impact on traffic intensity on toll roads, because users often choose free routes, as well as reduce the total number of trips [10, p.10]. Therefore, even keeping existing fares facing declining solvency of the population will not prevent decreasing of demand for toll roads. Several operators of toll roads in such a situation may react by tariff growth, which in turn will cause a new wave of demand reduction, as well as will have a negative impact on total revenues, required by operators to service the debt on loans subscribed in the investment phase of the project. In the projects where the state undertakes an obligation to provide the investor with a minimum guaranteed yield, reduced traffic entails unpredictable process of growth of budget expenditures in order to maintain viability of the project.

In concession projects with the payment of the grantor problem of reducing traffic intensity has less impact on project's implementation. The concessionaire receives from the state a fixed payment, the amount of which can be reduced only if road facilities failed to reach operational performance provided for by the agreement. Grantor shall also bear predictable financial burden for the entire duration of the agreement.

Conclusions. *Based on the above analysis the following conclusions can be made.*

Firstly, one of the important trends in the development of Russian law on concession agreements is the empowerment of the grantor for use in infrastructure projects of the mechanism of payment for availability, which is the most relevant to the requirements of funding organizations, as well as allows creating the necessary level of competition in the concession tender. On the opposite, imposing demand risk on the private partner in projects with direct collection of fees from users of the roads makes it difficult to attract debt financing, and neither motivates investors to represent potentially more lucrative offers.

Secondly, the observation over traffic intensity on the Russian roads, especially at toll sections, during a relatively short historical period, reveals the decline in traffic intensity, and also confirms theses of a high price elasticity of demand for paid tolls at locations where there is a real alternative route, this approach been generated by global practices.

Reducing of effective demand for the use of toll roads in Russia has a less impact on the viability of projects providing for payments for availability in comparison with projects involving the return on investment due to direct collection of fees from users of highways.

Thus, a steady tendency in the Russian practice of road concessions' implementation has been shaped out, predicting moving away from projects with direct collection of fees to projects that use fee for availability, and this trend is consistent with international practice and economic realities of today.

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ОАО «РЖД» ПРИСОЕДИНИЛОСЬ К СЕУЛЬСКОЙ ДЕКЛАРАЦИИ ОСЖД

27 мая в Сеуле (Республика Корея) участники Железнодорожного саммита ОСЖД подписали Сеульскую декларацию.

Декларация, в частности, предусматривает укрепление взаимодействия и сотрудничества между железными дорогами, перевозчиками, операторскими и экспедиторскими организациями на всем евроазиатском пространстве, включая сообщение с Корейским полуостровом.

Подписанты намерены акцентировать внимание на оценке азиатского и европейского рынков производителей для обеспечения обратной загрузки вагонов и контейнеров с целью снижения доли порожнего пробега, что позволит повысить ценовую конкурентоспособность евроазиатских маршрутов.

Кроме того, предполагается проведение согласованной тарифной политики, применение принципа «одного окна» при оформлении перевозочных документов, взаимодействие с государственными органами по вопросам упрощения процедуры пересечения границ.

Стороны планируют осуществлять согласованные действия по развитию инфраструктуры, информационных технологий, а также разработке графика движения поездов с целью сокращения сроков доставки грузов.

(По сообщению пресс-службы ОАО «РЖД» http://press.rzd.ru/news/public/ru?STRUCTURE_ID=654&layer_id=4070&refererLayerId=4069&id=85960&print=1) ●

RUSSIAN RAILWAYS SIGNS OSJD SEOUL DECLARATION

The participants in the 2015 Railway Summit held by the Organization for Co-operation between Railways (OSJD) signed the Seoul Declaration in the South Korean capital on 27 May 2015.

The Declaration among other things provides for closer interaction and cooperation between the railways, carriers and operating and forwarding companies across the whole Eurasian space, including the link with the Korean peninsula.

The signatories intend to focus on assessing the Asian and European producer markets to ensure the deliveries of cars and containers in order to reduce the proportion of empty wagon runs, which will increase the price competitiveness of the Eurasian routes.

In addition, it is planned to implement a coordinated tariff policy, apply the principle of a "single window" when completing shipping documents and cooperate with public authorities on simplifying border crossing procedures.

The parties plan to carry out concerted action to develop infrastructure and information technology, as well as develop train timetables in order to reduce freight delivery times.

(JSC Russian Railways press service http://press.rzd.ru/news/public/ru?STRUCTURE_ID=654&layer_id=4070&refererLayerId=4069&id=85960&print=1) ●