EASTERN EUROPE AND CENTRAL ASIA

WORLD FINANCE REVIEW

March 2014

SPECIAL FOCUS:

Public-Private Partnership in Russia

Kazakhstan's Bet on Innovation

Prospects for Further Development of Leasing Market in Uzbekistan

On the Path to Developing the Pearl of Central Asia

IFC Support Economic Diversification and Growth in Kazakhstan

YOUR PARTNER FOR SUCCESSFUL GLOBAL INVESTMENT finetime

RUSSIA

UKRAINE

Published by Finetime Ltd.
Winston House
2, Dollis Park,
London, N3 1HF
United Kingdom

Tel: +44 (0) 20 7100 8080
www.worldfinancereview.com

Chief Editor: Philip Henry
Deputy Features Editor: Nicholas Reni
Head of Production: Nigel Quelch
Advertising Director: Mark Cherry
Director EECA Thomas King
Director BRICS Paul G. Smith
Project Director: Eduard Erkin
Project Manager: Eric Salim

finetime

miningworld EVENTS

2014

miningworld RUSSIA

18th International Exhibition
for Mining and Processing of Metals & Minerals
9 – 11 April 2014
Crocus Expo, Moscow, Russia
www.www.miningworld-russia.com

AMM
ASTANA MINING AND METALLURGY
CONGRESS

Astana Mining and Metallurgy 2014
5th International Mining and Metallurgy Congress
12 – 13 June 2014
Astana, Kazakhstan
www.amm.kz/en

MINERALS METALS METALLURGY & MATERIALS
10th International Exhibition + Conference 2014

10th International Exhibition for Minerals, Metals, Metallurgy and Materials Exhibition and Conference
4 – 7 September 2014
New Delhi, India
www.mmmm-expo.com

miningworld CENTRAL ASIA

20th International Exhibition
for Mining and Processing of Metals & Minerals
17 – 19 September 2014
Atakent Exhibition Centre, Almaty, Kazakhstan
www.miningworld-centralasia.com

ORGANISED BY
ITE
THE ITE GROUP

For more information, contact:

MiningWorld Russia and MiningWorld Central Asia
Anna Aleinikova | T +44 (0)20 7596 5186 E anna.aleinikova@ite-exhibitions.com

AMM
Valentina Michaelson | T +44 (0)20 7596 5137 E valentina.michaelson@ite-exhibitions.com

MMMM
Sergejs Pogildjakovs | T +44 (0)20 7596 5164 E sergejs.pogildjakovs@ite-exhibitions.com

ITE Group Plc | 105 Salusbury Road | London | SW6 6RG | United Kingdom

www.miningworld-events.com

finetime

PPP in Russia: The First Steps

Interview with Pavel Seleznev, Chairman of the Board of the PPP Development Center, and Chairman of the Public-Private Partnership Committee at the Chamber of Commerce and Industry of the Russian Federation

Nowadays, significant experience has been accumulated in the area of public-private partnership (PPP) projects implementation in various economic sectors. Numerous PPP projects have been implemented within transport infrastructure, the energy industry and the social sector. Not all the projects are successful, however the number of PPP projects in the world is growing.

Today public-private partnership in Russia has reached a dynamic stage of development. The PPP federal draft law is currently being prepared for the second reading, which will embrace all forms of PPP agreements currently being used around the world. In this way, we can confidently state that PPP in Russia are slowly but steadily reaching international levels.

However, Russia is still remains far from the efficiency level of foreign countries where such mechanisms have been in use for many years. While raising private investments into the aforementioned sectors has long ago become widespread on a global stage, Russia is making its first steps in this direction.

How is the PPP developing in Russia today?

Today the Government of the Russian Federation understands that the development of public infrastructure requires raising private investments and private competitions.

Throughout the Soviet period, the infrastructure was created and maintained solely at the expense of the government. There was only the planned economy and so all infrastructures were built within the framework of budget financing and not within a business model framework. After Russia switched to the market economy, it became evident that public infrastructure should be developed around the attraction of private business, on account of non-state investments and competences. Firstly, this creates conditions for growth and development in various fields of the economy (especially for small and medium business), and secondly, the quality of services provided by the state may be improved by this collaborations with the private business. Russian authorities clearly understand that.

The scheme is simple. When the private sector is involved in infrastructure projects, on one part, these projects become more cost effective for the state budget and on the other hand – the quality of services provided improve. European countries and the USA embraced this way of development in the 1970's and 1980's (already a previous century) whilst Russia is applying this method only now. According to many international experts, the PPP market is one of the most plump and desired business sectors, however, it is one of the most risky in the Russian business environment as the legal pathway is still not fully developed.

Are there no assurances?

No, not at all. There are some gaps. Today, 71 of 83 Russian regions have their own regional laws regulating PPPs. This was put in place because regional authorities and municipalities began to understand that this area needs development. However, regional laws do not answer all questions. The public-private partnership market has been developing in Russia for only the past 10 last years and is experiencing continuous accumulation and updating. As a result, a year ago the decision was taken to adopt the Federal law "Regulating public-private partnership in the Russian Federation" which will resolve some topical issues, fix the concept PPPs as well as determining possible forms of agreements. The law should first of all determine the comprehensible rules of the game both for investors and the public sector, and as such, enable us to reduce risks to private investors whom the state wants to invite into the sector of public infrastructure.

There is opinion that public-private partnership projects are necessary first of all for government but not for the private sector. Why is this?

Yes, this is currently the case. Today, public-private partnership projects are necessary first of all for the state since it is the main initiator of such projects. The reason was already mentioned – the deficit of the state budget, which requires private investments to maintain and develop the social infrastructure. The state begins to understand today that its main objective is to raise interest and involve the private sector into relevant projects.

However, we should understand that any and all PPP project in Russia provide mutually beneficial participation. Therefore, within the framework of preliminary negotiations, a private partner prepares the project in accordance with the needs of the public party. So, it would be incorrect to say that only the public party is the initiator of PPP projects, especially when we mean projects at federal level. Everything is always preceded by preliminary meetings; these are negotiations where the consensus is always sought after. There is always a certain need from the public party and the objective of the authority is to clearly formulate such need. Therefore, the private party shall be offered such a project as long as it will satisfy the need of the public party.

Will the federal law on the PPP resolve all issues or will there be a need for separate laws for different economy sectors?

It is very probable that post the Federal law on PPP together with some accumulated experience, the market will need additional regulation acts, which will take into account sector specifications. We will soon face that in the defense industry, since force authorities – the Ministry of Defense, the Ministry of Industry and Commerce and the market of the defense industry complex as a whole think about PPP models especially in light of some models and projects already having been piloted. Maybe there will be a need for additional laws, but once again the initiative should be expressed not by the state but first of all by the market, investors and business as a whole. If the business recognizes this task as a necessity, the question on development of a literate and balanced expert suggestion will arise thereafter. Honestly speaking, the draft federal law on PPP was prepared in that way. When it became evident that the law was necessary for the market, and after a huge request on the part of financial institutions and business structures, only then and after one-year of discussions from various expert sites, the Ministry of Economic Development of Russia took the decision to prepare the PPP law as a necessity. As a result, this law is now being discussed in the State Duma of the Russian Federation.

What can you say about the international and Russian experience of overcoming system problems in the area of PPP management?

Considering the international experience, we can see that the public-private partnership is one of the most complicated directions within the area of public management. Taking part in public-private partnerships, authorities shall assess advisability and efficiency of implementation of an invested infrastructural project based upon the principles of the PPP. Today, the Ministry of Economic Development of Russian Federation in cooperation with the expert community, in particular, with the guidance from experts at the PPP Development Center, have been developing mechanisms which generally allow for the reduction of risks in the field of PPP. First and foremost, it is this methodology for efficiency assessment of the PPP, i.e., Value for Money (VfM).

The public sector comparator (PSC) is a preferred assessment tool in many countries which provides easier (relevant to cost-benefit analysis) yet precise analysis, whether the public sector would be able to achieve value for money or not. Simply put, the PSC provides the calculation of public in-house implementation costs which is utilized as a benchmark to compare the alternative policy options, primarily within the framework of the PPP.

To assess the potential amount of costs for implementation of an infrastructure project within the public procurement system the PSC (public sector comparator) methodology is used.

The VfM when considering an infrastructure project assessment includes, total costs and future financial costs as well as social output analysis, whilst comparing different policy options of the project implementation. This methodology has a real chance of becoming the main assessment tool, which will allow for mistakes to be avoided, this are now being observed first of all in Europe, specifically in Spain and Portugal. This, above all, is the mistake of the high debt ratio, debt load and excessive state debt in PPP projects.

We also develop other comprehensive actions allowing us to increase the level of manageability of PPP projects. Such actions include statistics systems development for accounting of PPP projects in the Russian Federation. The Ministry of Economic Development of Russia is preparing now a number of regulations that will determine a unified federal regulator whose competence will include PPP projects: this is an assessment of tender procedures undertaken by constituent entities of the Russian Federation and the monitoring of fulfillment of PPP agreements. This is an important element since most of projects are long-term, agreements may be concluded for 15-20 year periods. This is a long period when changes may occur, whether they be macroeconomic and/or political. This results in the need for the state to undertake continuous monitoring of the aforementioned processes. Certainly, PPPs are a new direction for Russia. This is a challenge, which requires high qualification on the part of public authorities as well as the market players, and today sees the government engaging experts, including PPP Development Center, to become a “qualified public partner” in order to avoid mistakes from European experience.

Please, tell us about the PPP Development Center.

The Public-Private Partnership Development Center was founded five years ago. The main objective of the Center is to develop mechanisms and determine ways of further developing PPPs in Russia. For that purpose an Expert Council was formed within the Center involving all leading consultants of the Russian and European markets. In particular, and in addition to representatives from business structures, the Council includes major consulting organizations, namely, KPMG, Ernst & Young, PricewaterhouseCoopers, Deloitte, Gide Loyrette Nouel and major Russian and foreign financial institutes such as World Bank, IFC, EBRD, Sberbank and Gasprombank of Russia. In addition, the PPP Development Center incorporates the Regional Council which consists of representatives from regional administrations. There is also an International Council presented by foreign and international organizations operating in the PPP arena.

All this was done to develop comprehensive PPP market rules. The result of our five-year work at the Center is, in particular, the draft law on PPPs, which was in turn prepared with an active participation of Center experts from the Ministry of Economic Development of the Russian Federation.

Besides, the Center developed and implemented training programs for the public sector and for the state. For that purpose the Public-Private Partnership Institute (PPP Institute) was founded. PPP departments were also opened in some major higher educational institutes within Russia and furthermore, international training programs were launched which engaged leading European PPP specialists.

There has been an informational vacuum in the area of the public-private partnership in Russia for a long time. To resolve that problem the Center has created a national federal portal presenting the entire theoretical base for public-private partnerships together with in depth data covering both international and Russian experiences with PPP projects. This has allowed us to minimize the informational barrier between the federal and regional authorities, allowing regions to obtain information today providing them with instant international experience as well as experience of their colleagues.

All this has ensured our recognition from both the state and business sector. Today, the PPP Development Center acts as a system operator that arranges cooperation between the public customer and the private party. Our organisation is invited by the government into some infrastructural projects as a strategic consultant for determination of business partners and expertise. We are also engaged as a methodological center for preparation of documents for development of public-private partnership. The PPP Development Center is today recognized by the European Bank for Reconstruction and Development as a unified coordinator for implementation of PPP projects, furthermore we obtained a grant for the development of document systems for the Russian Federation.

One such document system is the Methodological Recommendations for Preparation and Implementation of PPP Projects in constituent entities of the Russian Federation, which were developed with the support of the Ministry of Economic Development of Russia. The purpose of the prepared Recommendations is to form a unified approach to the process of PPP projects implementation in accordance to the state policy and project management. The Recommendations determine basic elements and stages of state PPP management system development in the region, they present the structure of PPP management process and determine key risks. Today the PPP Development Center and Ministry of Economic Development run seminars in various regions of the Russian Federation and implement such recommendations in regional administrations.

From your point of view, what is the next stage of PPP development in Russia?

After passing the PPP law, we hope that a fair number of companies who specialise in the management of public infrastructure, will come forward. We need to acquire international experience and we are absolutely open in this area. We willingly create platforms for dialogue with foreign business entities, as well as with foreign infrastructural funds that are ready to invest or are considering the possibility of investments into the Russian economy, including the public infrastructure. PPPs are one of the instruments for raising investments into infrastructure, however, its specialism requires regulation and support, plus, independent discussion alongside expert platforms. Today, the leading expert platform is PPP Committee of the Chamber of Industry and Commerce. The main purpose of that Committee is to consolidate efforts of business and academic communities, chambers of industry and commerce, federal and regional authorities.

Key objectives of the Committee include: improvement of legal PPP in the Russian Federation, building stable relationships with the business and expert communities in regard to PPP projects implementation; provision of methodological and informational assistance for development and implementation of the PPP in the Russian Federation.

Another important stage of development is the creation of an all-Russia experience exchange platfrom. Large-scale forums devoted to issues relating to public-private partnerships are hosted in most developed countries. The PPP Development Center, in cooperation with the Chamber of Industry and Commerce of the Russian Federation, will hold the largest event in the field of infrastructure development and PPP – the Russian PPP Week, which will take place in March 2014. The Russian PPP Week is about to become a regular federal discussion platform where PPP projects in various economy sectors will be presented for the purpose of selection for further implementation in Russian regions. Projects will be discussed with involvement of governmental and municipal authorities as well as national and foreign investors and experts.

We also plan to establish an association of concessionaires and operators of PPP projects for integration of advanced foreign practices in the PPP arena, allowing for the exchange of experiences in long-term management of public infrastructure objects.v

Recent Changes in PPP Laws - New Possibilities for Implemination of PPP Road Projects in Russia

By Pavel Karpunin, Partner, Capital Legal Services

Recently, the Russian authorities introduced several novelties aimed at stimulating private investors to implement road projects in Russia based on PPP schemes. On December 28, 2013, changes were introduced into PPP legislation in regard to PPP toll road projects, to clarify the procedure of establishing tolls for using such roads. In addition, a new procedure of Parallel Competitive Financing (PCF) was introduced, which enables the private partner to avoid long negotiations with financial organizations and attract financing from the financial organizations suggested by the public partner instead.

RECENT CHANGES OF LEGISLATION ON TOLL ROADS

PPP projects in the road infrastructure have been gaining more and more momentum in Russia during the last few years on federal and regional level (both public and toll roads).

PPP road projects are usually implemented in Russia based on concession agreements, which is the only form of PPP agreement regulated at federal level, for example (i) the construction and further operation of sections of toll highway between Moscow and St. Petersburg (M11) with total length of 669 km, (these projects are currently at various stages of project implementation, e.g. the concession agreement was concluded in 2009 in regard to section 15 – 58 km), and (ii) a highway bridge over the river Lena in Yakutsk (the project is currently at the tender stage).

On December 28, 2013, some changes were introduced into PPP legislation concerning toll roads to clarify the procedure of establishing tolls for the use of such roads. More specifically, the federal law "On auto roads and road activity in the Russian Federation…" (the "**Roads Law**") was amended to stipulate the following:

1. The methods for establishing tolls for roads created on the basis of concession agreements, and maximum levels of such tolls, shall be adopted by the Government of the Russian Federation (for federal projects) or respective regional or municipal authorities (for regional and municipal projects).
2. The concession agreement on construction/reconstruction and use of a toll road must include the procedure and conditions of establishing and amending of tolls as well as the highest possible amount of such tolls and possible procedure for its indexation. The toll collecting procedure must also be defined in the concession agreement.

The highest possible amount of tolls (established in the concession agreement) cannot be changed throughout the duration of the concession agreement. The only exception is when a legislative act adopted during the term of the concession agreement leads to heavy losses for the private investor (the concessionaire) and it could lose most of the expected gain.

COULD THESE CHANGES AFFECT THE IMPLEMENTATION OF PPP ROAD PROJECTS IN RUSSIA?

Not long ago toll road PPP projects were rare in Russia. The legislation in this sphere traditionally had some significant 'deviations' from the common world-wide practice and did not provide a clear procedure for toll calculating. Basically any private investor knew that its profit depended significantly on the public partner, but was given no clear explanation on how and why tolls could be calculated. In other words, no guarantees were given that investor's interest would be taken into account, and the investor had to rely only on the decision of the public partner.

With the recent changes introduced into the Road Law, the process has become clearer and the private investor does not have to step into the project blindly. The public partner shall still decide on the highest possible payment for toll road use, which shall certainly affect the private partner's profit, but the private investor will be able to see and calculate its own risks and profits while signing the concession agreement. Also, there are some safety measures for the private investor and its interests in the project: the highest possible payment for toll road use stipulated in the concession agreement can be changed only for the sake of protecting the private investor's interests.

The abovementioned changes into Russian Law are certainly favorable for private investors. The amendments create a legal framework for effective cooperation between the contracting state authorities and the concessionaire and should stimulate development of roads and road-side infrastructure in Russia.

PARALLEL COMPETITIVE FINANCING (PCF)

Generally, PPP road projects are financed in whole or in part with the use of project finance arrangements.

Project finance is deemed as the finance raising for the purposes of developing the large capital-intensive infrastructure and industrial projects (such as road projects), where the borrower is a special purpose vehicle (SPV) established for the purpose of project implementation. The repayment of the debt by the borrower will be dependent on the cash flows generated by a project.

Lately, a new procedure for selecting financial organizations, named Parallel Competitive Financing (PCF), has been applied in Russian PPP road projects. The procedure envisages that the public partner informs financial organizations of the essential terms of the project and negotiates with these financial organizations the possible terms for attracting the debt financing that the investor needs to implement the project.

The bidders also receive the revealed information and can use this information to form their bids. However, the private investor can choose a financial organization at its own discretion instead of using the information revealed during the PCF procedure. At the same time the financial organizations participating in PCF, in their turn, have to grant a loan to the successful bidder on the terms agreed upon with the public partner.

The tender documentation on PPP projects that apply the PCF procedure obliges the investor to provide the public partner with a signed agreement on provision of financial resources sufficient for the project implementation no later than on the signing date. Meanwhile, in PPP projects which do not apply the PCF procedure, the investor must provide the public partner with such agreement a certain time (e.g. 6 months) after the PPP agreement has been signed.

In particular, the PCF procedure is being introduced in the project on construction and operation of the 543 – 684 km section of the toll highway between Moscow and St. Petersburg with total project cost of 2.5 billion dollars. The construction of this section of the Moscow – St. Petersburg toll highway will be financed from two sources: 75% through capital grant from the federal budget and 25% through funds attracted by the concessionaire. The project is currently at the stage of selection of the preferred bidder. The State Company "Russian Highways" (Avtodor), in its capacity as the concessor in this project, negotiates with financial organization in order to attain the most favorable terms of attracting financing for the project's implementation and shall inform the bidders of such terms by the end of the tender stage.

The new procedure for selecting financial organizations, named Parallel Competitive Financing (PCF), has been applied in the project on construction and operation of the 543 – 684 km section of the toll highway between Moscow and St. Petersburg. The procedure envisages that the public partner negotiates with financial organizations the possible terms for attracting the debt financing and reveals the information to bidders.

It is worth mentioning that PCF helps to reveal the possible market conditions (including base interest rate) for the private investor to attract senior debt, which helps to reduce the period of negotiations between the private partner and the financial organizations and cut the time required for reaching financial closure. At the same time, the PCF procedure does not exclude the possibility for the private investor to apply a standard approach to attracting financial resources required for project implementation, including financing using its own funds.

Taking this into account, the PCF procedure appears attractive and profitable for the private sector in view of the following:

- The bid preparation stage could be accelerated;
- The bidders avoid the costs of holding negotiations with financial organizations by relying on their bids on the information provided by the public partner regarding the financing terms;
- The public partner bears the risks of attracting finance.

This year, Avtodor plans to attract private financing for not only modernization of pre existing federal highways, but also for broad construction of new high-speed roads, including a network of highways that will connect the big cities in Russia. Obviously, this will create a good opportunity for applying the new procedure of PCF in PPP road projects and attracting the private sector to participate in such projects.

The abovementioned changes into Russian Law are certainly favorable for private investors. The amendments create a legal framework for effective cooperation between the contracting state authorities and the concessionaire and should stimulate development of roads and road-side infrastructure in Russia.

Moscow Office
Chaplygina House, 20/7 Chaplygina Street
105062 Moscow, Russia
Tel: +7 495 970-1090 Fax: +7 495 970-1091

St. Petersburg Office
Bolloev Center, 4 Grivtsova Lane,
190000 St. Petersburg, Russia
Tel: +7 812 346-7990 Fax: +7 812 346-7991

www.cls.ru
e-mail: cls@cls.ru

PPP: Current Status & Perspectives

By Sergey Belyakov, Deputy Minister for Economic Development of the Russian Federation

Given today's high demand for adequately developed infrastructure, the Government of the Russian Federation focuses on policies that would enable the transition from the traditional federal budget financing of infrastructure projects to the development of various forms of cooperation between the state and private businesses in this area.

In this context, the public-private partnership (PPP) mechanism is becoming increasingly important, as it allows to resolve the problem of infrastructure investments by means of attracting private capital.

Implementation of coordinated policies on PPP development requires the establishment of transparent and clear rules for implementation of PPP projects as an important element of the state's investment policy, both in terms of forming a favourable investment climate in Russia, including the attraction of foreign capital, as well as from the point of view of integration of PPP projects into the budget process.

PPP development in Russia started in 2005 with the adoption of the Federal Law "On Concession Agreements". Here, it is important to note that in Russia concession agreements (COP) evisage only for the BTO (Build-Transfer-Operate) mechanism, according to which the facility is transferred to the state immediately upon commissioning. Following this, the ownership and operation rights specified in the concession agreement are transferred to concessionaire (the private partner).

In order to simplify and unify the execution process of concession agreements, the Government of the Russian Federation has approved 13 standard concession agreements provided by law. Concessions in Russia are concluded at the federal, regional and local levels, depending on the level of funding, decision-making and risks of the project implementation.

In 2013, the number of concluded concession agreements was as follows: in the housing sector - 842, in education - 17 , in the health sector - 7 , in the field of transport infrastructure - 14, in the socio-cultural sector - 1.

The reality is that that in most cases at the federal level concession agreements are implemented in the sphere transport infrastructure. At the municipal level concession agreements are limited to utility infrastructure development, roads and civil engineering projects of transport infrastructure.

Difficulties or inability to implement individual concession projects dictate the need to improve the concession law. Currently, the Government of the Russian Federation is in the process of submitting to the State Duma a draft of the federal law on amendments to the existing legislation on concession agreements in part of:

- Widening of possibilities to conclude concession agreements
- with subsequent payment by the grantor for all the objects of the CA
- (currently - for highways only);
- Securing of the possibility to find objects for concession agreements at the time of its conclusion on the basis of operational management at the state budget institutions and at the state or municipal unitary enterprises;
- Establishing of an open list of objects available for concession agreements, by introducing the concept of "other property";
- Securing of the possibility to conclude concession agreements by private initiative;
- Securing the possibility to provide guaranteed return on investments for the concessionaire and receiving amount of revenue envisaged by the agreement;
- Securing the possibility to conclude direct agreements with sponsoring organizations;
- Securing the creditor's rights to agree with the grantor the replacement of the concessionaire without competition provided this is stipulated in the agreement between the concessionaire and the creditor and that the essential terms of the concession agreement do not change;

It should be noted that the full legal and regulatory framework of public-private partnerships in the Russian Federation continues to take shape. Concession agreements are currently the only existing mechanism of PPP at the federal level in Russia, whereas in the world 9 forms of PPP agreements are used.

The need to integrate other PPP mechanisms has led to the development of regional legislation on public-private partnerships. As a result, PPP laws have been put in force in 67 regions of Russia. Moreover, practical experience in implementing PPP projects at the regional level has already been accumulated.

One of the key problems of the regional legislation in the sphere of PPP is the number of contradictions in legislation, and the resulting contradictions in the specific provisions of the agreements on PPP projects. In addition:

- it is impossible to allocate the necessary property, including land, for the realisation of PPP projects within the limits of a single tender (integration lots).
- there is a risk of challenging the PPP agreement by regulatory and supervisory authorities, which may lead to the agreement being declared invalid because Russian legislation only provides for concession agreements and contracts under public procurement.
- there is no unified terminology and conceptual nomenclature.

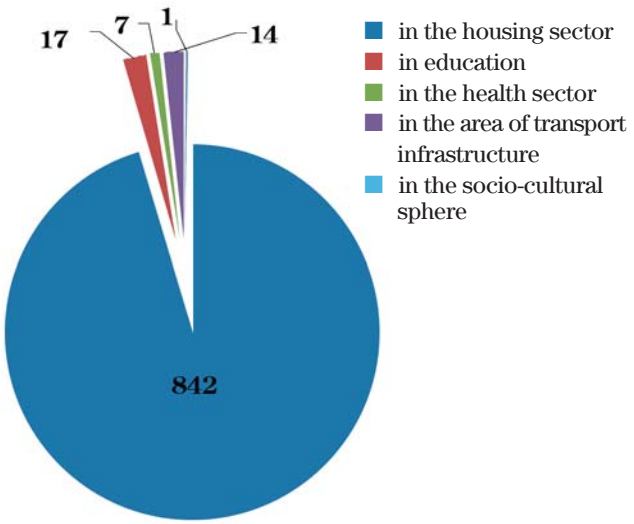
In order to expand the possible forms of PPP mechanisms and to develop the basis for private capital inflow into infrastructure projects the Ministry of Economic Development of Russian Federation has developed a draft of federal law "On the basis of public-private partnerships in the Russian Federation."

The main purpose of this law is to create conditions to attract private investment and competencies into the economy through harmonizing the legal framework in the PPP sphere and establishing an adequate legislative base for PPP projects in all possible forms of cooperation in relation to projects on the federal, regional and local levels.

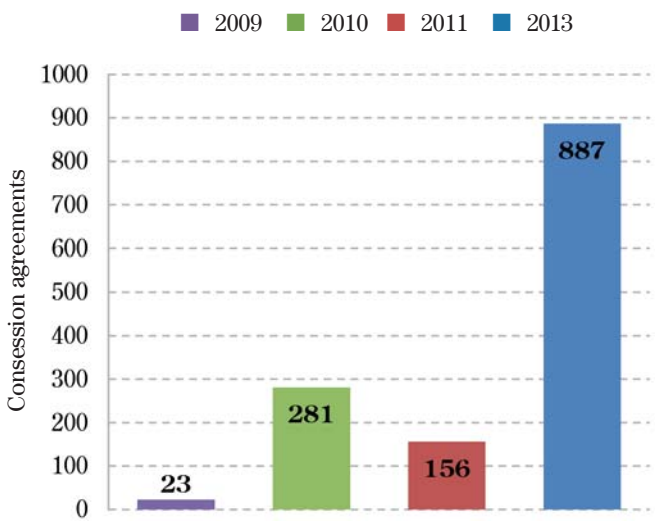
The draft law establishes:

- approaches to identify a project as the PPP project (financing by the private partner of the object of agreement and its subsequent operation in order to improve the quality and quantity of services provided to the population), that allows to identify PPP projects among other public procurement needs;
- rights and obligations of the parties of the PPP Agreement;
- powers of the Government of the Russian Federation, the subjects of the Russian Federation and municipalities within the realization of the PPP Agreement, including the power to control;

Scheme 1. Number of Concession Agreement in 2013 (by industry)



Scheme 2. Dynamics of the number of concession agreements



- unified conceptual terminology ("public-private partnership", "private partner", "public partner" and others);
- possibility to structure flexibly the PPP project (not limited list of fixed forms of PPP);
- possibility of rising ownership of the object of the agreement with a private partner during the term of validity of the PPP agreement or at the end of this period;
- ability to distribute ownership of the object of the PPP agreement, if such an object consists of several facilities of movable or immovable property;
- selection of the private partner on a competitive basis according to the principles of openness and transparency;
- opening of the list of objects of the PPP agreement, except for objects prohibited for disclosure;
- guarantees and protection of rights and legitimate interests of private partners and creditors against adverse changes in legislation, the so-called "grandfather clause" and a direct agreement between the private and public partners and the funding organisation.

As a result, the current restrictions will be eliminated, including the following:

- Provision of land to rent for activities under the PPP agreement without a separate trading on the land;
- The possibility to combine items in a single competition for the realization of the agreement;
- The legislation on public procurement remains unaffected towards the PPP agreements after the evaluation of the effectiveness of the PPP project by a competent authority.

Creditors of the project are entitled to enter into direct agreements between the private and public partners and the sponsoring organisation. In case of a material breach of the agreement by the private partner, a bank, in coordination with the public side, could replace such private partner. The selection of a private partner will be carried out by means of holding a tender.

Extensive discussions of the provisions of the law were held with the expert community, discussions on the key aspects of amended provisions took place in workshops with the participation of representatives of the regional executive authorities, heads of municipalities, non-profit organisations, legal firms and business structures. Currently, the law is being prepared for the second reading in the State Duma of the Federal Assembly of the Russian Federation, which is scheduled for the spring session.

To further regulate the implementation of PPP projects throughout the life cycle, from initiation to commissioning, it is necessary to adopt a list of acts of the Government that will establish:

- procedures for preparing of agreements on PPP,
- procedures for evaluation and validation of comparative advantages of PPP agreements over the placement of state orders,
- the order of the tendering process on the right to enter into PPP agreements;
- procedures for controlling and monitoring the progress of implementation of agreements.

It is also necessary to determine how to conduct public hearings on the decisions to conclude PPP agreements.

The Ministry of Economic Development of Russia is already developing such documents.

In addition, changes in the current legislation are the first step of forming a system of clear and transparent rules for all parties involved.

In this regard, organized seminars in 76 regions of Russia with the representatives of the executive authorities to discuss questions relating to the need to expand the practice of implementation of investment projects using the PPP mechanism.

Also the work on the projects, which is already started, aims to ensure that the necessary methodological accompaniment is in place. In particular, together with federal executive authorities and the expert community, methodological recommendations for the preparation and implementation of PPP projects in the Russian Federation have been developed.

Methodological recommendations prescribe the principles of organising the state and municipal governance for PPP, and the solutions for the PPP project management

The key provisions of the Recommendations are:

- procedures for formation and selection of ideas for PPP projects;
- evaluation of investment attractiveness and potential of PPP projects in the view of strategic objectives of regional development;
- evaluation of the budget effectiveness of PPP projects;
- assessment and risk allocation of the parties of PPP agreements;
- legal structure and financing of PPP projects involving a variety of sources;
- management and monitoring of the realization of the PPP project.

The Ministry plans to continue methodical support of PPP projects. In the nearest future recommendations on the preparation of the PPP model agreements with the industry characteristics will be developed, as well as the procedures for evaluation of the effectiveness and substantiation of comparative advantages of PPP agreements over the procurement orders for the state and municipal needs; recommendations for the establishment of target indicators for PPP projects; recommendations on competitive selection of private partners.

Today, the main challenge is to create the data bank in order to be able to replicate the best practices. The Ministry also plans to create a unified information system, a PPP portal, to store information about all tendering procedures for selecting private partners (concessionaires), monitoring the execution of agreements, as well as maintaining a register of model agreements, best practices, etc.

In our opinion, the described series of measures will help to create favorable environment for participation of private investors in infrastructure projects and will promote the development of PPP in Russia.

GOLTSBLAT BLP

The Russian practice of Berwin Leighton Paisner (BLP)

Public Private Partnerships (PPP)/ Infrastructure

Over 10 years, experience of advising on major project financings both in Russia and the UK on **all aspects of PPP/infrastructure**, from corporate and tax structuring to financing and regulatory.

Impressive track record of participating in large-scale and the most innovative public development projects to come to the market.

Our **international team** of dedicated PPP/ Infrastructure lawyers provides support at our offices in Moscow and London, as well as at our Abu Dhabi, Beijing, Berlin, Brussels, Dubai, Frankfurt, Hong Kong, Paris and Singapore offices.

Our services

- Legal advice on land zoning/ planning and real estate aspects
- Corporate finance and project finance advice and documentation
- Concession agreement advice and documentation
- Full support for paperwork within a PPP/Infrastructure project
- Environmental
- Regulatory aspects of natural resources
- Full legal support for construction activity
- Corporate and tax structuring advice and documentation, including JV and consortiums
- Advice on contractual arrangements for operational contracts and systems
- Full support on employment matters for consortium activity and operation
- International arbitration
- Tax advice

Abu Dhabi Beijing Berlin Brussels Dubai Frankfurt Hong Kong London Moscow Paris Singapore

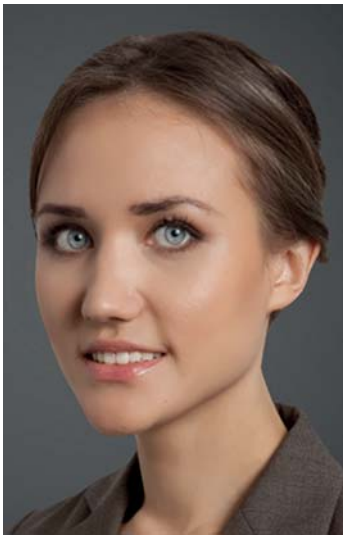
T.: +7 495 287 44 44
E.: info@gblplaw.com

www.gblplaw.com

Demand Risk for Russian PPP/IPP Projects

By Svetlana Savina, Senior Associate, Real Estate and Construction, Goltsblat BLP

Infrastructure facility output demand is a vital indicator of economic success. Lack of demand can constitute a quite substantial risk, so, to encourage private investment and ensure recoupment, the state (mainly interested in the facility itself) sometimes assumes this risk. Below are certain aspects of this risk in relation to Russian PPP and IPP projects.



DEMAND RISK AND TARIFF REGULATION

Infrastructure facility output (solid domestic waste disposal, electricity supplied to certain consumer categories, electricity transmission services, heat and its transmission, etc.) often has to be sold at regulated prices (tariffs). Therefore, the investment recoupment often depends on rates, established by the relevant authority. The prices (tariffs) shall be: (i) high enough (sufficient to cover the costs) and (ii) cheap enough (affordable for consumers).

Yet the public partner often cannot unconditionally guarantee acceptable tariffs because:

- Many tariffs envisage a limited list of costs and relevant standards. Fixed asset repair costs for electric power, for instance, proceed from the cost standards approved by the Russian Energy Ministry and Rosatom.
- Tariff regulation is the domain of various-level state authorities: for solid domestic waste decontamination, tariffs are set by regions, while tariff surcharges for consumers are established by municipalities.
- Tariff setting (by regulation sphere and method) is usually governed by profit margin rules not taking full account of the project financing specifics and terms.
- Tariff setting may not be within the competence of the public partner but may be the responsibility of a different level authority (for heat and water supply, for example, tariffs are usually set by the constituent entity authority, whereas a local government body might exercise public partner powers).
- Tariffs have a limited term, differing by regulation sphere and method. They are usually set for a year but, even when regulation is based on long-term parameters, are adjusted annually.
- Even given a fair tariff, the relevant legislation might be amended, as has happened regularly in relation to tariff regulation for engineering/utility organisations.

If the tariff is too high (for covering costs and investments), consumers might not be interested in using the relevant facility (an excessive road toll, for instance, will force drivers to take alternative routes; a too high heat tariff will put consumers off, etc.). Take the GTPP Kolomenskoye project.

In early 2004, the Moscow Government officially predicted connection, by 2010, of additional municipal capacity of 3.9 th MW of electricity and 9.8 th GCal/h of heat and recognised that new generating capacity needed to be built, including using private funds.

In 2006, a public tender resulted in the Moscow Government concluding an investment contract with the privately-owned NaftaSib Energy LLC on the following terms: (i) NaftaSib builds a 136 MW gas turbine power plant and 171 GCal/h of heat capacity using its own and borrowed funds; (ii) NaftaSib holds the title to the GTPP; (iii) NaftaSib pays budget revenues for 20 years (strangely defined as "payment for land plot lease").

For building the GTPP, the private partner intended to engage the Moscow heat-supply company OAO MOEK, later to become the main heat consumer, but the GTPP was ultimately built without MOEK's participation.

In 2009, GTPP Kolomenskoye won the competition "Utility infrastructure facility (including utility networks and Moscow Government Economic Complex facilities)".

Since GTPP Kolomenskoye was built using private and borrowed funds, the tariff was set for recouping credit investments and leasing, topping that of Moscow's main heat supplier, MOEK. The assumption was that MOEK would be the GTPP's main consumer and would, in turn, sell heat to end consumers (the cost of the higher GTPP tariff being passed on to MOEK consumers).

On 30 November 2011, MOEK cancelled the agreement owing to the excessive tariff and, from January 2012, GTPP Kolomenskoye was disconnected from the MOEK heat network. NaftaSib, which built GTPP Kolomenskoye, is currently undergoing bankruptcy proceedings.

In 2013, two other power plants of outside investors, TETs ZIL and TPP Mezhdunarodnaya, functioned on the Moscow heat-supply market and construction of three new energy sources was nearing completion. According to official sources, in order to ensure sale of MOEK heat, the TPP Mezhdunarodnaya tariff was deliberately set lower than required for covering investments.

MITIGATION OF RISKS AND POSITIVE DEVELOPMENT TRENDS

Guarantee of stable prices (tariffs) and recent legislative amendments

Recent amendments to the Russian legislation establish certain private partner guarantees mitigating these risks with respect to road tolls under PPP concession projects.

On 10 January 2014, a Federal Law came into force stipulating that a toll road concession agreement include the maximum toll (not exceeding the limit set by the competent authority) and indexation of it. The parties may

agree to change this condition only proceeding from a decision of the Russian government, Russian Federation constituent entity or local government body (depending on the level of the project) and only if rules substantially against the concessionaire's interests are introduced.

The public partner bears the lack-of-demand risk

Construction of the M11 Moscow–St Petersburg Highway from 334 to 543 Km, structured as a long-term investment agreement, provides another example. This road sector is characterised by both a relatively high construction cost and the risk of a high toll meaning demand fails to cover costs.

As a mitigation method, the state was to bear the lack-of-demand risk. Project payback is guaranteed by payments from the public partner (not road tolls) as follows.

During investment: (i) prepayment of 30% of the stage against a bank guarantee; (ii) work performed and confirmed by relevant certificates (less the prepayment and the private partner's investment element). The finance sources consist of construction subsidies and bond issues, while obligations to place and maintain bond issues are borne by Avtodor.

During operation: (i) quarterly operational payments; (ii) annual repair payments against a bank guarantee; (iii) annual investment payments consisting of: (a) an irreducible amount, including the non-indexed sum for paying back the borrowed funds, and the indexed sum for paying a return on borrowed funds; and (b) a reducible amount, paid provided the facility complies with transport and operational parameters, including a non-indexed amount – to pay back own funds and the indexed amount – return on own funds.

The toll is paid directly to the budget rather than the private partner.

Specific of lack-of-demand risk in concession projects

By federal law, a concession agreement public partner may also assume some of the PPP facility creation and use costs. However, this relates to particular concession projects only (highways, highway sectors, auxiliary structures and road service facilities) and provided the concessionaire does not receive other creation and use payments and that the given payment constitutes a tender condition. Possibility of public partner payment is not envisaged for other facilities, so sometimes such projects are not structured as concession agreements.

In some cases (tariff regulation or payment by the concessor), the private partner may be released from making a concession payment (i.e., traditionally contributed to the budget during PPP facility use). Only in July 2010 did it become possible to structure concession projects without a concession payment.

One concession project where the public partner bore the lack-of-demand risk was the Km 543-684 sector of the Moscow-St Petersburg Highway, for which the federal budget finance consisted of: (i) partial financing of the road-building costs (capital grant); (ii) payment by the concessor, including: (a) operating payment (for road maintenance costs); (b) investment payment (for road-building costs in consideration of returns on invested capital; (c) additional payment (only if more tolls are collected than anticipated).

However, public partner financial obligations also entail other problems.

Budget limitations

Russian budget outlays are specified for the relevant budgets' expenditure obligations for each financial year (and planning period). The draft federal budget is approved for three years: the financial year and planning period, whereas Russian constituent entity or local budgets are set for one or three years (as above).

Recent positive amendments to the budget legislation (law of 2 July 2013) permit concession agreements to last longer than the approved budget limit term.

It is also possible to approve budget allocations for long-term target (sub) programmes but, on the basis of the annual programme appraisal, the competent authority may cut or terminate such allocations early.

Most PPP projects involving state financial obligations thus entail a risk of them not being fulfilled.

Russia also has special regulations on use of budget funds to create publicly useful facilities, such as those on

Construction of the M11 Moscow–St Petersburg Highway from 334 to 543 Km, structured as a long-term investment agreement, provides another example. This road sector is characterised by both a relatively high construction cost and the risk of a high toll meaning demand fails to cover costs.

placement of state or municipal orders regulating facility creation out of budget funds, which stipulate a special tender procedure and model for contracts and co-operation. The legislation on state and municipal orders may thus potentially apply to PPP projects involving payments from the budget.

There have been recent court decisions confirming the possibility of reclassifying and invalidating PPP agreements, though they are few in number and relate to obvious violations or attempts to bypass legislative restrictions.

The given legislative contradictions and gaps may be resolved by the draft law "On the Fundamentals of PPP in Russia", currently being considered by the State Duma. On 26 April 2013, the Draft PPP Law passed its first reading out of three. To become law in Russia, it should also be approved by the Federation Council, signed by the President and promulgated. Particular attention should be paid to preparation of a PPP project, including the choice of form, in order to foresee potential risks and preclude unfavourable consequences, if possible.

Russian budget outlays are specified for the relevant budgets' expenditure obligations for each financial year (and planning period). The draft federal budget is approved for three years: the financial year and planning period, whereas Russian constituent entity or local budgets are set for one or three years (as above).

PPP as a Mechanism of Developing Transport Infrastructure

By Dmitry Tvardovsky, Assistant to the Minister of Transport of the Russian Federation

Different types of PPPs have been used for transport infrastructure development depending of the legislation, business traditions and culture.

Development of transport infrastructure is the basis of the economy of any country. Especially it applies the country like Russia. Vast territory should be provided with safe connections for freight and for passengers. Globalization and intensive development of international economy also require additional transport capacity.

Transport infrastructure objects construction and maintanance has quite vast capital cost but at the same time it stimulates development of many other spheres of economy and provide demand in various industries.

Transport system of all kinds is a frame of the country and it needs an outpacing growth for economy rising and improvement of living standards.

Highways are the most extended type of infrastructure. It serves main cargo and passenger traffic. Railroads take main volume of general cargo.

Aiviation provides connection for passengers of different regions of Russia and obtain an international flights. Maritime transport serves export-import cargo operations. Inland waterways is oriented on local cargo and tourism. All means of transport infrastructure have its own pecularities that specify appropriate legal and financial instruments for it's development. However all kinds of infrastructure is very expensive for budgets. Taking into consideration the need for intensive development we have to alocate considerable volumes of financing.

Strong limits of state budgets forces to find alternative sourses for financing. Primarily such sourses are private investors and banks. Attracting such companies for participation in infrastructure development is one of the core vectors of modern Ministry of transport after the unification of all means of transport in it.

Sea ports are probably the pioneers where the appropriate conditions for private investments were created. Similar process with private participation has been launched in the sphere of airport terminals development. Almost at the same time the railway sector reform has started and one of the biggest infrastructure railways company has been created. It obtains a vast instrumentals for attracting private investments and best practice. It's bonds are now placing both on russian and international markets. Highways infrastructure sector was waiting for the concession mechanism.

And in the 2005 the special law on concessions agreements have been worked out and adopted. Special state company Russian Highways has been created. Now it attracts financing on a market basis. First two concession agreements were signed in 2009 and in 2013 first 30-year concession road has started functioning.

At the end of 2014 the second 30-year concession road - the beginning of new Moscow - St.Petersburg highway would be launched. Concession mechanisms has started it's implementation in road sphere but now also other types of infrastructure are planning to develop on a concession basis.

To the present moment the volume of private investments in transport infrastructure has exceeded 1 trillion rur (approx. 30 billion usd).

Different types of PPPs have been used for transport infrastructure development depending of the legislation, business traditions and culture. Creation of special project companies for separate projects is one of the most popular form of PPP and is used in all kinds of infrastructure. Other form of PPP is longterm investment contract. Concession is a kind of it and is regulated by the special concession law.

Lease contract with investments obligations is less used and mainly for infrastructure of maritime and airport.

Besides additional private finance PPPs allows to improve the quality of the object because part of the risks are transfred to the private party who is motivated for the high quality standards fulfilment.

PPPs are changing the motivation of the contractor and it becomes possible to switch to the project finance structure. Project finance principle allows to attract even more resources. Such as state funds.

In the year 2013 President of Russia Vladimir Putin announced that part of the National Wealth Fund would be invested in infrastructure. That is a very positive sign for the investment society. State funds are one of the most imporrant part of the PPP financing structure.

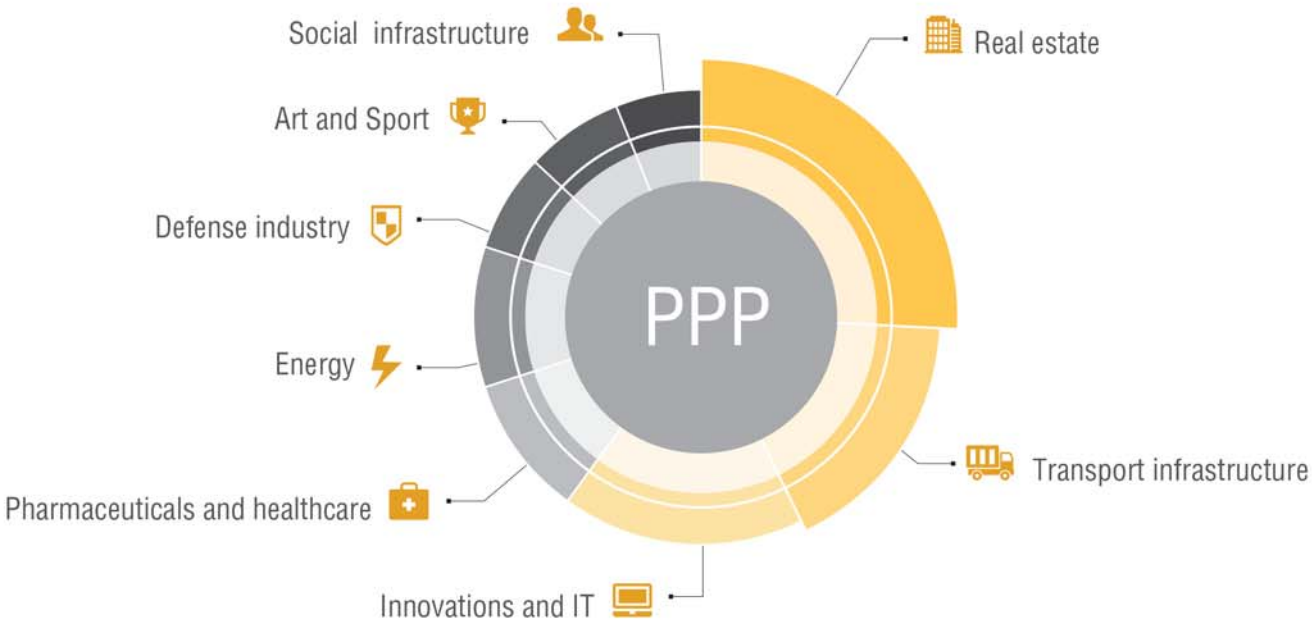
To the present time a pipeline of PPP projects is formed that is established by official documents programmes and investment plans of the companies. Every project has optimal legal and financial scheme.

According to the plans till the year 2020 the volume of private financing should exceed 2,5 trillion rur (approx. 71 billion usd) to the PPP project of all kinds of transport infrastructure.

YUST
LAW FIRM

Founded in 1992

PPP projects:



Why YUST?

Over **80** lawyers
recognized by Russian and international law networks and ratings

21 years of successful legal activity

Experts in PPP
project support at the regional and federal level

Reputation
of the best specialists of court practice – advocates with a high level of professional responsibility

The strong team of Partners,
consisting of several generations' representatives, which means combination of many years of experience and modern approaches to project management

43, Sivtsev Vrazhek Lane,
119002 Moscow, RUSSIA
tel.: +7 (495) 795 08 45
+7 (495) 795 32 72
fax: +7 (499) 241 19 48
www.yust.ru

The LEGAL 500 · ПРАВО.RU 300 · RANKED IN CHAMBERS GLOBAL · Best Lawyers® LINKING LAWYERS AND CLIENTS WORLDWIDE

PPP in the Housing and Utilities Services Sector

How not to Pour Private Investments Down the Drain?

By Anna Kotova-Smolenskaya, Doctor of law, Partner and **Dmitry Zhubrin,** attorney-at-law

Anna Kotova-Smolenskaya
Doctor of Law
Partner, "YUST" Law Firm

Dmitry Zhubrin
Attorney-at-law
"YUST" Law Firm

Investing in is currently one of the most popular topics in Russia. The reform of the sector involves the transfer in the near future of the majority of municipal infrastructure to private companies.

Continuously the sector of housing and utilities was financed mainly from the budget. The lack of market elements in this area was the cause for intra-monopoly and poor quality of services, and physical and moral deterioration of infrastructure due to the lack of financing for its development.

Foreign practice (USA, Europe) and the size of the annual turnover (according to experts over 4 billion) within the housing and utilities market in Russia, as every citizen is considered as the payer for public utility services – all this evidence in favor of the fact that this market sector cannot not be interesting for business.

The Government together with respective experts is doing a great job aimed at ensuring the investment attractiveness of the sector. Among of such measures: change of tariff policy, broaden options for attracting financing, guarantees compensation costs.

Currently, the utilities objects are owned by municipalities, which, in their turn, assign such objects to municipal unitary ventures established for this specific purpose. Meanwhile, the municipality remains the owner of the property and keeps the right to regulate tariffs within the limits set by the federal laws.

The existing model of utilities infrastructure management cannot be acknowledged as an efficient one, because the unitary ventures are not sufficiently interested in the improvement of the quality of rendered services and modernization of the infrastructure. The lack of financing is another significant problem: operator's expenses cannot be duly compensated by means of customers' payments due to the tariff system of pricing, and the municipal budges are unable to bear the necessary expenses.

World experience shows that public-private partnership is one of the most efficient mechanisms of solving the problems in the utility sphere.

Approximately 50 PPP projects in the utility sphere are currently being implemented in Russia. Attraction of private capital into this sector is usually done by lease, by privatization or on the base of a concession agreement.

LEASE

Long-term lease of municipal property is currently the most common mechanism of PPP in this sphere. Utility infrastructure objects are assigned to the investor on the basis of a lease agreement. The municipal unitary venture that owns the leased object on the basis of the right of economic responsibility is the lessor. Such agreements often stipulate the investor's obligation of capital repairs or improvement (modernization) of the leased property. The business's interest here is the possibility to exact payment for the rendered services from the populace.

Due to the requirements of antimonopoly legislation, the agreement of lease of municipal property may only be executed according to the results of a tender.

PRIVATIZATION

In the course of privatization, municipal unitary ventures that own infrastructure on the basis of the right of economic responsibility are transformed into open joint-stock companies, and said infrastructure objects are contributed to their charter capital. The municipality becomes the initial proprietor of the shares. The stock of the newly created joint-stock company may subsequently be sold to a private investor or remain in the property of the municipality.

CONCESSION

Concession agreements stipulate the obligation of the private partner (concessionary) to create and/or reconstruct the property determined by the agreement, while the property title to that property belongs or will belong to the public partner (assignor).

Concession is the most convenient mechanism of attraction of private funds, because, on one hand, it allows the assignor to keep the property title to the infrastructure objects; and on the other hand – it opens wide opportunities to attract private funds for the purpose of creation of new and modernization of existing objects as well as ensuring their efficient use.

Concession agreements in the utilities sector are successfully employed in the world practice. However, this form of PPP has not yet seen much practical use in Russia, and this is especially true concerning the relations of small and medium businesses with local and regional authorities. Such situation is largely due to the current imperfect legal and normative regulation.

Amendments to the Federal Law "On concession agreement" entered into force on January of 2014. They are aimed at the improvement of the attractiveness of said legal instrument for private investors, who wish to become operators of utility infrastructure objects. Such amendments stipulate the following provisions, inter alia, as material conditions for concession agreement sin that sector:

- Planned values of activity indicators, which the concessionary must reach in the course of performing under the concession agreement;
- Maximum amount of expenses involved in the creation or reconstruction of the object of the agreement and the procedure for their compensation;
- Long-term parameters of regulation of the prices (tariffs) for the services rendered by the concessionary.

The adopted amendments will allow to greatly alleviate the risks that private investors bear, when they enter into concession agreements, because said amendments will bring much certainty to the maximum amount of the concessionary's spending and also set the indicators of efficiency of the agreement's performance.

However, it should be acknowledged that the measures taken until now are not sufficient for any crucial change of the situation: a comprehensive reform of the legislation in this sphere is required, with regard to the accumulated experience and world practice.

Long-term lease of municipal property is currently the most common mechanism of PPP in this sphere. Utility infrastructure objects are assigned to the investor on the basis of a lease agreement. The municipal unitary venture that owns the leased object on the basis of the right of economic responsibility is the lessor. Such agreements often stipulate the investor's obligation of capital repairs or improvement (modernization) of the leased property. The business's interest here is the possibility to exact payment for the rendered services from the populace.

The Government of the Russian Federation has recently approved another set of amendments to the Federal Law "On concession agreements" prepared by the Ministry of Economic Development of Russia. The respective draft law will be filed with the State Duma in the nearest future.

The draft of the amendments, in particular, includes the following changes:

- The sphere of application of the life cycle contracts has been expanded: the possibility to extend the mechanism of payment by the assignor to the concessionary for any objects of the concession agreement (this used to be possible only concerning automobile roads);
- The possibility for the concession agreement object to be on the right of operative management (this is currently a holding-back factor for modernization of many infrastructure objects);
- The mechanism of change of material conditions of concession agreements and of change of the concessionary has been determined;
- The possibility to execute a concession agreement on the initiative of the private investor without tender, if only one participant files the application.

We believe that adoption of said amendments will open the way to elimination of a majority of legislative obstacles and significant improvement of the attractiveness of PPP projects in the sphere of utilities for business.

In the course of privatization, municipal unitary ventures that own infrastructure on the basis of the right of economic responsibility are transformed into open joint-stock companies, and said infrastructure objects are contributed to their charter capital. The municipality becomes the initial proprietor of the shares. The stock of the newly created joint-stock company may subsequently be sold to a private investor or remain in the property of the municipality.

The Favorable Investment Climate is a Necessary Condition for the Implementation of Public–Private Partnership (PPP) Projects

By Igor Slyunyaev, Minister of Regional Development

Over the last ten years, Russia made a way to the market, to which most industrialized countries took a century to come. Russian economy has undergone a lot of significant changes, has become open and stable. This is proved by the leading rating agencies and macroeconomic indicators.

In the World Bank's ranking of Doing Business the Russian Federation was in the top hundred in 2013, in the Bloomberg's ranking – in the fifth decade, and, what is most important, – every year forward movement is proceeding in all areas of economic development and quality of life.

The Federal Government, Russian regions, companies and civil society institutions take an active part in improving the business climate in Russia. The President of the Russian Federation Vladimir Putin controls this work personally. He set a target by 2018 to bring Russia to the top twenty countries in terms of doing business.

Russian legislation was significantly improved, in connection with the requirements of the World Trade Organization, the next step – joining the Organization for Economic Co-operation and Development (OECD), which also entails improving the legal framework in the field of capital investments regulation, financial markets and fight against corruption.

Attracting investment through the public–private partnership (PPP) tool is becoming one of the main directions of the state policy.

There are few PPP forms which are used in modern Russia and most of them are limited by the concession agreements according the WTO scheme (Construction – Transfer - Management). However, this area is under active legal registration. Not so long ago, in February the Federal

Government prepared amendments to the Federal Law "On Concession Agreements" and separate legislative acts of the Russian Federation, aimed at expanding the scope of the concession mechanism.

Specifically, we are planning to extend the fee mechanism of the grantor to the concessionaire not only for motor roads, as it is now provided by legislation, but also for the entire list of objects of the concession agreement. This quota will allow to implement investment projects with the use of deferred charge (TIF), in which reimbursement of the expenses of private investor for building infrastructure is at the expense of tax revenues from the projects generally. As a tool for returning funds to the investors it is supposed to use the Investment Fund of the Russian Federation.

The new draft law provides the possibility for finding objects of the concession agreement on the right of housekeeping or for operational management at the state or municipal unitary enterprises, for operational management – at the state, municipal budget and autonomous institutions. Currently, the Ministry of Sports, Ministry of Culture, Ministry of Health, Ministry of Education, Ministry of Regional Development and its subordinate agencies and enterprises themselves have 49,000 objects.

We are expanding the opportunity to participate on the side of the grantor several individuals what will allow to create large linear objects under a concession agreement on the territory of several public law entities.

It is planned to legislatively guarantee the return on investment (ROI) of concessionaire and receive the amount of revenue provided by the concession agreement.

The possibility to conclude a concession agreement on the initiative of the private investor that will simplify the procedure of the tender for the concession agreement, as well as shorten the period of the conclusion of such an agreement, - is a very important step. Some amendments will also be added to the Federal Law "On Privatization of State and Municipal Property". They stipulate that peculiarities of particular property privatization, that is a part of the concession agreement, after its expiration date can be set by concession legislation.

By using these legal steps, we are moving towards widening the use of the mechanism of concession agreements at the federal, regional and municipal levels.

However, for the effective operation of the PPP it is also necessary to create a favorable business environment in Russia and investment in various sectors of the economy.

It is noteworthy that in the report "Russian regions: growth drivers", which was presented at this year's World Economic Forum in Davos, it was concluded that for investors nowadays is useful not to look at Russia generally but on its regions individually. Eleven Russian regions now have indicators of the economy and investment attractiveness higher than the national average and significantly higher than in the EU.

In the regions of the Russian Federation special legislation to support investment was established. Investor's support mechanisms were added: tax breaks on property and income, interest rate subsidies on the attractive loans, state guarantees.

For example, Krasnodar region offers its residents a decline of 4.5% rate on corporate income tax and exemption from property tax for the period to 10 years, Leningrad region offers to the large investors a zero rate of tax on property and 13.5% for income tax.

There are about 300 regional development institutions, supporting investment projects, including: regional investment funds, business incubators, industrial parks, venture capital funds. Therefore, the "best practices" and more comfortable environment should find relation to specific areas and cities.

The Ministry of Regional Development of the Russian Federation carries out focused and systematic work to ensure favorable investment climate in the regions. Work carried out simultaneously on several fronts: the introduction of the common standard in the investment activities of the regional authorities, the alignment of the system of regional strategic and territorial planning, training and retraining of civil servants responsible for economic development and investment, reducing administrative barriers for investment, especially in the construction field.

The objective was set to reduce the number of administrative procedures in obtaining a building permit from the current 50 to 11, the number of days in obtaining building permits – from 423 to 56, to reduce about half of the costs incurred by the investing company for administrative procedures at the beginning of the construction of the facility.

In the Ministry of Regional Development of the Russian Federation a working group was created in 2013 aimed at increasing the investment attractiveness of the Russian Federation. This group selects promising investment projects, which further get assistance through the development of mechanisms of getting extra-budgetary investment. Working group acts as an integral platform for cooperation between public authorities, banks, investors and initiators of investment project.

In 2014, the Russian investment agency "Invest in Russia" was registered – on the initiative of the Ministry of Regional Development of the Regional Development and with the active participation of the World Association of Investment Promotion Agencies (WAIPA), consolidating 180 investment agencies from 130 countries. The presentation of the new Agency will be held in March at the site MIPIM in Cannes.

The Russian Federation is the only one of the BRICS countries, in which there wasn't specialized national agency focused on working with the regions. Now this niche is filled, out Agency will coordinate the activities of regional agencies, and also act as a subcontractor for the similar foreign development institutions.

A considerable work is underway on the investment attractiveness of the Russian Federation. And today, the call: Invest in Russia!" sounds like a good offer.

Postion of the Russian Federation in the Doing Business Report by the WORLD BANK GROUP

Year	Position of the Russian Federation
2010	120
2011	124
2012	120
2013	112
2014	92

PPP in Russia 2013:
Results, Trends and Actions for the Future

By Dmitry Kovalev, Capital Projects and Infrastructure, Partner, PwC Russia and **Yulia Kostina,** Capital Projects and Infrastructure, Manager, PwC Russia

A lot of concerns and questions have been raised regarding the sustainability of Russia's public-private partnership (PPP) market over recent years. Primarily, projects have faced difficulties in their implementation despite vast and established international practice. However, 2013 was successful enough for the development of PPP practice in Russia. Some key PPP-related stories in 2013 were the following:

- Several large Russian PPPs reached their next phase of development: the Western High-Speed Diameter highway (WHSD) reached its financial close in February 2013; Pulkovo Airport was put into operation in December 2013;
- Development of regional projects: A PPP project for the construction and operation of two toll bridges in the Udmurt Republic (with total capital expenditures over RUB 12bn) reached its financial close in September 2013.
- There has been rising interest in Russia on the part of international investors: France's Vinci Concessions has participated in several tenders over recent years while Spanish companies Construcciones y Auxiliar de Ferrocarriles, S.A., Corsan-Corviam Construccion S.A., Sacyr Concesiones and Macquarie Infrastructure & Real Assets are ready to invest in the country through the Russia & CIS Infrastructure Fund.

We would like to highlight five main trends in 2013 that demonstrate key changes in industry.

LEGAL CHANGES - AMENDMENTS TO THE FEDERAL LAW ON CONCESSIONS

In spring 2013, the State Duma approved the Federal Law "On Public Private Partnership" in its first reading. Throughout the year, there was much debate about the details of this law on the part of state representatives, lawyers, bankers and private investors. Owing to these disputes, the Ministry of Economic Development prepared draft amendments to the Federal Law "On Concession Agreements". The main changes are the following: (1) the list of real estate objects/ facilities which can be transferred under concession is now unlimited; and (2) state operational payments are now allowed for any project, not just highway development.

In February 2014, the Russian government approved these amendments. As a result, we expect an increase in the number of concession agreements in 2014 as limitations on concession objects are no longer an issue. Furthermore, the option for including an operational payment from a public source in an agreement will likely make concession projects more attractive.

The most important issue, which is still under discussion, is the criteria for separating concession projects and state orders. The Federal Antimonopoly Service recommends considering only those projects where a private source provides no less than 50% of financing as public partnerships.

Financing opportunities – resources from the National Welfare Fund can be used for projects deemed to be important for the state

Not only legislative difficulties have slowed PPP development Russia. The amount of capital expenditures for the majority of projects is usually too large for development without proper state support. In addition, investors and creditors are currently concerned by instability, risk and discomfort with respect to financing.

In November 2013, Russian President Vladimir Putin approved the allocation of no more than 40% from the National Welfare Fund in order to finance projects considered to be important for the state, such as construction of the Central Ring Road (CKAD) in the Moscow Region, as well as the reconstruction of Baikal-Amur Mainline (BAM) and Trans-Siberian Railway.

In order to obtain financing from the National Welfare Fund, projects should be self-supporting (i.e. the project's rate of return should exceed the inflation rate by at least 1%). Furthermore, each project should undergo a selection process with the involvement of the relevant industrial ministries, as well as the Ministry of Economic Development and the Ministry of Finance.

The authorities' participation in project selection is very important in order to ensure a qualitative review.

Nonetheless, a significant issue now under discussion concerns the specific rules for projects with foreign investors. The Ministry of Finance suggests changing the rules for investing National Welfare Fund sources in projects with the participation of the Russian Direct Investment Fund (RDIF) and its foreign partners. The Ministry of Finance believes that foreign investors should invest no less than what the RDIF contributes along with the National Welfare Fund (in cases of consolidated financing). The Ministry of Finance also wants a comparable rate of return for both state investments and foreign partners. Such requirements could make certain projects extremely unattractive for foreign investors and would hinder the attraction of investment.

ADDITIONAL CONTROL OVER CAPITAL EXPENDITURES – TECHNOLOGICAL COMPONENT

The government is continuing to develop new additional measures in order to ensure sufficient control over PPP projects. Since 2014, all state investment projects with total capital expenditures more than RUB 8bn are obliged to pass an independent technological and price review. State financing is allocated only if an independent advisor has issued its positive assessment.

The technological and price review analyses various technological and cost aspects in order to make sure that they correspond with modern technologies

and the set requirements. Even if total capital expenditures are reasonable, a review can uncover reserves making it possible for further reductions in costs.

Some participants argue that this is a "double-check" since any construction project in Russia now should receive the approval of a special state institution (Glavgosekspertiza). For instance, officials have noted that Glavgosekspertiza already checks a project's estimates and its conformity to safety requirements.

Nonetheless, this initiative has garnered a positive response. For instance, in 2014, technological and price reviews will be performed for Central Ring Road and four other projects of State Company Russian Highways. Other mega-projects, such as the reconstruction of the Baikal-Amur Mainline and the Trans-Siberian Railway, are also subject to this procedure.

Thanks to this measure, the minimum project cost following a review could be reduced form RUB 8bn to RUB 5bn.

ADDITIONAL CONTROL OVER CAPITAL EXPENDITURES – INVOLVEMENT OF FINANCIAL INSTITUTIONS

Additional control over capital expenditures is now also expected to be implemented by financial institutions. In December 2013, a proposal was made to introduce obligatory banking support for capital projects. Banking support assumes that a bank will open separate account for construction project calculations in order to separate the investment stream from any other economic activities of the contractor. Hence, this averts mixing investment resources for a project with the contract's regular operating activities.

Banking support will likely help track project expenses correctly by, for instance, making sure that payments corresponded to the total cost sheet, that they are made in due time and in the required amount. This will likely result in significant reductions in inappropriate expenses and suspicious operations.

Banking support will likely be applied for the first section of the Central Ring Road. We also believe that additional control is necessary.

Not only legislative difficulties have slowed PPP development Russia. The amount of capital expenditures for the majority of projects is usually too large for development without proper state support. In addition, investors and creditors are currently concerned by instability, risk and discomfort with respect to financing.

ENCOURAGEMENT OF PRIVATE INITIATIVES

In February 2014, the Russian government approved draft amendments to the Federal Law "On Concession Agreements" as prepared by the Ministry of Economic Development. In addition to the changes mentioned above, these amendments include an option for entering into agreements without a tender if an initiative originates from a private source. The public side will have the option of not holding any tender if the private party with the initiative enters into an agreement.

The private side should send its offer to the government (either to a regional administration or municipality, depending on what the property in the proposed project consists of). If officials agree that the project is necessary, they should declare the option of its execution to other applicants for the contract by publication of the project concession agreement on the internet. Potential participants have 30 days after this publication to declare their interest for the project. If responses are not forthcoming, the agreement can be concluded with the company initiating the project without the need for a tender.

In short, this approach is in place in order to simplify and optimise tender procedures. Furthermore, it also simplifies the participation process for the private investor. In addition, it shortens the terms for concluding an agreement. This would also reduce budget expenses for preparing tender documentation and executing the process. This type of regulation of private initiatives is very important for Russia's regions.

Among the major issues for discussion regarding this measure, market participants noted the shortened timeframe for providing a response. For instance, over a 30-day period, a potential participant may have to decide on their involvement based on available public information that may be insufficient. Furthermore, the notification of potential applicants may be not be made in due time. This might be quite difficult for foreign companies owing to their internal corporate procedures even if they declare their readiness to take part in a tender.

Although the overall idea has generally received positive appraisal, its implementation currently demands more accurate regulation and a lot more clarifications.

We want to express our hopes that last year's initiatives will positively impact on industrial development, which, in turn, should continue to become more efficient.

Additional control over capital expenditures is now also expected to be implemented by financial institutions. In December 2013, a proposal was made to introduce obligatory banking support for capital projects. Banking support assumes that a bank will open separate account for construction project calculations in order to separate the investment stream from any other economic activities of the contractor. Hence, this averts mixing investment resources for a project with the contract's regular operating activities.

With Years of Frugality Ahead, It is Time the Russian Infrastructure Market Embraced the Megaprojects Concept

By Sergey Samolis, Senior Project Manager, Eurasian Development Bank

Though the PPP legal and regulatory framework is still far from being sufficient, and the Federal PPP Law debate protracting for years, there is considerable room for relatively fast-track improvement of the way that Russian infrastructure projects are being planned and executed should the modern post-Enron methods of project management be embraced. The so called "third wave of project management" with a strong emphasis on the planning stage and analysis of ex ante project risks encourage taking an outside view of the project as a means of overcoming optimism bias and other reasons for delusion and deception - genuine and malicious - particularly relevant for mega project development.

MACROECONOMIC BACKDROP

The new, more conservative official forecast of social and economic development of Russia, produced by the Economic Development Ministry this November, revised the long-term GDP growth rate from 4% to 2,5%. Within the year 2030 forecast horizon Russian economy is expected to lag behind the global economic growth rate (anticipated average of 3,4-3,5%) even on the basis of a bullish assumption regarding the oil prices dynamics (range of $90-100 per barrel in 2010 inflation-adjusted US dollars). To meet Present Putin's 2012 pre-election commitments, Russian economy would have to grow along the lines of the "accelerated scenario" at an ambitious 5-5,3% GDP growth rate.

The key downward revision factor vis-a-vis the more optimistic "innovation scenario" of March 2013 is a lower level of investment (from 3,5% to 2,2% GDP), in particular a more conservative outlook on private investment in infrastructure. According to the Economic Development Ministry, chances to meet the "accelerated scenario" parameters hinge primarily on spearheading new projects in transport infrastructure with a strong emphasis on PPPs that would allow replacing public spending with private investment.

RUSSIAN PPP EXPERIENCE

The first Russian PPPs achieved financial close in 2010, and neither of transport infrastructure PPPs is through the construction stage yet. Currently some databases refer to over 850 deals signed on the basis of the Federal Concessions Law or regional PPP legislation. However, most of the experts concur that, probably, only less than a dozen of those in fact display the key features of PPP deals, such as transparent procurement rules, detailed risk and benefit sharing structure between the public and private participants, lender participation in deal negotiation and documentation, etc.

Year 2014 looks promising in terms of number and volume of transport infrastructure bids to be awarded by the state owned Russian Highways Company Avtodor (toll roads, total amount circa Rub 870 bn.), Federal Road Agency – a bridge spanning the Lena river next to Yakutsk (Rub 56,3 bn.), Moscow Underground – a 30-year supply and maintenance contract for 3.000 metro cars (Rub 200 bn.), etc. As compared with the first PPPs of 2010, competition is higher today with more local as well as international companies forming consortia. The overall quality of participants is higher as well, largely due to experience of earlier landmark projects such as international award-winning Pulkovo Airport and Western High Speed Diameter toll road PPP deals in StPetersburg as well as M1 and M11 toll road concessions nearby Moscow.

FUNDING SHORTFALL

However the above project pipeline, itself instrumental for spearheading GDP growth, may be compromised by the current Government drive for fiscal austerity as well as reduced balance sheets strength of regional authorities, translating into the growing lack of public sector funding capacity. As a result, fewer new projects will be originated; some deals may be stuck in the development pipeline prior to coming to market. Existing and new PPP projects with a tariff-based revenues (in particular, the municipal infrastructure ones) are hit by the freeze for tariff growth in 2014 to be followed by capping tariff growth at inflation rate until 2023. Government decision to use 100% of the savings component of mandatory pension contributions to partially replace Federal Budget transfers into the Pension Fund of Russia in 2013 and 2014 effectively wiped out Russian pension funds (state as well as private) as major, not to say the only, sources of CPI+ coupon project bonds for the growing number of PPP deals with inflation-linked toll structure.

To plug the resulting gap in transport infrastructure financing Russian authorities discuss tapping into the sovereign National Welfare Fund to finance the Transsib and Baikal-Amur Railway projects as well as the Central Ring Toll Road in the Moscow Region to the tune of Rub 150 bn. for either of the two projects. It is noteworthy that another high profile megaproject, the over Rub 1 trillion Moscow - Kazan High Speed Railway, has for the time being failed to secure NWF financing, Economic Development and Finance Ministries experts challenging the project traffic forecast and costs projections.

MEET THE MEGAPROJECTS CONCEPT

Facing the budgetary constraints the Russian authorities are hard pressed to change tack from next to profligate spending on numerous sport and political mega-events (to mention just the 2014 Sochi Olympics budget, already escalated to over USD 51 bn. from the originally envisaged USD 19 bn.) that cause a lot of public outcry, to a more prudent approach. It is no surprise that top level officials, including Vladimir Putin, got involved in discussions of the merits of megaproject management and financing, the Russian President recently admitting that Russian infrastructure investment in still notoriously poor in terms of estimation and control of costs.

Megaproject definition criteria:

- must cost more than a billion dollars;
- must take more that 5 years to move from design to operations;
- must affect more than a million people';
- must have a transformational impact on the area in which it is located.

Source: "The Megaprojects Paradox", interview with Professor Bent Flyvbjerg (Chair of Major Programme Management, Oxford University's Saïd Business School) to KPMG's "Insight", Issue 4, 2013

USEFUL LESSONS

Though the PPP legal and regulatory framework is still far from being sufficient, and the Federal PPP Law debate protracting for years, there is considerable room for relatively fast-track improvement of the way that Russian infrastructure projects are being planned and executed should the modern post-Enron methods of project management be embraced. The so called "third wave of project management" with a strong emphasis on the planning stage and analysis of ex ante project risks encourage taking an outside view of the project as a means of overcoming optimism bias and other reasons for delusion and deception - genuine and malicious - particularly relevant for mega project development.

With over a decade of megaprojects theory development, now focusing at the Major Programme Management Centre at the Saïd Business School (University of Oxford), Omega Centre for Mega Projects in Transport and Development at the Bartlett School of Planning (University College London), to name just two, the nucleus of practical application of that methodology currently is with the Major Programme Management Association, established in 2010 within the UK Cabinet Office structure. All projects above GBP 1 bn. seeking the HM Treasury support are subject to MPA scrutiny, which led this May to 32 out of 191 schemes worth GBP 350 bn. given a red or amber/red rating, i.e. deemed unachievable or in doubt, saving the British taxpayer more than GBP 1,7 bn.

Though no equivalent of MPA yet exists within the Russian Government structure, many of the megaprojects management methods already featured in first Russian PPPs owing to rigorous due diligence and tough negotiating stance of the lenders, led by IFIs (EBRD, IFC, EDB, etc) and major Russian banks (VEB, VTB Group, Sberbank, Gazprombank). For instance, the M11 toll road and Pulkovo Airport PPP deals were phased with ramp-up periods introduced on lenders request allowing to slim down the asset design until traffic is sufficient for the facility expansion, thus giving an answer to a typical megaproject hazard of early project stage overcommitment. The technique of reference forecasting, at the core of megaproject planning, was applied on lenders' insistence, when the WHSD toll road traffic forecast took a 20% haircut in line with observations that similar projects typically were 20% wrong in their traffic projections.

EFFICIENCY PROVEN

Lenders taking an outside view of the project with a conservative slant counterbalancing optimism bias of the public authority and the concessionaire proved effective, looking at the financials of the first Russian PPP to record a full year in operational stage. Passenger traffic at the Pulkovo airport in 2012 was recorded at 11,15 million, outperforming the project bankers' base case financial model by 8,5%, total gross revenue outperformance was 11%. Year 2014 will witness first Russian toll roads becoming fully operational, providing in one year's time more statistics to gauge efficiency of forecasting traffic and evaluating costs of first Russian mega infrastructure PPPs.

Growing but Slowing: Russian CEOs Expectations for 2014

By David Gray, Managing Partner, PwC Russia

Given the interest of the international business community in Russia, as well as Russia's significance to the global economy and its role in geopolitics, we have put together a Russian edition of PwC Annual Global CEO Survey for the second year in a row. The number of Russian CEOs from various industries taking part in the survey this year has increased to 56, including a number who provided in-depth interviews. This has allowed us to take a comprehensive look at the state of Russian business and offer an objective picture of the Russian economy through the eyes of some of its key players.

We've named the 2014 survey "Growing but slowing". Russian CEOs are losing confidence and believe that the country requires sweeping and fundamental changes to drive further growth.

2013 was clearly rather disappointing for Russia; the pace of economic growth in the country slowed over the course of the year, even as expectations for economic growth in developed economies such as the USA and the UK recovered. Perhaps reflecting this pattern, the results of the PwC Global CEO Survey highlight that Russian CEOs confidence has fallen, even as their Global piers are increasingly more optimistic.

According to the results of the Russian edition of PwC's 17th Annual Global CEO Survey, 17% of Russian CEOs are confident in improved global growth in 2014 in contrast to 44% of CEOs globally. A year before, only 18% of CEO's globally surveyed expected to see growth in the global economy so there has been a clear pick up in expectations outside Russia.

In 2013 Russian CEOs were the most optimistic among their global peers, especially in regards to their revenue growth forecasts, where 95% of them were confident that their companies' earnings would increase. This year they are slightly more cautious in their predictions. Nevertheless, 74% of CEOs in Russia remain confident that their own companies will post revenue growth compared to 85% of their global counterparts.

Russian top managers, as with CEOs in other countries, are increasingly on the lookout for new game-changing technologies and anticipating changes in consumer preferences.

Russian CEOs also believe that the government has to play a critical role in supporting new sources of growth for the economy through a continued focus on improving the investment climate of the country.

Highlighting Russia's market size, this year, Russia for the first time joined the Top-10 countries cited by respondents as being of most important for their respective companies with respect to business development. 7% of CEOs surveyed plan to develop their businesses further in Russia over the next 12 months.

WHAT ARE THE BIGGEST CONCERNS FOR RUSSIAN CEOs?

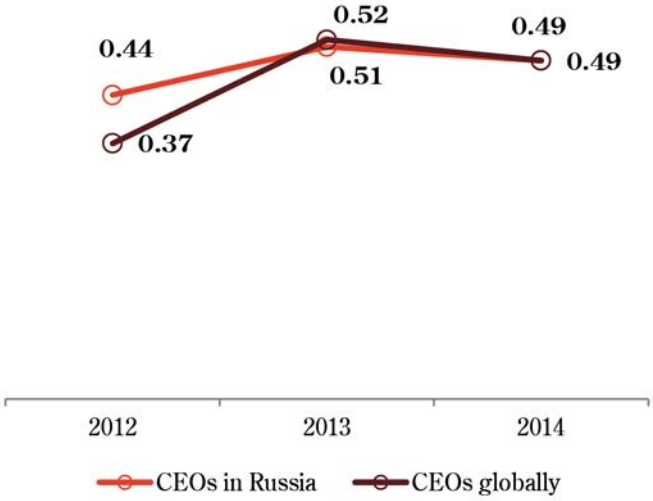
CEOs from Russia mentioned technological advances (77%), shifts in global economic power (60%) and demographic changes (55%) as key trends impacting their businesses.

The deficit of skilled human resources remains a critical concern for Russian CEOs. 85% of Russian CEOs are either partially or very much alarmed by the lack of qualified personnel and believe this could be a threat to economic and political stability in the country.

In 2014 a possible lack of stability in capital markets moved to the second place in terms of main concerns for Russian CEOs compared to the seventh place last year. Russian capital markets have underperformed in the last year, failing to track the recovery seen elsewhere in the world.

Figure 1. Percentage of CEOs globally and in Russia confident that global economy will improve over the next 12 months

Figure 2. Percentage of CEOs globally and in Russia confident that global economy will stay the same over the next 12 months



Shifts in consumer spending and behaviours are also a matter of concern for 70% of Russian CEOs. This is higher than in the rest of the world (52%) perhaps reflecting the "maturing" of the Russian consumer, following a period of catch up. In addition, 70% of Russian CEOs are concerned by the possibility that tax hikes could pose a threat to their businesses, reflecting concerns about the deteriorating fiscal position of the Russian state as the economy slows.

GETTING READY FOR THE FUTURE

In the past year, Russian CEOs have taken active steps towards restructuring their operations. For example, 79% of respondents implemented initiatives to reduce costs in their businesses, 28% entered into a new strategic alliance or joint venture, and 15% carried out a merger or acquisition at the national level. It looks like 2014 will also be busy with many companies planning to take further initiatives to reduce costs (49% CEOs in Russia and 64% globally), or to enter a new strategic alliance or joint venture (35% in Russia and 44% globally).

It is interesting to note that Russian CEOs are more cautious than their counterparts around the globe with respect to outsourcing business processes. In the near future, only 11% of the interviewed Russian CEOs from Russia were ready to outsource a part of their companies' functions, but 9% considering to actually halting outsourcing.

WHAT DO CEOs WANT FROM GOVERNMENT?

Russia CEOs noted three key priority areas for government: developing a skilled workforce (51%), improving the country infrastructure (49%), and ensuring financial sector stability and access to affordable capital (47%). Furthermore, 45% of Russian business leaders believe developing competitiveness globally and an effective tax system to be important while 28% considered developing innovative ecosystems able to support growth to be key.

Overall, Russian business people are inclined to consider government measures to support growth to be less effective compared to their counterparts in other countries. For instance, 46% of the CEOs of the leading global companies in various countries believe that their respective governments are effective in stabilising the financial sector and ensure access to inexpensive capital (for example, 53% of CEOs in China expressed this opinion). In Russia, only 15% of CEOs hold this position.

A key concern expressed by CEOs was the lack of development in base infrastructure. This was a concern expressed by business leaders in BRICS countries in particular, including by 53% of Russian CEOs.

Also, according to the PwC survey results, graft and corruption are still considered major threats to the economies of emerging markets. For instance, 62% of the CEOs surveyed in Russia are concerned by the impact these factors have on economic prospective.

SO WHERE ARE WE GOING IN 2014?

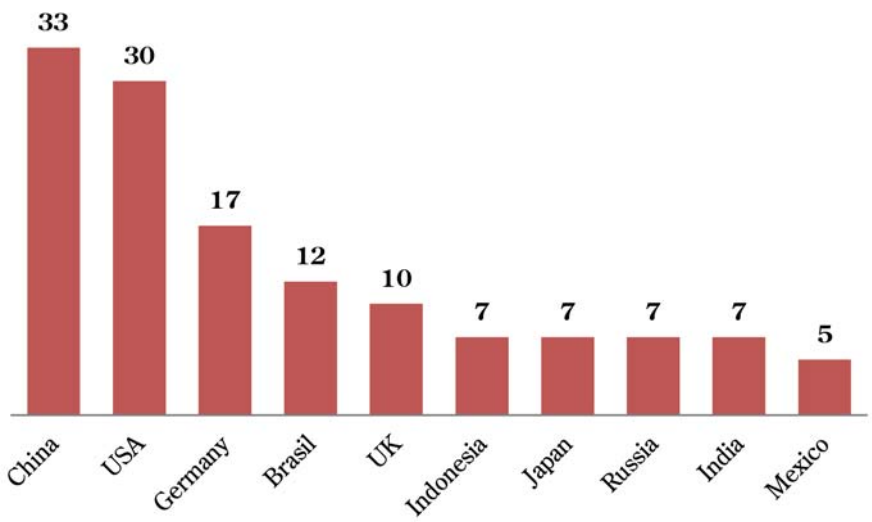
Looking at the prospects for 2014, I continue to believe that Russia has the latent capability to sustain growth above some of the moderate rates that have been talked about by many forecasters, including government ministers, which have been in the range of 2-2,5%. In my view such levels of growth would represent an underachievement under the likely benign international economic environment in 2014. Russia still be targeting 3-5% growth, but to achieve that level of growth we need to see more progress in the diversification agenda, driving growth in key innovative sectors, including the middle market and small business sectors and growth sectors such as technology and services.

There are positive signs in many parts on the middle market and small and medium business sectors, and that is certainly something that we are seeing in our own business in terms of demand for our services, which started to pick up even as the economy has slowed in the last half of 2013. It is critical that the government continues to work on providing support for growth through reducing bureaucracy, effectively challenging corruption and also looking at the cost of capital in the economy which, among other factors, is driven by the perceptions around the business environment and the ease of doing business in Russia.

All of us involved in Russian business can play a part in helping to deliver growth and improved standards of corporate governance and social responsibility. There is undoubtly a great deal of talent and entrepreneurial skill in Russia. If business can capture the opportunities that these natural human resources bring we can deliver the kind of growth that Russia needs in order to meet the challenges posed by global competition, which only gets stronger every year. The rest of the world will not stand still and unless we in Russia are pushing ahead in business we will continue to struggle to compete globally.

As 2014 started I was looking forward to the Sochi Olympics which is a focus for Russia and the world in the first quarter of 2014. Despite the relentlessly negative coverage in much western media, the Sochi Olympics have demonstrated that there is a new Russia out there which the media, and especially the international media, often misses. Real progress has been made in terms of modernizing Russia`s infrastructure and society, to the benefit of all Russians. In Sochi a modern, confident Russia showed what it is capable of. Hopefully Russia can continue to move up the economic medal table.

Figure 3. Countries that CEOs globally consider the most important for overall growth prospects over the next 12 months, % of respondents



Central Bank of Russia's List of Systemically Important Banks is Unlikely to Prompt Rating Actions

By Standard & Poor's Rating Services

HIGHLIGHTS

- ***The Central Bank of Russia (CBR) has published preliminary criteria to identify which banks in Russia's fragmented banking sector are systemically important.***
- ***We believe these banks will account for about 80% of total system assets and therefore affect the whole sector's regulatory and competitive environment***
- ***We do not expect the publication of the CBR's list of systemically important banks to have any immediate impact on our ratings on Russian banks.***

The Central Bank of Russia (CBR) has published preliminary criteria to identify which banks in Russia's fragmented banking landscape are systemically important. Standard & Poor's Ratings Services anticipates that the list will likely include about 50 banks, which the CBR might place under stricter supervision. Given that these banks represent more than three-quarters of total banking sector assets, we believe this will affect the regulatory environment for the whole banking system. But we do not expect the list to immediately affect our ratings on Russian banks.

The CBR's criteria factor in banks' asset size, involvement in the domestic interbank market, and their amount of retail deposits. Even if the CBR's list ends up shorter, we still believe it will include more than 60% of the banking sector's assets, given that the five largest players constitute about 57% of total system assets. We also believe banks that don't make the list are likely to be affected indirectly because the regulatory and competitive landscape will change for them too, depending on how the list is perceived by the banks' clients and what further regulatory steps the CBR takes for systemically important banks.

We also believe that, in the final legislation, the CBR is likely to leave some room for the use of its own analytical judgment.

Our criteria already consider some public and private banks to be of "high" or "moderate" systemic importance, in Russia and the rest of the world. That means we already give Russian banks that meet this definition an uplift above their stand-alone credit profiles (SACPs) to reflect our view that the authorities would be likely to intervene to prevent a failure that would have a large negative impact on the local economy and financial system. We give no uplift to banks with "low" systemic importance and therefore do not expect the publication of the CBR's list of systemically important banks to have any immediate impact on our ratings on Russian banks.

SYSTEMICALLY IMPORTANT BANKS COULD FACE TOUGHER REGULATION

We believe that the CBR might follow similar actions by regulators across the world trying to define their banking systems' cores by compiling lists of strategically important banks. So far, the G20's regulatory policymaker, the Financial Stability Board, has published a list of 29 global systemically important banks (G-SIBs). Some national regulators, including the U.S., Japan, and Denmark, have published their own lists, and the assets of the banks under special regulation usually account for approximately 60-80% of total systemwide assets. Regulatory frameworks for systemically important banks and tools to ensure orderly recovery and resolution regimes differ across countries, and no single established and internationally recognized framework is in place. Furthermore, progress on the development of special regulation for systemically important banks is uneven internationally, and each country is working at its own pace to implement an effective resolution framework for failing banks.

It is not yet clear if and when the CBR will introduce significantly tougher regulations for systemically important banks. However, based on our observations in other countries, "too big to fail" institutions are usually required to hold more capital, meet higher risk management standards, show better data aggregation capabilities, and stick to stricter internal controls. If the Russian regulator eventually imposes stricter rules for larger players, it could prevent these banks from expanding into unproven and risky areas, hamper business growth, and create some benefits for smaller players in the system.

In our view, the banks the CBR eventually decides are systemically important will differ widely from each other in terms of size. For example, Sberbank, Russia's largest bank, will be 100 times larger by assets than the fiftieth-largest bank. We therefore believe it could be difficult to introduce unified higher regulatory requirements for all of the banks on the list.

At the same time, we expect that, regardless of the new regulation, the dominance of larger players in Russia is likely to strengthen further. We see this as a long-term fundamental trend driven by economic considerations such as protracted economic slowdown, combined with the limited profitability and scarce capital supply for smaller Russia-based financial institutions.). Currently more than 900 banks operate in Russia, some of them very small and regional, with marginal integration into country's financial system. The largest 200 banks comprise approximately 95% of total sector assets.

WE BELIEVE THE RUSSIAN GOVERNMENT, LIKE MANY EUROPEAN ONES, REMAINS SUPPORTIVE OF ITS DOMESTIC BANKING SECTOR

We believe that the Russian government would be ready to provide liquidity and capital to state and privately owned systemically important banks to avoid a destabilization of the sector as a whole. The new regulation could also clarify the CBR's policy on providing support to the banks, thereby reducing the risk of moral hazard from bank owners' or clients' perception of implicit support from the CBR in case of need.

At the moment, we assess G-20 governments, with the exception of Argentina, as "supportive" or "highly supportive" toward their national banking systems, meaning that governments still have leeway to bail out banks, despite the agreement on bank resolution regimes.

The predictability of support for the financial sector by the authorities has improved since 2008-2009, but Russia's immense size and its very large number of banks have sometimes led to an uneven track record in supporting private-sector banks. There have been examples of the Russian authorities rescuing banks with only negligible market shares in terms of systemwide assets, when they were notable regional players. We believe such cases could arise in the future, especially given the tensions and retail deposit volatility in several regions at the end of 2013, following some license withdrawals among midsize Russian banks.

We do not anticipate early introduction of recovery and resolution regimes for systemically important Russian banks. We think the core aim of the special regulatory regime for large financial institutions is to avoid a scenario in which the government steps in to support an insolvent bank and spends taxpayers' rather than shareholders' money. A resolution regime could address the problems arising at the largest financial institutions clearly, consistently, and predictably. It could avoid the negative consequences of market perception that some banks are too big to fail. At the same time, the largest banks in Russia are state controlled, and we believe that the Russian government will continue to be supportive and provide necessary funds to bail out these banks in case of need. We also think that privatization of the largest financial players is unlikely in the near future. Our view is reflected in the uplift for extraordinary government support we give to our ratings on several Russian banks that we identify as government-related entities (GREs).

Nevertheless, we expect the government and CBR to focus more on preventive measures to avoid distress and costly bailouts for systemically important banks. Higher capital adequacy requirements for these banks, more stringent regulatory oversight, and requirements for regular stress tests could all be considered by the regulator to strengthen the banks' creditworthiness and prevent them from failing.

Standard & Poor's View Of Russian Rated Banks' Systemic Importance

	Systemic importance	Type of support
Banks with high systemic importance		
VTB Bank JSC	High	GRE (high likelihood of support)
Gazprombank	High	GRE (high likelihood of support)
Banks with moderate systemic importance		
Alfa-Bank OJSC	Moderate	Sovereign
Bank of Moscow OJSC	Moderate	Group
Bank Rossiya	Moderate	Sovereign
Bank URALSIB (OJSC)	Moderate	Sovereign
Credit Bank of Moscow	Moderate	Sovereign
MDM Bank	Moderate	Sovereign
Promsvyazbank OJSC	Moderate	Sovereign
Russian Standard Bank JSC	Moderate	Sovereign
Raiffeisenbank ZAO	Moderate	Group
Sviaz-Bank	Moderate	Group
ZAO UniCredit Bank	Moderate	Group

Source: Standard & Poor's

THE NEW REGULATION IS UNLIKELY TO AFFECT OUR ASSESSMENT OF EXTRAORDINARY SUPPORT FOR RUSSIAN BANKS

In assessing the likelihood of extraordinary support for Russia-based banks, we apply our own criteria to decide whether or not a particular bank could be subject to external intervention in case of emergency. We typically examine the level of a bank's interconnectedness with the rest of the financial sector and payments system and its market share in retail and total sector deposits at the national level, although high geographic fragmentation can mean smaller banks play significant roles in regional economies. We also examine the bank's role in providing politically or socially sensitive products. The stronger these characteristics, the higher the probability of being of high systemic importance.

We usually factor government support into the ratings if we believe a bank is a GRE such as VTB Bank JSC or if we consider that the loss of market confidence in a bank which could be private could lead to a loss of confidence in the entire national banking system and potentially impair the real economy.

We therefore typically give notches of support to private sector banks we consider to be of high or moderate systemic importance, under the terms explained in our criteria. In general, we consider government support to be stronger and more direct for public banks rated under our GRE methodology, and therefore lead to more uplift. We currently rate 13 Russia-based banks for which we believe external support from the Russian government, either through our GRE methodology or systemically important framework, might be available in case of emergency. We assess banks as being of high, moderate, or low systemic importance based on the scope of potential impact of the bank's default on the country's financial system.

There will likely be differences between our assessments of Russia's systemically important banks and the CBR's. The eventual list is unlikely to lead us to change our view on the potential sovereign support we incorporate into the banks' ratings. However, any further rating actions on Russia's systemically important banks will take into account our view of the willingness and capacity of the government to preserve a supportive attitude toward its banking system.

High Risks for High Rewards Temper Reinsurers' Enthusiasm for Central and Eastern Europe

By Standard & Poor's Rating Services

HIGHLIGHTS

- ***The CEE region's potential for growth continues to attract reinsurers.***
- ***Recent losses in motor and engineering insurance and natural catastrophe events highlight the unpredictable nature of some of the risks affecting the region's insurance markets.***
- ***Our ratings reflect the reinsurers' elevated product and country risks, as well as their adequate risk management.***

Global and regional reinsurers see considerable growth opportunities in Central and Eastern Europe (CEE). Despite a number of recent loss developments, total capacity available actually increased at the Jan. 1, 2014, renewal date. However, Standard & Poor's Ratings Services believes that the region's potential for growth may be tempered by the unpredictable nature of the risk exposure.

Our ratings on the region's reinsurers reflect the high levels of unmodeled and unforeseen risks inherent in writing local business through several factors within our ratings analysis. The recent losses demonstrate heightened earnings and capital volatility for regional insurers and reinsurers. We indicate the sector's vulnerability to external risks in our risk position assessment; for most rated reinsurers in this region, we assess the risk position as high. Many ratings are further constrained by country-specific risks associated with doing business in this region. Each company's ability to manage the risks it is exposed to also affects its rating.

Although we expect insurance growth in CEE to outpace GDP growth, we consider that the riskiness associated with the region will weigh on the sector's growth and profitability prospects in the short-to-medium term.

LOSSES IN MOTOR AND ENGINEERING LINES HAVE RISEN SHARPLY IN RECENT YEARS

Insurers and reinsurers especially those in Romania, Russia, and Bulgaria have suffered significant losses in recent years from writing motor business. Despite the development of various product lines, motor insurance still makes up more than 50% of premium in most of the region's markets.

In our view, heightened consumer awareness has led to an increase in the frequency of claims, exacerbating the impact of recent losses. Meanwhile, claims severity is also rising because of motor and medical claims inflation, higher policy limits, and unexpected losses following unfavorable court rulings. Soft pricing conditions, tariff caps on certain compulsory lines, and high acquisition costs also contributed to losses.

Large, unpredictable loss events complicate pricing

A single large loss event a flood at the Zagorskaya power plant in Russia in September 2013 is likely to hit a number of global and regional reinsurers. Soil subsidence below its foundations triggered flooding, but the underlying cause is still under investigation. The plant is under construction and the flood could stem from deficiencies in project design or in the construction process.

This event could be the largest single insurance payout in the history of the Russian market; loss estimates vary considerably, from Russian ruble (RUB) 3 billion to RUB14 billion ($90 million to $420 million). We understand that the three primary insurers affected were Russia-based Ingosstrakh Insurance Co. and AlfaStrakhovanie PLC covered the construction and engineering risk and OJSC Sogaz covered the property risk. A large proportion of the risk was ultimately ceded to the international reinsurance market.

The magnitude and unforeseen nature of such a loss make it very difficult for reinsurers to price the risks involved, especially given uncertainty regarding the terms of the primary coverage.

Disproportionate catastrophe losses put reinsurers out of pocket

The region has also experienced a disproportionate share of natural catastrophe losses in recent years. According to Swiss Re's sigma study, flooding in Central and Eastern Europe in June 2013 caused over $18 billion in economic losses and over $4 billion in insured losses; these events accounted for about 10% of the year's global insured catastrophe losses. The Far East region of Russia also experienced its worst flooding in over a century, which caused economic losses estimated at about $1 billion from property, infrastructure, and crop damage. Insured losses were relatively small, however, because of the low level of insurance penetration in this region.

As in 2011, when Asia-Pacific suffered a series of catastrophes, events in CEE in 2013 mean that the region's share of global catastrophe losses outweighed its share of global premium. It will take some time for reinsurers to recoup their losses.

Elevated supply is pushing reinsurance pricing down

The recent losses have encouraged reinsurers to reduce their exposure to the affected lines of business. However, the historical profitability of CEE business particularly on property and other product lines means that reinsurers are not withdrawing from the region. Indeed, according to a report from Willis

Re, an insurance broker, both global and regional reinsurers generally increased the capacity they offered to CEE cedants at the Jan. 1 renewals and the number of reinsurers offering reinsurance programs across the region has increased. As a result, prices have generally fallen, except for in the specific loss-affected areas.

OUR RATINGS REFLECT HIGHER RISK EXPOSURES FOR CEE REINSURERS

The CEE region's robust economic growth has made it an attractive market for many insurers and reinsurers. It also offers potential for growth in insurance penetration. However, our ratings analysis takes into account that insurance business in the region carries a higher level of risk than business in more mature markets, such as Western Europe.

Rising GDP and insurance penetration means considerable potential for growth

According to Swiss Re's sigma studies, non-life insurance penetration (the ratio of gross written premium to GDP) is about 1.3% across the region; that is, considerably lower than the 3.5% average in developed markets. We forecast that real GDP will increase by about 2.3% across the region in 2014 and by 3% in 2015. At the same time, we expect insurance penetration to increase, causing insurance premiums to grow faster than GDP.

Insurers remain vulnerable to impact of external events and weaker investment opportunities

Our view of the higher levels of risk in CEE insurance markets, compared with levels in more mature markets, is based on the recent losses sustained by insurers and reinsurers in the region. These accentuated heightened earnings

GDP And Insurance Penetration Rates Across Central And Eastern Europe

Country	2013e Nominal GDP (bil. US$)	2013e Per capita GDP (US$)	2013e Real GDP (% chg)	2014f Real GDP (% chg)	2015f Real GDP (% chg)	2013e Unem-ployment Rate (% of workforce)	2013e CPI (avg % chg)	2012 Non-life GPW (mil US$)*	2012 Non-life insurance pene-tration (%)*
Albania	13	4,052	1.3	2.0	3.0	13.1	2.5	N/A	N/A
Azerbaijan	75	8,082	3.8	4.0	4.2	5.2	4.0	N/A	N/A
Belarus	72	7,652	1.8	2.5	3.0	1.0	18.0	495	0.9
Bosnia and Herzegovina	18	4,696	0.5	2.0	2.5	28.0	2.4	N/A	N/A
Bulgaria	54	7,346	0.5	1.5	1.8	12.9	0.5	886	1.7
Croatia	58	13,646	(1.3)	(0.5)	1.0	15.8	2.0	1,124	2.0
Czech Republic	203	19,307	(0.6)	1.5	2.0	7.2	2.0	4,165	2.0
Estonia	24	18,528	1.3	2.8	3.5	9.2	3.4	N/A	N/A
Georgia	16	3,680	2.0	4.0	5.0	15.0	1.0	N/A	N/A
Hungary	130	13,160	0.7	1.7	1.5	9.9	2.0	1,524	1.1
Kazakhstan	216	12,679	5.3	5.5	6.0	5.3	5.8	1,067	0.5
Latvia	31	15,178	4.1	4.2	4.5	11.4	0.2	N/A	N/A
Lithuania	46	15,447	3.4	3.9	3.9	11.6	1.2	N/A	N/A
Macedonia	10	5,002	2.2	2.5	2.8	30.0	3.5	N/A	N/A
Montenegro	4	6,919	1.9	2.4	2.8	14.9	2.6	N/A	N/A
Poland	514	13,339	1.2	2.5	3.0	10.8	1.0	9,318	1.9
Romania	183	8,599	2.2	2.2	2.5	7.3	2.4	1,812	1.1
Russia	2,138	14,939	1.7	2.2	3.0	5.4	6.4	24,296	1.2
Serbia	42	5,894	1.5	0.5	1.5	26.0	8.0	571	1.5
Slovakia	95	17,521	0.8	1.5	2.0	14.4	1.7	1,385	1.4
Slovenia	46	22,454	(2.6)	(1.5)	0.9	10.3	2.3	1,873	4.0
Ukraine	181	3,981	(1.0)	1.5	3.5	8.6	(0.5)	2,798	1.7
Total	4,169	13,588	1.5	2.3	3.0	7.5	4.6	51,314	1.3

List includes all CEE countries with a sovereign rating. e--Estimated. F--Forecast. N/A--Not applicable. Source: S&P Sovereign Risk Indicators, Dec. 13, 2013, and Swiss Re Sigma 3/2013.

and capital volatility. Our analysis indicates a high risk position for most of the region's reinsurers because of their vulnerability to external risks and the greater risk within the companies' asset portfolios. Companies hold a higher proportion of high-risk assets than in more mature markets because the range of investment outlets available is generally smaller. This leads to asset concentrations, particularly in the banking sector. The high risk position assessment weighs on the ratings we assign to regional reinsurers in CEE.

Country-specific risks weigh on our ratings

Political and financial system risks are higher in CEE than in more mature markets and payment culture and the rule of law are generally less developed. These factors cause us to assess country risk as moderately high (4) across Central Europe and high (5) across Eastern Europe. By contrast, our average country risk assessment across Western and Southern Europe is low (2). These assessments affect our view of an insurer's business risk profile.

We also see evidence of elevated industry risk in some CEE markets. For example, there have been unfavorable claims settlements, particularly in court cases involving motor insurance, as well as reserve strengthening by some insurers and reinsurers. In our view, this indicates higher product risk. In addition, we consider institutional frameworks in CEE markets to be less developed than those in many Western European markets.

We consider ERM to be of high importance within our rating analysis for most reinsurers because they have exposure to some complex risks that could cause a significant loss of capital and earnings. Reinsurers manage the amount of their potential losses by monitoring their risk exposure and any risk accumulations. As part of the rating process, we assess whether (re)insurers' risk management practices establish an effective risk-reward framework for controlling potential losses. We assess the ERM framework as adequate for most of the region's rated reinsurers. This, combined with our assessment of management and governance, has a material effect on the rating of insurers and reinsurers in CEE.

Enterprise risk management is an important element of our ratings analysis in CEE

We consider ERM to be of high importance within our rating analysis for most reinsurers because they have exposure to some complex risks that could cause a significant loss of capital and earnings. Reinsurers manage the amount of their potential losses by monitoring their risk exposure and any risk accumulations. As part of the rating process, we assess whether (re) insurers' risk management practices establish an effective risk-reward framework for controlling potential losses. We assess the ERM framework as adequate for most of the region's rated reinsurers. This, combined with our assessment of management and governance, has a material effect on the rating of insurers and reinsurers in CEE.

OFFERING REINSURANCE IN CEE WILL CONTINUE TO CARRY ELEVATED RISKS

Reinsurers continue to see investing in this region as a risk made worthwhile by the potential for rewards. Although we agree that the market could grow significantly faster than more mature markets, our ratings analysis flags financial, political, and product risks as areas of particular concern that could affect the sector's prospects. We anticipate that some reinsurers may struggle to manage their exposure, particularly to unpredictable external risks.

Country Risk Assessments By Group And Country On Nov. 19, 2013

--Ranging from Group '1' (lowest risk) to Group '6' (highest risk)--

Intermediate risk (3)	Moderately high risk (4)	High risk (5)	Very high risk (6)
Czech Republic	Bulgaria	Albania	Belarus
Estonia	Croatia	Azerbaijan	Ukraine
Slovakia	Hungary	Georgia	
	Latvia	Kazakhstan	
	Lithuania	Russia	
	Poland		
	Romania		
	Slovenia		

Investment Attractiveness of Regions of Ukraine: Advantages and Challenges

By Oksana Kuziakiv, Artur Kovalchuk, Iryna Fedets, Institute for Economic Research and Policy Consulting, Ukraine

Corruption, insecurity of property rights, regulatory and tax burden are the main problems of the investment climate in Ukraine. The roots of these problems are at the both levels of governance. The national policies, rules and laws that affect the quality of the business climate in the country are made at the national level of policy making. This is the responsibility of the central government. The implementation of policies and rules as well as law enforcements is largely depended on the local situation. It is at the regional level should we seek answers to many pressing issues for investors. In this paper we used the results of survey of enterprises managers and survey of economic experts from all regions of Ukraine conducted in the fall of 2013 by the Institute for Economic Research and Policy Consulting.

COMPETITIVE ADVANTAGES

Investment attractiveness of the region is an ability to attract investment which depends on the investment attractiveness of the country as a whole as well as advantages and risks of particular region. According to the results of enterprise survey 49.1 % of respondents perceived the geographical location of the region as the most important sources of competitive advantages of the region. Second place in rating of regional competitive advantage is occupied by quality of labor force – 35.2% of respondents were sure that highly qualified personnel in the labor market could be an advantage of their region. The third position in this rating is held by quality of local markets. There are 31.7% of managers that believe that high level of trade will attract investors to the region. The developed consumer market (26.1 %) and favorable weather conditions (25.3 %) are also among the key strengths of the regional investment attractiveness. Cheap labor is a source of competitive advantage in the opinion of 22.0 % of respondents. Approximately 1 out of 5 respondents considered the natural resources (minerals, land, forests etc) as well as developed infrastructure could be an advantage. Developed industrial sector is an advantage according to opinion of 17.1% of managers. It is important to note that in regional dimension, developed industry is perceived to be a source of competitive advantage only by respondents from areas that traditionally have a high level of industrial development. Contradiction in assessments of infrastructures as factor of investment attractiveness of region is another important finding of this survey. Managers believe that infrastructure in their region is developed at more or less affordable level, but its quality is rather poor and insufficient, as result, infrastructure is not among key competitive advantage in any region. The share of respondents who consider the overall business conditions in the region as an advantage is quite low (9.9 %). It is so sad to report that innovation and technological development capacity is not among factors which could attract investor to regions of the country. Only in two out of seven regions that have been traditionally perceived as centers of research and innovation activities in Ukraine the factor of innovations and technology is at least in the middle of the rating (respectively, 25.0 and 16.7 % of respondents), in other regions the share of respondents that consider science as competitive advantage do not exceed 10 %.

ATTRACTIVE SECTORS FOR INVESTMENT

Agriculture, tourism and engineering are the most promising sectors for investment in Ukrainian economy, according to the interviewed experts. Since 65% of respondents believe that their region might be interesting for potential investors by agriculture sector. 40.0 % of respondents suggest that tourism, in particular green tourism, is perspective sector for investment in their region. 21.0 % of respondents have been sure that engineering and machinery building could be potentially attractive for investment. 16.0 % of respondents considered the energy sector development with strong focus on clean energy would be interesting for investor. Also 12.7 % of the experts suppose that industrial infrastructure, in particularly storages and port

Oksana Kuziakiv

Artur Kovalchuk

Iryna Fedets

infrastructure could be prospective for investment. Finally 12.4 % of the experts believe that the food processing industry has a great potential for future investment. Also among the sectors which could be attractive for investors, respondents mentioned information technology, wood processing, mining, logistics, transport and construction.

COOPERATION BETWEEN BUSINESS AND LOCAL AUTHORITIES

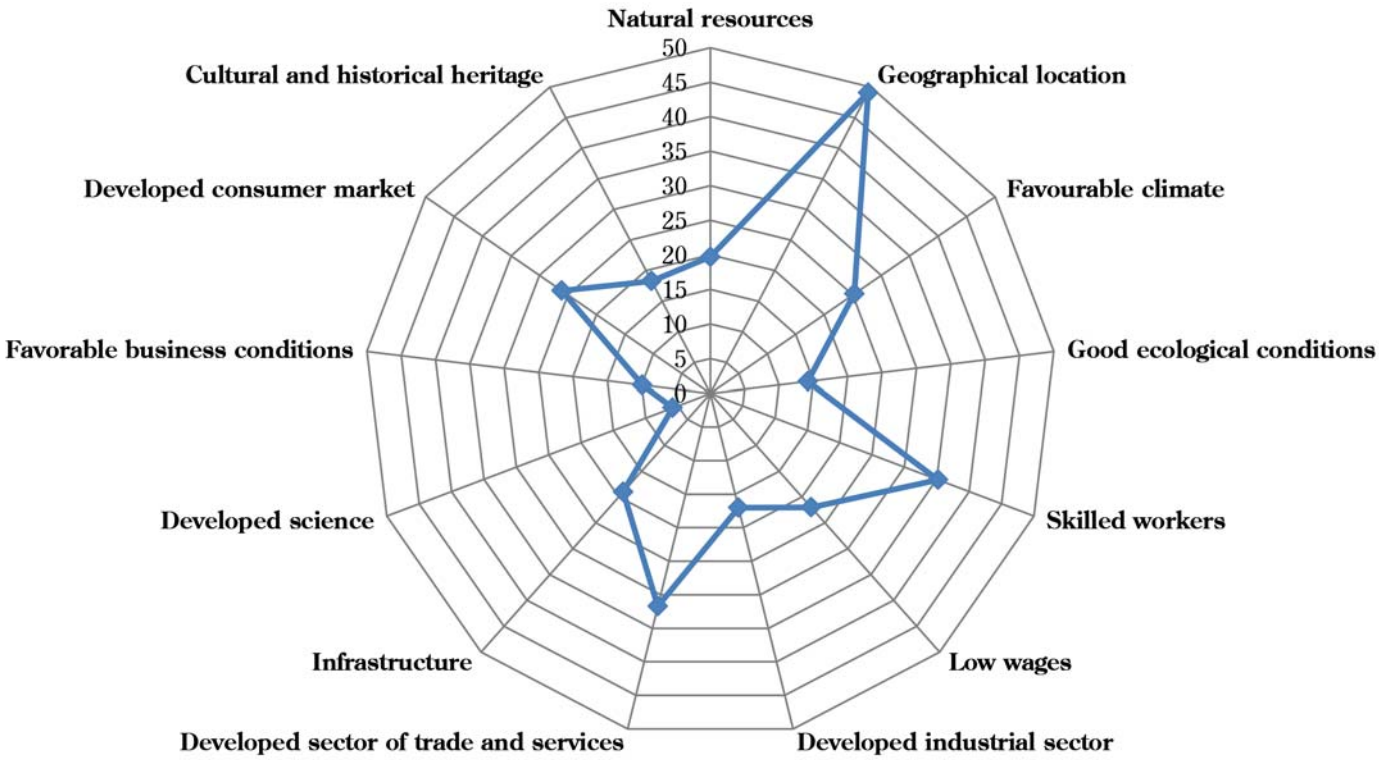
According to legislation each region of the country should have a program for attracting investment and appropriate mechanisms for working with potential investors. The effectiveness of these programs is rather poor according to surveyed experts' assessments. This is not mainly due to the shortcomings of programs the problems refer rather their implementation, including such issues as insufficient funding , lack of powers of local government , tax burden, lack of economic incentives , unclear business regulation, and, finally, corruption. Almost all interviewed economic experts reported about large investment projects that been implementing in their region. Typically, these commercial projects funded private business. At the same time, about 30% of the experts informed that there are investment projects funded jointly by private business and government (see Fig. 18). There are also large projects that financed only from public budgets sources, 22 % of the experts informed about such kind of venture in their region.

The survey shows that the question whether the local authorities would be ready to provide support for the investor is determined by the size of expected investment, the importance of investment for regional development , the business sector and the investor's image. Thus, 35% of respondents reported that all investors can count on support in their region. 10.8% of the experts say that local authorities are ready to help only those investors who operate in the priority business sectors of the region (e.g., agriculture, food industry, mining, etc.). 8.4% of experts said that the support is provided to foreign investors, and 7.2 % indicated only support for large investors.

Regions have clear requirements for investors who wish to be supported. For example, terms of investment attraction program of one of the industrially developed regions of Ukraine provide that investor must invest at least $2 million U.S. dollars and create at least 50 jobs in order to get help in setting up a business. Another region in the South of Ukraine supports investors if they meet at least one of the following criteria: creating at least 20 jobs, investing at least 1 million hryvnyas, or being of "social importance". Yet, written criteria sometimes differ from their practical implementation: respondents reported biased approach to investors support. Thus, according to respondents in one of the central regions, only business close to local government can hope for some help from the authorities. In another region, it is reported that support will be provided to the investors who have made an agreement to bribe the authorities.

The study noted the fact that local authorities are mostly focused on supporting large-scale investment projects, while small investors do not get enough attention. The respondents' opinions on this issue vary. Those who claim that local authorities are doing enough to attract small investors argue that the government is interested in small businesses development because it creates jobs and small investors are more profitable and easier to work with. Small business along with large and medium one participates, according to these experts, in the councils of business that consult local government.

Picture 1. Competitive advantages of regions of Ukraine, % of respondents



Experts also report that grants and cross-border projects are likely to attract small investors more intensively. In addition, it is quite often reported that all investors get equal attention, regardless of their size.

The reason why local authorities do not attract small investors actively enough is, according to the respondents, that such investors either are not the priority for the authorities or are not interesting for them, or just do not need help from the authorities. The lack of special programs to attract small investors and funding problems also hinder such attempts: banks do not provide loans with low interest rates that are necessary for small businesses. According to some experts, working with small investors requires a lot of time and effort that local authorities will better reserve for attracting big investment projects. However, a number of experts believe that small investors do not need to be attracted deliberately. In their view, it is enough to simplify the regulatory environment and to create equal and steady "rules of the game" for all market players for small business to develop.

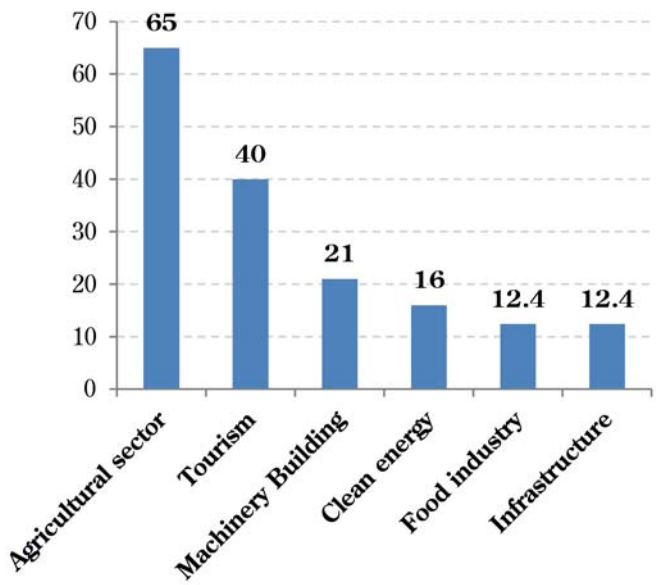
Cooperation between business and government is an important component of investment attractiveness of a region. According to the experts, local government does attract business to development of investment programs in the region to a certain extent. However, businesses find themselves being involved in resolving social and economic problems of the region more often, for example improving infrastructure and providing social support. What is alarming is that business undertakes the issues that belong to the responsibility of the authorities, in particular, funds the spending that should be covered by local governments but lacks allocated funds. And the important point is that business does not always participate in helping the local community on a voluntary basis, which may discourage investors from doing business in the region.

BRIEF CONCLUSIONS

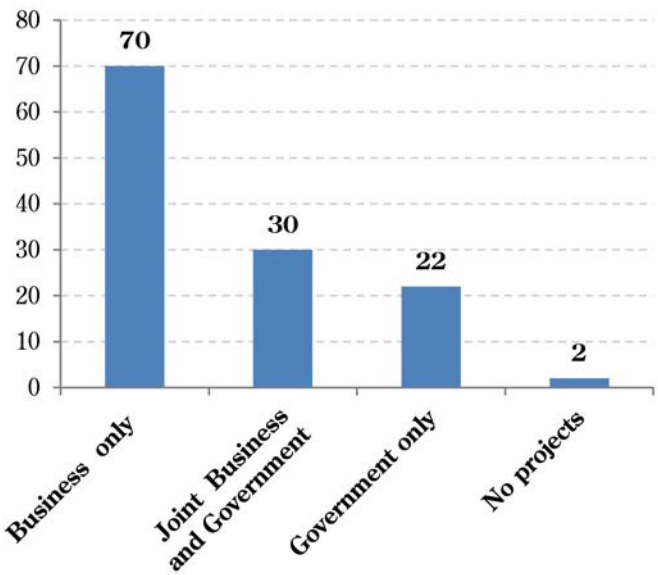
Analysis of competitive advantage once again confirms that the top of rating of the regional strengths is occupied by location and resources related factors such as geographical, minerals and land as well as weather conditions. This implies lacks a well-performed business environment and modern innovative products that regions could propose for investors. It decreases level of competitiveness of domestic economy and its perspective on international markets from point of view of development new products, services and technologies. Moreover the potentially strong factors may be difficult to use because of insufficient development in related areas. For example despite favorable geographical location which is noted as advantages in many regions, the quality of local infrastructure has been assessed as insufficient. It is clear that poor quality infrastructure does not allow investors to use an advantage of the favorable geographical position. Similar situation is observed for human resources that is one of the most mentioned factors of investment attractiveness of regions. Now high qualification of labor force is one of the strongest advantages of many regions of Ukraine, but if in the nearest future the quality of education of labor force would be deteriorate and labor remuneration would not be grow, the this advantage will be more disadvantage.

Our findings shows if the investment project aims at creating many of new jobs or it has key importance for social sphere of region or the project is implemented by foreign investors, the probability of support of such project and investors by local authorities would be higher comparing to probability of support of small-scale project. At the same time, small investors are those small and medium enterprises that can potentially create jobs in the regions not less than one large enterprise Therefore, despite searching of large investment projects, small investment projects should not be put on the back burner. In order to successfully work in the area small business, it would be enough to create a simple, clear and equal “rules of game”. While the primary measures that must be introduced to improve the business climate in the country and increase the attractiveness of regions for investors must be focused on combating corruption at the national and regional levels.

Picture 2. Sectors of Ukrainian economy that perceived to be the most perspective for investment, % of respondents



Picture 3. Sources of funding for investment projects in the region, % of respondents



EBRD Launches US$ 100 Million Sustainable Energy Lending Framework in Ukraine

Raiffeisen Bank Aval becomes first bank to join the programme

The European Bank for Reconstruction and Development is continuing its efforts to develop sustainable energy sources and to promote energy efficiency in Ukraine, with a new US$ 100 million financing programme.

The EBRD's Sustainable Energy Financing Framework was approved by the Bank's Board of Directors at the end of 2013, and aims to inject new skills into the energy sector in Ukraine, backed by project financing via the domestic banking network. By promoting investment in energy efficient technologies the project will help Ukraine gradually reduce its overall energy requirements and improve the environment.

The Framework is complemented by technical cooperation funded by Austria to assist participating financial institutions and sub-borrowers with the implementation of projects.

Raiffeisen Bank Aval – a long-term financial partner of the EBRD in Ukraine – is the first bank to sign up to the new framework, with financing from the EBRD of US$ 20 million.

Raiffeisen Bank Aval, and other banks expected to join the programme later, will provide individual loans to eligible local companies that are developing energy efficiency and renewable energy projects in Ukraine.

The Ukraine Sustainable Energy Financing Framework follows in the footsteps of the Ukrainian Energy Efficiency Programme (UKEEP), and which successfully financed 77 energy efficiency projects around Ukraine through five financial intermediaries during 2007-2013.

One such project was the EBRD's financing for Ukraine's leading producer of fats, margarines, sunflower oil and biofuel pellets. That funding supported the introduction of efficient new equipment that helped the company save 9.1 million cubic metres of gas per year.

The UKEEP also paved the way for the establishment of a carbon lending market in Ukraine.

The EBRD is the largest financial investor in Ukraine. As of 1 January 2014 the Bank had committed €8.7 billion (US$ 11.9 billion) through 321 projects in Ukraine.

USELF Boosts Ukraine's Renewable Energy Sector

EBRD's Ukraine Sustainable Energy Lending Facility supports biogas, small hydro, wind and solar energy

The first phase of the EBRD's Ukraine Sustainable Energy Lending Facility (USELF) will deliver 200 GWh of renewable energy through an innovative combination of EBRD commercial financing, dedicated technical assistance support and concessional grant co-financing.

After a slow start due to the under-developed renewable energy sector in Ukraine, the Facility has now signed seven renewable energy projects. These use biogas, biomass, small hydro, wind, and solar energy to generate heat and power. With a strong project pipeline now established, a Phase II for USELF is in the works for launch early this year.

"Financing renewable energy continues to be a strategic priority in Ukraine," said Sevki Acuner, the EBRD's Director for Ukraine. "The combination of policy dialogue, technical assistance, and concessional and commercial financing is proving to be a very effective mix of delivery for the Bank in this important sector".

The Facility, totalling €100 million, consisted of €50 million in EBRD commercial financing, €20 million in climate finance from the Clean Technology Fund and €30 million of sponsor equity.

This was further supported by technical assistance of $8.45 million (€6.62 million equivalent) from the Global Environment Facility. These support activities were essential to the success of USELF and would not have been possible without generous contributions from the CTF and GEF.

Through these activities USELF has strengthened the business environment for private sector renewable energy, and fostered the development of related projects.

By combining effective policy dialogue and financing support for the nascent renewable energy sector in Ukraine, the EBRD is supporting the Ukrainian government to reduce the country's dependence on imported fossil fuels.

Porogi Solar Project, pictured above, a 4.495 PV solar facility, was the first USELF project to be commissioned and the first PV solar facility directly financed by the EBRD. The project sponsor, Rengy Development LLC established the special purpose company, Green Agro Service LLC (GAS), in the Vinnitsa Oblast, to generate 5.0 GWh per year of renewable solar power to the local grid and reduce greenhouse gas emissions by around 5,000 tC02 per annum.

Total investment of €9 million included an 8-year EBRD loan of €4.1 million and a 15 year loan of €1.6million from the CTF.

In addition to increasing power generation from renewable energy, Porogi Solar is improving the quality and reliability of power supply in the region and has laid the groundwork for limited recourse financing for future projects in the Ukraine.

EBRD Commits more Resources to SMEs Support in Ukraine

US$ 55 million credit extended to Ukraine's PJSC Raiffeisen Bank Aval

The EBRD is pledging more funds to support small and medium-sized enterprises in Ukraine, at a time when there are very few SME lending programmes available from other financial institutions.

A new SME lending facility of US$ 55 million will be available through PJSC Raiffeisen Bank Aval - a long-term financial partner of the EBRD in Ukraine. Raiffeisen Bank Aval has established itself as a committed SME lender and has one of the largest regional networks of branches in the country. It is perfectly positioned to address the financial needs of small and medium-sized Ukrainian businesses, especially those seeking longer maturities.

Such support is vital in Ukraine. Although SMEs are responsible for only 15 per cent of GDP (compared to 47% in Poland and 40% in Turkey) long-term financing for such businesses remains scarce.

Press releases by the EBRD

IFC, AGI Team Up to Boost Ukraine's Agriculture, Reduce Harvest Losses

IFC, a member of the World Bank Group, is partnering with Ag Growth International (AGI) to bring new grain storage technologies to Ukraine's agricultural sector, helping small and medium-sized producers reduce losses and contributing to global food security.

IFC and AGI, a leading producer of grain handling, storage, and conditioning equipment, will develop and roll out a nationwide education campaign on new technologies for post-harvest grain storage. The technologies will also be tested at pilot farms in different Ukrainian regions. At a later stage, the campaign will launch new financial products to improve farmers' access to finance.

"In North America, most grain farms consider an acceptable level of loss due to spoilage to be less than one percent," said Gary Anderson, President and CEO of AGI. "We see many farms in other parts of the world regularly lose 15 percent or more due to improper storage or a lack of storage. That is a direct hit to the bottom line of the farm, and can be the difference between being a viable business or not. We are excited about teaming up with IFC, leveraging our knowledge and experience in other markets to the benefit of Ukrainian producers."

Rufat Alimardanov, IFC's regional head for Ukraine and Belarus, said: "Ukraine is already a leading grain exporter but the potential is so much greater. Due to the underdeveloped storage infrastructure and limited access to finance, farmers here lose around 8 million tons of grain a year. Through our advisory program and pilot projects with agro companies, we want to create best practice examples that the entire sector can replicate."

The initiative is part of a broader IFC advisory program, Sustainable Development of Small and Medium-Sized Farms in Ukraine. Under the program, IFC works with market participants to make innovative technologies and high-tech solutions available to small and medium-scale farmers. Bayer is a key private sector partner for the program. It provides farmers with broader access to agricultural knowledge, technologies and agricultural inputs such as improved seeds and innovative crop protection solutions.

IFC launched the six-year advisory project last year in partnership with the Austrian Ministry of Finance. IFC supports the entire agriculture and food value chain, from farm production to collection, processing and distribution, and has already invested over $800 million in Ukraine agribusiness.

IFC Invests in Ukraine's IMC to Support Innovation, Sustainable Agriculture

IFC has provided long-term financing to Industrial Milk Company (IMC) to help increase grain production and land cultivation and promote innovative farming practices, strengthening Ukraine's agricultural sector.

IFC's investment includes a $30 million loan and warrants for up to $20 million. It will help the company expand in Ukraine's northern and central regions and increase grain production, contributing to global food security.

"IMC has been growing steadily over the past two years," said CEO Alex Lissitsa. "With IFC's support, our investment program – aimed at expanding our grain operations and storage – will be implemented more quickly. We are also working with IFC to increase the efficiency of our agricultural production by implementing new, innovative technologies in our operations."

IMC is participating in a pilot project aimed at increasing productivity across the agricultural value chain in Ukraine. The project is being implemented by the IFC advisory program Sustainable Development of Medium and Small-Scale Farmers in Ukraine, in partnership with Austria's Finance Ministry.

"Agribusiness is at the center of our investment and advisory work in Ukraine because of the country's huge potential to play an important role in global food security," said Elena Voloshina, IFC's head of operations in Ukraine. "Supporting some of the best private companies, such as IMC, we want to spur faster growth and more innovation in the agribusiness sector, a key for Ukraine's long-term growth."

IMC, a producer of agricultural crops and raw milk and meat, currently has about 120,000 hectares in northern and central Ukraine and plans to increase the land under cultivation to about 285,000 hectares by 2019.

IFC Lends $65 Million to Ukraine's Mriya Agro Holding to Help Expand Agricultural Sector

IFC is providing $65 million to Mriya Agro Holding, one of Ukraine's leading agricultural producers, to support its expansion, improve agricultural land productivity, and increase sustainable production of food crops, contributing to global food security.

IFC's investment includes a multi-year working capital facility and a loan to improve waste management practices. It will also support Mriya's investment program, aimed at expanding the scope of its agricultural operations to about 400,000 hectares in three years. The expansion of farming operations will help create jobs in Ukraine's impoverished western regions where the bulk of Mriya's work is concentrated.

"Our long-term partnership with IFC has helped us secure steady growth over the past few years, despite challenging economic conditions in Ukraine," said Mykola Guta, CEO of Mriya. "The new IFC loan will enable us to grow further and continue to improve the efficiency of our operations."

Over the last seven years, Mriya has expanded its cultivated land from 16,000 hectares to about 300,000, producing over one million tons of grains in 2012.

"Our financing will support one of the most dynamic and productive agricultural companies in Ukraine. Supporting increased production of food through sustainable use of land and other resources is a priority for us in Ukraine. It will help Ukraine maximize its agribusiness potential and play a key role in global food security," said Rufat Alimardanov, IFC's regional head for Ukraine and Belarus.

In agribusiness, IFC supports the entire chain, from farm production to collection, processing, and distribution. It has invested over $800 million in various projects so far in Ukraine's agricultural sector. IFC also offers an extensive advisory program, including projects focusing on simplifying business regulations in the sector, developing the agricultural insurance market and expanding access to finance for farmers, improving food safety and resource efficiency standards, and developing supply chains.

Press releases by the IFC

Introduction of Transfer Pricing in Ukraine: What Should Business Brace Itself For?

By Victoria Chornovol, Partner-in-Charge, Tax & Legal Services, Deloitte **and Alexander Cherinko,** Senior Manager and Transfer Pricing leader, Tax & Legal Services, Deloitte

The law "On transfer pricing", in effect in Ukraine since September 2013, was drafted on the basis of the legislation that is effective in a number of developed countries and neighboring Russia. Meanwhile, Ukrainian businesses are already considering changes to commercial arrangements and pricing approaches in intragroup transactions.

The existence of such a law is necessary, in today's world, to ensure effective price management in commercial relations between related parties and to prevent tax evasion. However, the ins and outs of the law's implementation in Ukraine may lead to the government regulation of a considerable share of cross-border and domestic transactions. The business community is currently busy preparing for the transformation of the tax environment, working under tight deadlines and without a sufficiently developed regulatory framework to cast light on the general approach to determining controlled transactions and parties, as well as the substantiation mechanism.

The concept behind the transfer pricing law is that a company has to substantiate either the price or the profitability level in transactions with related parties, or face increased tax liabilities. Experts within the tax authorities believe that additional government revenues resulting from the law's application may top UAH 20 billion in the next three years. In the meantime, entrepreneurs have already begun to receive letters from the tax authorities, recommending that they analyse the prices of controlled transactions and accrue additional tax liabilities as and when necessary. Some major taxpayers have even got letters containing calculated amounts of tax adjustments.

In this article we will focus on the key features of the introduction of transfer pricing in Ukraine and its potential effects on the Ukrainian business community and its counterparts abroad.

TIMING

One of the key features of the transfer pricing law was its timing, which saw it come into effect on 1 September 2013, although the Parliament had only passed it in July 2013. This gave taxpayers less than two months to adapt to new rules, which was not enough time. The hasty adoption of the law resulted in issues with settling differences and preparing bylaws. In turn, the tax authorities did not have enough time to provide a clear description of the "rules of the game"; even as the law came into effect, they still seemed to be ignorant of particular issues that might arise.

One of the biggest problems faced by taxpayers is the timing of the first reporting period, between 1 September and 31 December 2013. This four-month reporting period is unique in world practice, and has already created a lot of difficulties for taxpayers. Indeed, the law provides for the application of methods by business entities to substantiate and, in the end, compare different profitability indicators (levels). Several of the sources of information (international databases) that may be used to search for comparable companies often contain financial information for a calendar year only. Moreover, even the taxpayers themselves are not always able to calculate specific profitability indicators for the last four months of a calendar year. As a result, companies have been forced to compare profitability in different periods. Those taxpayers with seasonal production cycles and major costs falling in a certain period will be particularly affected. This may lead to an imbalance that would be difficult to record in the books and reflect in reporting covering a period of only four months. Some businesses may have to review their activities for the whole year, even though this is not expressly stated by the law.

At this stage, there has been no tax ruling on the approaches to be applied in this situation, and it is difficult to predict the demands of the tax authorities in this regard. Nonetheless, most major companies are preparing to file their reports and statements in May of this year.

CONTROLLED TRANSACTIONS AND RELATED COMPANIES

The way the tax authorities interpret the provisions of the transfer pricing law in regard of the recognition of transactions between Ukrainian-resident related parties as controlled transactions gives rise to a large number of questions and disputes. The law limits the cases in which transactions carried out within Ukraine between related parties may be regarded as controlled (i.e. subject to the requirements of the law itself). In particular, it states that for transactions between two resident related parties within Ukraine to be regarded as controlled in 2013, their volume should be no less than UAH 50 million, and one of the parties should meet a series of criteria that may lead to tax optimisation (for example, the application of a special tax regime by one of the parties to the transaction). However, according to a ruling issued by the tax authorities, the number of companies that may meet the criteria for controlled transactions far exceeds the number that was initially expected. In fact, the tax authorities consider nearly all transactions between resident related parties as controlled, even though these residents regularly pay CIT (i.e. they are profitable), do not receive any special tax treatment, and were CIT and VAT-payers at the beginning of the reporting year.

This conclusion is based on a literal interpretation of the transfer pricing law by the tax authorities. The law states that if, during the course of a year, one of the parties to a transaction between related parties within Ukraine paid CIT or VAT at a rate other than the base rate, the total volume of transactions with related parties will be subject to control for transfer pricing purposes.

Let's take the following example: a Ukrainian resident trading company purchases products from a manufacturing plant, which is a related party of the company. The total volume of transactions between these two related parties exceeds UAH 50 million per year. Both the trading company and the plant are CIT and VAT-payers at the beginning of the year, both declared income in the previous year, and neither receives any special tax treatment. However, in that year the trading company exported products and applied a 0% VAT

rate (which, in the opinion of the tax authorities, is not a base rate). According to the interpretation of the tax authorities, the total volume of transactions between the trading company and the plant is, therefore, subject to control for transfer pricing purposes.

Another example: the same case as above, but this time the trading company does not export any products and does not apply the 0% VAT rate. In that year the trading company paid interest on a loan from a non-resident and deducted withholding tax at a rate other than 19% from that payment. Inasmuch as the trading company paid CIT (in this instance the tax authorities are disposed to equate withholding tax with CIT) at a rate other than the base rate (19%), the tax authorities take the opinion that the total volume of transactions between the trading company and the plant is subject to transfer pricing control.

SELECTION OF A TRANSFER PRICING METHOD

The selection of a transfer pricing method is an important step in terms of ensuring compliance with the rules. Global practice offers a number of methods to substantiate prices for the tax authorities. Most companies apply methods of comparing profitability. In countries where transfer pricing legislation has been employed for several years, the price comparison method is rarely used (in up to 10% of cases), primarily due to the fact that the method requires the transactions being compared to be highly similar. In practice, this is rarely feasible, and is sometimes even impossible.

In Ukraine, although the transfer pricing law provides for five different transfer pricing methods, there are legislative provisions that motivate companies to apply the first method. In their comments on the application of the transfer pricing law, the tax authorities are mainly talking about the price comparison method, while the generally accepted profitability comparison method is hardly considered worthy of mention. The key aspect of the profitability related methods is the procedure of searching for comparable companies and calculating financial indicators for the purpose of comparison. The law does not provide enough information in this respect, so companies and consultants are prompted to apply global best practices and those provisions of the law that are indirectly relevant to the issue. There are solid grounds to consider this approach reasonable. On the other hand, clarification from the state authorities on the issue would make all parties feel safer.

SOURCES OF INFORMATION FOR PRICE CONFIRMATION

None of the statutory methods of price or profitability confirmation can be applied without diverse sources of information. Information can be obtained from transactions with non-related parties, official publications approved by the Ministry of Revenues and Duties, international databases, etc. In this respect, the Ukrainian lawmakers also demonstrate a position slightly different from the standard world approach.

First of all, this is evident in the fact that the transfer pricing law provides for two categories of source. The first includes official sources approved by the Resolution of the Cabinet of Ministers of Ukraine, such as periodicals published by the state enterprises Derzhzovnishinform and Ukrpromzovnisheksperty za (both of which are closely related to the state authorities), the Bulletin of the Ministry of Revenues and Duties, and data from the Agrarian Commodity Exchange, Ministry of Agricultural Policy and Ministry of Regional Development. The second category includes sources that may be used when no information is available from category 1 sources.

Official sources of information represent a key potential problem of the new transfer pricing law. There are significant doubts regarding the following issues:

- Sufficiency of information to decide whether or not data from official sources is comparable with taxpayers' transactions
- Independence of these sources from the state authorities.

If the law is interpreted reasonably and accurately, official sources will rarely be used in practice. With this aim, Ukrainian legislation provides for "other sources". The law contains some vague statements about databanks and accounting data that may later be included in technical databases to be used when applying the resale price, cost plus, and transactional net margin methods. Based on the experience of other countries, these sources are of paramount importance for transfer pricing. However, they are not of the highest priority, and there is a high risk of the tax authorities' challenging their use.

The list of information sources included in the transfer pricing law is unique to Ukraine and not at all inherent to the legislation of developed countries. Global practice prescribes the use of any and all sources of information about comparable transactions, with the company's own transactions with non-related parties remaining the principal source.

Transfer pricing does not involve the state regulation of prices, but provides market mechanisms. We believe the tax authorities will be governed by the same principles.

SPECIAL RULES FOR EXPORT SECTORS

The export/import of goods with certain commodity codes is subject to special "arm's length" pricing rules, effective until 2017 (inclusive). The list of commodity codes covers the main export sectors of the Ukrainian economy, such as the steel industry, the chemical industry, and agriculture.

Without going into great detail, these rules mean that analysis is either heavily dependent on the state authorities or simply unfavourable to taxpayers.

If taxpayers apply a reasonable approach, they can prove their position even within these special rules; however, arguments can be more troublesome and less convincing when it comes to potential claims by the tax authorities.

CONCLUSION

Over half of the time granted to the Ukrainian business community to prepare for the application of the transfer pricing law has now passed. Keeping in mind the complexity of the legislation, there is very little time left for business to adapt, with the reporting period set to commence on 1 May 2014. Still, many important issues remain unclear, due to the lack of a sufficiently-developed normative framework in the area of transfer pricing, with primary sources including only the transfer pricing law itself and the one and only tax ruling from the tax authorities covering basic issues, such as the definition of controlled transactions and the criteria for recognising parties as related. However, a great number of issues remain open concerning the preparation of reporting. With this in mind, we should expect a vast number of different interpretations and, consequently, numerous attempts to impose penalties on companies.

The first rulings issued by the tax authorities demonstrate that their approach to transfer pricing could prove to be more fiscally-oriented than is contemplated by the goals and principles of transfer pricing introduction throughout the world. Nevertheless, companies are currently actively preparing to protect their positions in May 2014, using the provisions of the effective legislation and generally-accepted global best practices.

Banking Industry Country Risk Assessment: Uzbekistan

By Standard & Poor's Rating Services*

Standard & Poor's Rating Services classifies the banking sector of the Republic of Uzbekistan (not rated) in group '8' under our Banking Industry Country Risk Assessment (BICRA) methodology[1].

MAJOR FACTORS

Strengths:

- Strong fiscal and external surpluses, supported by good economic growth prospects.
- Limited economic imbalances driven by the closed and state-controlled economy.
- Moderate general government indebtedness.

Weaknesses:

- Very high credit risk in the economy, given the population's low level of wealth, relaxed underwriting standards, and weak rule of law.
- Weak institutional framework, governance, and transparency.
- Distorted competition due to government involvement.

ECONOMIC RISK | 7

The economic risk score for Uzbekistan is '7', based on our assessment of three main factors: economic resilience, economic imbalances, and credit risk in the economy–all of which our criteria define.

ECONOMIC RESILIENCE: VERY HIGH RISK

Our assessment of economic resilience is based on our view of the underlying stability of an economy and its resistance to adverse economic developments, such as external shocks.

Economic structure and stability. Uzbekistan's economic resilience is constrained by a low level of economic development. We estimate GDP per capita to be moderately above $1,900 in 2013. The closed nature of the Uzbek economy has helped it to withstand the impact of the recent global financial crisis, in our view. Real GDP growth remains strong, averaging more than 8% on an annual basis over 2008-2013. This sustained high growth is largely attributable to the government's policy to stimulate demand through public investment, as well as annual increases in social expenditures, such as high annual wage increases. Strong remittances from Uzbek nationals working abroad also support domestic demand. According to Russian Central Bank data, remittances from Uzbeks working in Russia amounted to $6.2 billion or 12% of Uzbekistan's nominal GDP in 2012 (up from 10% in 2011). We note, however, that part of the remittances might be represented by so-called "grey exports"--Uzbek goods unofficially sold in Russia. We expect strong economic growth to continue in 2013-2014, supported by government investment in industry and infrastructure, under our base-case assumption that the political regime will remain in place over this period.

The economy has high external and fiscal surpluses, low exposure to global financial markets, and benefits from currently high--though generally volatile--commodity prices for key exports such as gas, gold, and copper. Commodity exports constitute at least 80% of total goods exports, while over half of imports are machinery. Uzbekistan's dependence on commodity prices--natural gas, metals (mainly gold), and cotton--leaves the Uzbek economy vulnerable to external shocks.

Macroeconomic policy flexibility. In our opinion, monetary policy flexibility is significantly constrained in Uzbekistan. A parallel exchange rate exists in the black (unofficial) foreign exchange market, and there is a persistent gap between this rate and the official exchange rate, despite narrowing in recent years. The government continues its policy of slow gradual depreciation of the official exchange rate. That said, it limits the official supply of foreign currency, which

Economic Resilience (tril. UZS)

	2009	2010	2011	2012	2013f
Nominal GDP (tril.UZS)	49	61.8	77.8	96.7	117.4
Per capital GDP ($)	1,195	1,367	1,559	1,737	1,895
Real GDP growth (%)	8.1	8.5	8.3	8	7
Inflation rate (CPI)	14.1	9.4	12.8	12.2	11.4
General government debt as % of GDP	11	10	9.1	8.6	8.5

Standard & Poor's calculations based on IMF and CBU data. f-- Standard & Poor's forecast. UZS--Uzbek sum.

** This report has been edited for length. The full version is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.com.*

[1] Other countries in group '8' are Argentina, Azerbaijan, Bolivia, Georgia, Hungary, Kazakhstan, Lebanon, Nigeria, Slovenia, Sri Lanka, and Tunisia.

shifts operations to the black market and results in gaps between exchange rates. The central bank continues to pursue monetary loosening in an effort to stimulate credit growth and liquidity, despite inflationary pressures. The International Monetary Fund estimates inflation at year-end 2012 was over 12% and we expect it to remain at similar levels through 2013-2014.

We also note that tight control over cash transactions led to discrepancies between the value of paper cash and bank current accounts, which constrains the efficiency of the economy and the banking system.

Uzbekistan's strong external and fiscal performance is partly due to the exchange rate restrictions, in our view.

Uzbekistan is a twin surplus economy. Gross external debt as a whole is low and is estimated at about 13% of GDP at year-end 2012. Although the fiscal and current account surpluses may narrow over the medium term, we estimate that Uzbekistan will remain an external creditor over the next two years given increased expenditure as part of the government's large investment program and potentially weaker external demand.

Political risk. In our view, Uzbekistan has very high political risk given a lack of transparency in the policymaking and uncertainty about eventual political succession. President Islam Karimov maintains a very firm grip on power. Karimov, who has been in power since 1991, was elected for a further seven-year term in 2007. In March 2012, presidential elections were postponed to the first half of 2015. There is a high degree of uncertainty on whether President Karimov would run for the post and who may become his eventual successor.

CREDIT RISK IN THE ECONOMY: VERY HIGH RISK

Our credit risk score summarizes our view of a banking sector's credit risk relative to its exposure to households and companies, and to the sovereign. We assess credit risk largely by looking at private sector debt capacity and leverage; lending and underwriting standards; payment culture and rule of law; and sovereign government credit stress.

Private sector debt capacity and leverage. Uzbekistan has relatively low levels of corporate and personal indebtedness; the ratio of domestic credit to the private sector to GDP was 21% at the end of 2012. Household debt to GDP is only 3%, which is below that of other countries in the Commonwealth of Independent States (CIS). Nevertheless, households' payment capacity is limited, due to extremely low wealth levels, as indicated by Uzbekistan's GDP per capita of about $1,700, or $3,500 based on purchasing-power parity, at year-end 2012. The credit standing of the state-owned corporate enterprises, which dominate the economy, is largely driven by government policies, which determine production, pricing, and taxation of these companies. While corporate debt is low, the credit quality of the corporate loans might have been impaired by the inefficient distribution of financial resources.

Lending and underwriting standards. In our view, lending practices and underwriting standards in Uzbekistan are "relaxed," as our criteria define the term. In our opinion, lending decisions are subject to government interference, as most state-owned banks are directed to provide financial support to key economic sectors. The banking sector exhibits high single-name concentrations. On average the top 20 loans account for 2x-3x common shareholders' equity at rated banks, which compares poorly with banks in other countries with an economic risk score of '7'. Another risk factor is the high level of foreign currency lending in the economy (42% on Sept. 30, 2013), which exposes banks to the risk of currency fluctuations. Positively, most foreign currency lending is provided by two state-owned banks: National Bank For Foreign Economic Activity Of The Republic Of Uzbekistan and Uzpromstroybank, which distribute funding from the FRD and bilateral loans from international financial institutions to finance strategic investment projects initiated and supported by the state.

Payment culture and rule of law. We view the payment culture and rule of law in Uzbekistan as "weak." In our opinion, Uzbekistan has a slow, non-transparent, politicized judicial system, and an underdeveloped legal framework, while there is pervasive corruption in the private and public sectors.

Uzbekistan has a relatively young banking market with an evolving payment culture. We view positively the creation and wide use of the National Institute of Credit Information, which maintains information on all borrowers. Nevertheless, due to the weak rule of law the legal process for loan workouts, including recovery of the collateral, is complex.

INDUSTRY RISK | 9

The industry risk score for Uzbekistan is '9', based on our assessment of three factors: institutional framework, competitive dynamics, and systemwide funding.

Credit Risk In The Economy

	2009	2010	2011	2012	2013f
Per capita GDP ($)	1,195	1,367	1,559	1,737	1,895
Domestic credit private sector & NFPEs as % of GDP	17.4	18.6	20.1	21	22
Household debt as % of GDP	2.6	3.1	3.9	2.6	3
Corporate debt as % of GDP	14.8	15.5	16.2	18.4	19
NPAs as % of total loans (year-end)	1.2	0.9	0.6	0.5	0.5
FC lending (% of total lending)	33.8	36.9	39.4	38.6	40

Standard & Poor's calculations based on IMF and CBU data. f--Standard & Poor's forecast. NFPEs--Nonfinancial public enterprises.

The Uzbek authorities use administrative methods to control liquidity in the banking sector. Direct lending, subsidized interest, and other forms of support for state-owned banks keep the entire sector under government control and link the creditworthiness of the industry to that of the government. Loans guaranteed by the government are not subject to the maximum risk per borrower regulatory ratio, which could lead to the accumulation of risk at some banks that are heavily involved in lending to particular industries or enterprises.

Institutional framework: extremely high risk

Our institutional framework risk score is based on an analysis of banking regulation and supervision, regulatory track record, and governance and transparency.

Banking regulation and supervision. In our view, banking regulation and supervision in Uzbekistan are "weak" and more relaxed than international standards. The Central Bank may be subject to political influence. At the same time, the regulator has a tight grip over the banking sector and has significant power. Corporate governance is also weak, in our view, raising questions about conflict of interest, given that the Central Bank is a government body and almost 80% of the system by total assets is state-owned.

The Uzbek authorities use administrative methods to control liquidity in the banking sector. Direct lending, subsidized interest, and other forms of support for state-owned banks keep the entire sector under government control and link the creditworthiness of the industry to that of the government. Loans guaranteed by the government are not subject to the maximum risk per borrower regulatory ratio, which could lead to the accumulation of risk at some banks that are heavily involved in lending to particular industries or enterprises.

The Uzbek regulators, in line with a presidential decree, have introduced a banking sector development strategy for 2011-2015. The strategy involves stringent regulations requiring banks to increase their capital by 20% annually and their customer deposits by 30% annually, cover all loans overdue by more than one day with provisions, and introduce stress testing and liquidity risk management. It remains to be seen if the measures will prove sufficiently robust.

That said, we notice the negative trend of banks' decreasing capitalization in the sector. In our view, this is driven by the banks' rapid asset growth boosted by public investments against the backdrop of lagging internal revenue generation and external capital injections. As a result, the ratio of total regulatory capital/total assets decreased to 10.7% at Sept. 30, 2012 from 13.8% at year-end 2010 (IMF data). In July 2013, we lowered the rating on Kapitalbank to 'B-' owing to the continued erosion of its capital buffer. If we continue to see this downward trend in other rated Uzbek banks' capitalization ratios, we might also take negative rating actions on these banks.

We consider that it will take time to create a robust and independent supervisory and regulatory framework in Uzbekistan that mirrors international standards. Heavy political influence weakens regulation and renders anti-crisis measures inefficient. In our view, the effectiveness of Uzbek banking regulation is undermined by a still-developing compliance culture and at times lax enforcement. The limited scale of the economy and a lack of well-established international practices undermine the country's regulatory system.

Regulatory track record. Uzbekistan's regulatory track record is "weak," reflecting our view that policies and practices are more reactive than proactive. In early 2012, the central bank withdrew licenses for foreign currency operations from a number of banks or postponed the issue of such licenses, which put significant pressure of the business profiles of the banks affected. In late 2011, state-owned Agrobank reported fraud-related losses and required recapitalization. In June 2013, we suspended the ratings on the small Uzbekistan-based Samarkand Bank, as the bank did not provide us with timely information to maintain surveillance of its ratings. We believe that the bank faced serious liquidity problems and we are not aware of any supervisory action to remedy the situation. Consequently, on Dec. 19 we withdrew the ratings on Samarkand Bank owing to a continuing lack of information.

Governance and transparency. We consider governance and transparency in the Uzbek banking system to be "weak." The high level of state ownership in the economy, including the banking sector, weighs on the independence of market participants and increases the state's direct influence on bank operations. Transparency is below international standards with only annual reporting to the central bank under IFRS and monthly reporting under local accounting standards. The central bank publishes very limited data, and official figures for nonperforming loans and certain other statistical measures are understated because of government support for state-owned enterprises and the financial rehabilitation program, whereby banks take bankrupt corporate borrowers on their balance sheets. We believe these programs mask the underlying credit quality of the banks' loan portfolios and production inefficiencies.

Competitive dynamics: high risk

The competitive dynamics factor represents the structural implications of the competitive landscape faced by a bank within the broader banking industry, and is determined by risk appetite, industry stability, and market distortions.

Risk appetite. We consider Uzbekistan's banks to have a "moderate" risk appetite. We have observed rapid asset growth during the past four years, averaging 30% annually in nominal terms, but that was mainly due to government-sponsored programs and directed lending. State-owned banks do not have much flexibility in risk taking and are expanding their loan portfolios to meet government targets for financing strategic industries, small and midsize enterprises, and individuals. Private banks are trying to keep up with their competitors to build critical mass and to improve their market positions.

Banking sector profitability is comparable with that of other sectors. However, the Uzbek banking industry has no disciplined risk pricing that is

free from market distortions created by the existence of government-owned banks, creating a very high degree of pricing differentiation.

Positively, traditional lending and deposit products dominate the financial market, and there is very limited use of innovative, complex, and risky products and securitization, as the Uzbek market is at an early stage of development and is relatively closed.

Industry stability. In our opinion, the competitive environment remains unchanged. The fact that the top-five banks control about 65% of total system assets indicates that smaller banks have a limited impact on the sector's performance and overall risk profile.

We do not expect material changes in the competitive landscape in the short-to-medium term, and believe that state banks will continue to dominate the system. The Uzbek authorities restrict the entry of foreign banks into the sector, and the entry process is cumbersome and bureaucratic. The established brand names and strong positions of larger players create significant barriers to entry. New entries are possible only through the acquisitions of existing banks or niche startups, but such attempts are unlikely to dominate the market.

Market distortions. In our view, the significant presence of state ownership and control in the Uzbek banking system distorts competition in a way that is unfavorable for private sector banks' creditworthiness. The system is highly concentrated, with state-owned banks controlling 77% of total assets. The four largest state-owned banks have a strong influence over systemwide loan growth and interest rates through their participation in state-run lending programs, and enjoy the privilege of servicing domestic blue-chip companies. Nonbank competitors are limited to a number of microcredit organizations that lend to specific groups of individuals.

SYSTEMWIDE FUNDING: VERY HIGH RISK

The systemwide funding risk score assesses the relative stability of a banking sector's funding sources and banks' access to alternative funding sources.

Core customer deposits. Core customer deposits (defined as 100% of household deposits and 50% of corporate deposits) comprised about 64% of systemwide loans on Oct. 1, 2013, a figure unlikely to change substantially in 2013-2014. The ratio has improved since the 2006 level of 35% driven by a state initiative to increase non-cash transactions and reduce the size of the shadow economy. However, it has been decreasing recently (from about 75% in 2011), as corporate deposits grow faster than retail ones. Customer deposits should continue to account for about 70% of bank liabilities (data for the first nine months of 2013), with three-quarters coming from enterprises, and one-quarter from individuals.

External funding. We estimate the Uzbek banking sector's net external debt to systemwide loans was about 12% a year-end 2012. All banks' external borrowings are collateralized by government guarantees. The two main institutions that attract cross-border funding are National Bank For Foreign Economic Activity Of The Republic Of Uzbekistan, by far the largest bank in the country, and Uzpromstroybank. These banks receive bilateral loans granted under special programs with state participation to fund imports as well as to develop large industrial projects. Most other banks cannot raise deposits from non-residents; both long- and medium-term external debt markets are effectively closed for them.

Domestic debt capital markets. We view Uzbekistan's domestic debt capital markets as "narrow and shallow." There is no active capital market in the country for the issuance of speculative-grade debt by the private sector. The domestic private sector bond market equates to only 0.3% of 2012 GDP, about 1% of banks' liabilities. The domestic capital market is underdeveloped and at an early stage. As international capital markets remain closed for funding to Uzbek banks, the banks have to rely mostly on domestic resources, with state-related funding representing a notable share of total system liabilities.

Government role. We assess the government's role in systemwide funding as "adequate". However, we note that the central bank has a moderately successful track record of providing guarantees and liquidity during periods of market turmoil mostly to large state-owned banks. Small private banks have effectively no access to the central bank's refinancing facilities. The central bank's lending facilities are adequate in terms of its capacity to service the size of the industry's funding needs (if any), and the government is moderately responsive. Due to the small size of the banking system relative to GDP, we view the regulator's capacity to service the size of the industry's funding needs as adequate; however, the regulator's willingness to support some private banks could be arbitrary.

We do not expect material changes in the competitive landscape in the short-to-medium term, and believe that state banks will continue to dominate the system. The Uzbek authorities restrict the entry of foreign banks into the sector, and the entry process is cumbersome and bureaucratic. The established brand names and strong positions of larger players create significant barriers to entry. New entries are possible only through the acquisitions of existing banks or niche startups, but such attempts are unlikely to dominate the market.

GOVERNMENT SUPPORT

We classify the Uzbek government as "highly supportive" toward its domestic banking system. This classification recognizes the government's tight control of almost 80% of the banking sector and its policy of frequent interventions through regular direct capital increases for state-owned banks, substantial quasi-fiscal activity through state-owned banks in the form of guarantees, price regulation, tax deferrals, and state-sponsored lending programs as well as a state-orchestrated program to refinance distressed borrowers or restructure their debt.

We believe that the Uzbek government has the capacity and willingness to support domestic banks of high systemic importance.

On the Path to Developing the Pearl of Central Asia

Hamkorbank – Topping New Heights
Ferghana Valley – Pearl of Central Asia

HAMKORBANK
LET'S GROW TOGETHER

Ikram Ibragimov
Chairman of Executive Board
of OJCSB "Hamkorbank"

Ferghana valley is located in the east of Uzbekistan and peculiar with its unique nature, ancient history and enormous economic potential. Ferghana valley stretches along the Tien Shan tectonic basin in the middle stream of the Syrdarya river at height of 300-1000 meters. Ferghan valley is a unique place of Central Asia. All types of landscapes are represented here. Nature of the valley astonishes with an abundance of colors. It brags the softest climate in Uzbekistan.

Fergana valley is the most densely populated region of Uzbekistan. Almost the third of the country's population resides here. It is called the heart of Uzbekistan. Nearly 25.000 square kilometers of fertile land and large oasis surrounded by mountain ranges.

The total territory of Ferghana valley is 77,9 thousand square kilometers where 6 provinces of 3 neighboring Central Asian countries are located. Three provinces of Uzbekistan – Andijan, Ferghana and Namangan provinces are located in northern part of Ferghana valley.

DEVELOPMENT OF INDUSTRY IN UZBEKISTAN

Uzbekistan is a country with developed industry. Its development is directly linked to a comprehensive development of natural and economic resources of the country. Since the early days of independence such sectors defining scientific and technical progress i.e. mechanical engineering, oil and gas sector, power industry, non-ferrous metallurgy, chemical industry, metal processing have been developing in the country at accelerated paces. In recent years such large industrial enterprises as Tashkent and Syrdarya hydroelectric power stations, Asaka and Samarkand automobile plants, Bukhara oil processing plant, Shurtan gas and chemical complex and others have been commissioned in the country.

New modern production lines of telecommunication and computer equipment, cellular telephony, wide range of consumer electronics have been launched. Almost all sectors of our economy have been modernized and, in fact, technologically renewed.

Such traditional sectors of the economy as light, textile and food industry are continuing to rapidly develop.

THE BANK'S PLACE IN THE BANKING SYSTEM OF UZBEKISTAN

Uzbekistan has been carrying out the reforms aimed at ensuring the interests and well-being of people. Therefore, a paramount importance is attached to strengthening financial and banking system of the country.

A two-tier banking system led by the Central Bank of the Republic of Uzbekistan makes up the basis of financial stability in the country. It was established in 1995 and the Bank's Association of Uzbekistan was established the same year. Now 27 banks with different forms of ownership operate in the market of the country. Fourteen banks have an extensive branch network.

Currently, the indices of banking system of Uzbekistan meet the universally accepted world standards and exceed them in some aspects. Particularly, in recent years the annual growth of main indicators of banking sphere make up nearly 30 percent. Thus, as of January 01, 2014 the assets of the banks of Uzbekistan grew by 30 percent, aggregate capital by 25 percent and credit investments by 30 percent.

Reliable services with guaranteed execution are an important factor of development of cooperation between a bank and a client. In this regard, a special attention is attached to reforming financial system of the country which aims enhancing the activities of banks and providing the population with timely and quality services.

It is worth noting that thanks to measures taken by the leadership of the country, the banking system of Uzbekistan is dynamically developing and there is high competition in financial services market. Today clients can choose between banks which to make them their reliable partner and entrust their savings.

At the same time, the competition urges banks to steadily improve the quality of their services, increase their number and variety, enhance customer support and prove that they deserve the clients' trust.

Constant attention to such aspects allows Hamkorbank to secure its commendable place in financial market of the country. Currently, the bank has been able to significantly consolidate its position on a number of indicators. Upon the absolute amount of profit for 2013m the bank secures 7th place among 27 banks of the country. Upon the assets and capital profitability, it is at the top ten. Upon clients' deposits, the bank went up from 9th to 11th place.

Behind these figures lies a several-years hard work of well-organized and strong team of like-minded professionals, who proved their high competence and innovative approach to work.

HAMKORBANK – YOUR RELIABLE PARTNER IN UZBEKISTAN

Open joint-stock commercial bank Hamkorbank started its business in the sphere of banking services on September 01, 1991. For more than 22 years the bank has been successfully operating in the financial market of Uzbekistan. The head office of the bank is located in Andijan city.

Today Hamkorbank is a universal bank, which offers comprehensive banking services to physical and legal entities. Reliability, high quality of services, as well as friendly and mutually beneficial relations with all clients and partners are the main principles of the bank.

INTERNATIONAL ACTIVITY

Hamkorbank is proud and values its relations with strategic partners – international financial institutions which include the International Bank for Reconstruction and Development (World Bank group), International Finance Corporation (World Bank group), International Development Association (World Bank group), Asian Development

Bank (ADB), German Development Bank (KfW), Dutch Development Bank (FMO), Islamic Corporation for Private Sector Development and others. Since 2010, the IFC has been one of the main shareholders of Hamkorbank.

Hamkorbank is an active participant of projects initiated by the ADB, IFC and IDA, which are aimed at developing micro-financing, small business financing and restructuring agricultural enterprises.

In 2013, the bank made a number of agreements with international finance institutions and foreign funds in the sphere of international banking. Thereby, the total balance of attracted assets of international financial institutions grew almost 2 times. At the same time, the share of resources of international financial institutions in the bank's assets has reached 9 percent.

Significant international experience accumulated by the bank for over the period of cooperation with international financial institutions, as well as trust put by correspondent banks add to Hamkorbank's attractiveness for direct foreign investments.

Cooperation with international financial institutions is one of priority directions in the bank's development. The strategy of Hamkorbank is the expansion of activity by attracting additional foreign investments in the economy of the country. Thus, the bank contributes to development and strengthening of the economy of Uzbekistan.

Hamkorbank adheres to the principles of openness and transparency of financial information, timely and fully meeting its obligations before the clients and partners. Annual audit of the bank is conducted by Price Water House Coopers and Ernst & Young. The bank was among the first ones to start cooperation with Moody's rating agency.

REBRANDING OF THE BANK

Having launched rebranding in 2013, which is one of the most ambitious projects in its history, Hamkorbank continues to change its external and internal essence.

Today Hamkorbank has nearly 200 sales points across Uzbekistan. With its branch network, the bank secures 8th place in the banking market of the country. Meanwhile, we are intentionally not planning to increase the number of sales points. We will close unpromising sales points and open the same number of new ones in renewed format. In this case, we count on client orientation. While offering our clients the new format of office services, we bring the new standard of service in the first place. It is important for the bank as we are improving convenience and quality of our service. New sales points are for the benefit of our clients, not ourselves.

New format of sales points is based on the world's best practices of customer service. We have taken into account all main aspects, which make the bank-client contact barrier-free, convenient and productive. Thus, the client service areas are organized in line with a principle of "open space" while all physical barriers before a client and a bank personnel are removed. Each process whether it is sale or service - has its own area. There is a transaction area where operation-cashier staff conduct relatively simple and quick transaction operations. Meanwhile, consulting and sales area is the place where relatively sophisticated services are rendered by more qualified sales specialists and client managers. The process of specialization went even further: clients now are divided into segments. There are specialized subdivisions and areas for each segment with different service procedures, as well as special staff – segment client managers. In general, the client flow is optimized as well. It is achieved by a multi-tier navigation system and the system of "electronic queue" in the hall.

However, a client may deal with the bank without any foreign assistance. They only need to create the necessary conditions: arrange a 24-hour zone of self-service, information stands and work places with Internet access to the bank's website for necessary information and conducting operations through Internet banking system. Waiting areas add convenience to all the said processes while new and modern design corresponding to the new brand and corporate style of the bank add to the whole picture.

PRESERVING TRADITIONS, KEEPING PACE WITH TIME

Hamkorbank grew and developed in par with strengthening of independent Uzbekistan and contributed to enhancement of the country's financial component. Together with devoted shareholders, partners and clients whose number steadily grew, we have traversed a long path of over two decades. The path crowned with success and accomplishments. Constant search of innovations and flexibility before the requirements of economic development determined new approach to formulating the business philosophy "Through partnership to prosperity".

Today Hamkorbank whose name can be translated as the Partner Bank, stands ready to develop an equal cooperation for the benefit of prosperity of all.

THE BANK TODAY

- *Indisputable authority based on over 20 years of faultless activity.*
- *Developed regional network: twenty-eight branches are at disposal of our partners and clients, 154 mini-banks, 18 specialized points, 2 representative offices and 9 subsidiary companies.*
- *Pioneer in establishing partner relations with international financial institutions, Hamkorbank has been effectively cooperating with over a dozen partners among international financial institutions.*
- *International Financial Corporation is one of shareholders of the bank.*
- *The only bank in Uzbekistan to be a member of the Association of Russian Banks.*
- *One of the banks in Uzbekistan to be assigned an international rating.*
- *Associated member o f Visa International payment system.*
- *Recognized leader in the market of international remittances of private persons in Uzbekistan.*
- *One the top three largest banks in the country on micro-crediting.*
- *Force majeure guaranteed – the system of corporate management, internal control and risk management.*
- *Global Finance named Hamkorbank as the best bank of Uzbekistan in the markets of Asia-Pacific.*
- *Asian Banking & Finance – one of the leading financial editions of Asia named Hamkorbank as SME Bank of the Year in Uzbekistan upon the outcomes of a survey conducted among 200 largest financial institutions.*
- *Financial performance of the bank undergoes an annual international audit.*
- *IT systems are constantly renewed – an indicator of consonance with time.*
- *Over 1,5 thousand employees.*

Prospects for Further Development of Leasing Market in Uzbekistan

By Zafar B. Mustafaev, General Director of "Uzbek Leasing International A.O."

Macroeconomic overview. As a result of comprehensive deliberate policy of state the Republic's GDP increased by 8.0% compared with Year 2012. It should be noted that there was growth in all major sectors of the economy, industry by 8.8%, agriculture by 6.8% and construction by 16.6%. Inflation rate was lower than predicted, and was 6.8%.

By the end of Year 2013 volume of capital investments to the Republic amounted for more than UZS 27.5 trillion. As a result, the increase over the previous year was 9.8%.

Overview of leasing services. According to the annual analysis undertaken by Uzbekistan Lessors' Association, despite of the young age of leasing service in the Republic of Uzbekistan, leasing activity of companies and banks keeps steady growth. Share of leasing in the amount of capital investments has slight increase, and constituted 2.92% and compared to the Year 2012 is set to rise. As for the leasing transactions, during Year 2013 the volume of overall leased assets totaled UZS 805.2 billion and increased by 36% in comparison with Year 2012. Besides, it is necessary to emphasize that the share of leasing transactions in GDP of the country increased to 0.67% from 0.61% in Year 2012.

Also, it should be highlighted that share of leasing portfolio in GDP of the country remained stable and constituted about 1.3%. Nevertheless, in comparison with previous year, portfolio of the lessors had increased by more than 16% and reached UZS 1.5 trillion.

Table 1: Investments through leasing

Year	Average exchange rate UZS per US$ 1	Cost of transferred leasing assets (US$ mln.)	Share of leasing in capital investment (%)	Share of leasing in GDP (%)
2009	1,470.4	272.5	3.19	0.84
2010	1,591.3	270.4	2.79	0.70
2011	1,721.7	281.4	2.65	0.62
2012	1,897.5	311.3	2.67	0.61
2013	2 202,2	365,6	2,92	0.67

Table 2: Leased property volume (in bil. UZS)

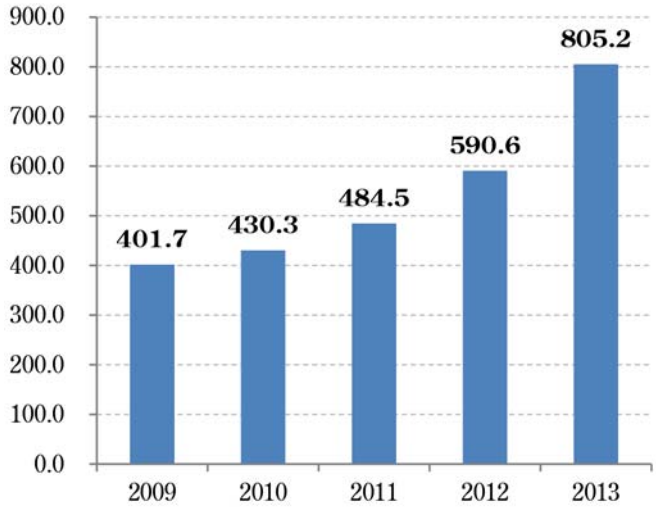
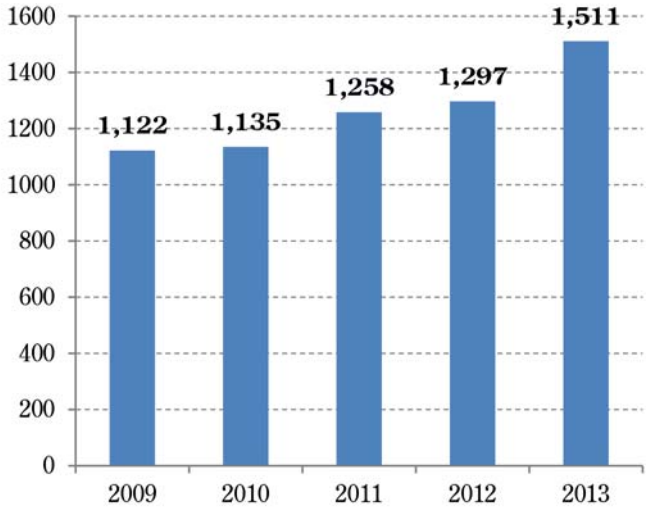


Table 3: Volume of leasing portfolio (in bil. UZS)



Analyzing the leasing market may be noted that farms, industrial, transport, construction sector, as well as the real estate industry is increasingly used in its leasing activities.

Considering the structure of the leased property at the end of Year 2013, the leader in terms of value of the property leased, became agricultural. The volume of financed agricultural machinery as lease objects was over UZS 296.9 bln., with market share equal to 37.5%.

Current growth in the volume of leased projects and portfolio could be explained by the fact that nowadays, Uzbekistan has stable regulatory and legal frameworks for leasing services and also there are several preferences for leasing Companies, approved by government, such as: income tax and VAT exemption on leasing services until January 01, 2017 for the organizations which are providing leasing services.

Those kind of leasing preferences which are making Uzbekistan leasing market beneficial to the players tend to create new lessors which mostly came as private leasing companies, joint-venture companies and local banks' subsidiaries.

According to Uzbekistan Lessors' Association, as of December 31, 2013 there are 99 players on the leasing market of Uzbekistan, including 75 leasing companies and 24 commercial banks which are engaged in providing leasing services.

According to the annual analysis, in 2013 about 69% of all leasing transactions were concluded by leasing companies and remaining 31% of leasing market deals was made by commercial banks. 33.7% of the total leasing market (including leasing companies and commercial banks) was occupied by "O'zqishloqxo'jalikmashlizing" SLC whereas 8.1% of market share were taken by SJSCB "Asaka", leader among banks which are providing leasing services.

Distribution of deals by regions. In Year 2013 the distribution of leasing operations among regions changed insignificantly, in comparison with Year 2012, capital of the country remained as the main market place for the lessors. According to the analysis of the Uzbekistan Lessors' Association, in Year 2013 share of Tashkent city constituted for 22% and amounted to UZS 176.9 billion. But, in contrast to Year 2012 results, share of Tashkent city declined by 4%. Tashkent region was the second among regions by the volume of leased assets, although, during Year 2013 its share decreased by 0.2% and leasing volume reached UZS 90.9 billion. Volume of leasing transactions in Samarkand region boosted significantly and reached UZS 76.9 billion. Share of Samarkand region, in leasing market of Uzbekistan, constituted 9.7%. The highest number of leasing transactions (over 800 deals) was made in Tashkent region.

Prospects for the development of leasing services in Uzbekistan. Analyzing the leasing market of the Republic of Uzbekistan, the following trends can be forecasted: Demand for leasing service will continue to grow and this growth would be the reason for creation of new leasing market players – both leasing companies, captive leasing companies under commercial banks and others.

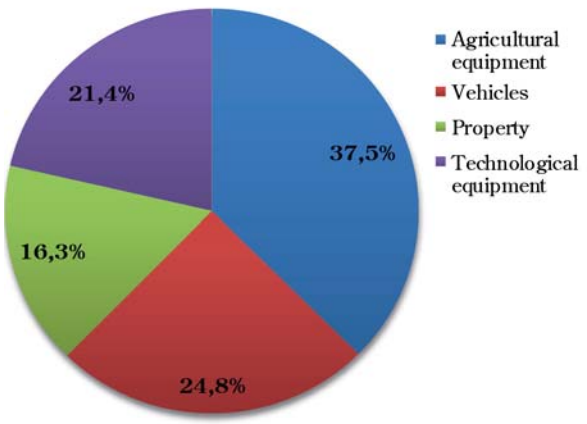
Increase of the number of leasing market players would certainly promote to the growth of competition in leasing market and consequently will lead to the further improvement and flexibility of leasing services.

Diversification of leasing objects is the prospect for further development of leasing market. Future projects for provision of leasing services would cover financing the production of renewable energy, wind power plants, equipment and technologies for the reduction of energy consumption, etc. Such leased assets diversification will have a positive effect on the development of economy as a whole.

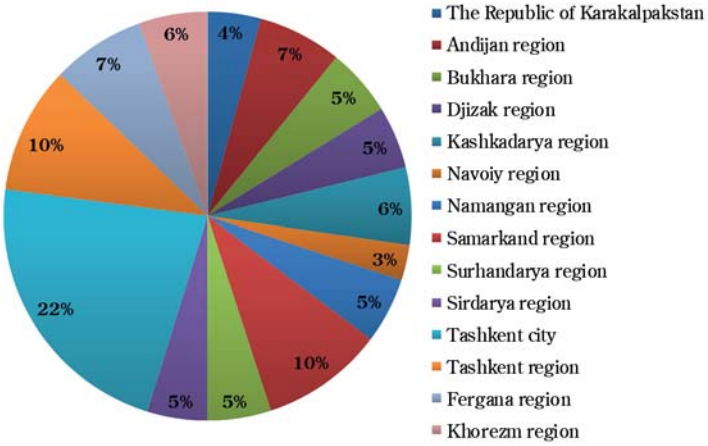
Operational leasing could also take significant part of the market in future. However, its growth is not considered to be so dynamic, due to the reason that Uzbekistan financial market did not have such financial product, yet.

However, such perspectives of leasing market growth would not have much impact on the share of leasing in GDP, due to the expected relative fast growth of the economy and GDP of Uzbekistan. Consequently, the share of leasing transactions volume and portfolio in GDP of the country would insignificantly increase. However, this would not mean that leasing sector tends to deteriorate. It will remain stable, and become more transparent, predictable, and competitive.

Y 2013



Y 2013



For further information please visit website www.uzbekleasing.com

Horticulture Development in Uzbekistan

By Takuya Kamata, WB Country Manager for Uzbekistan

Uzbekistan is a major agricultural producer, both regionally and globally. Agriculture remains a significant component of national income, and has grown at a robust pace in recent years. It generates about 16 percent of GDP and contributes to the well-being of about 14.5 million people in rural areas.

Horticulture subsector has been a source of growth and offers an opportunity to sustain recent gains in agricultural productivity. It is a vital source of income for almost 4.7 million households that operate private farms in rural communities. Growing fruits and vegetables is among the most profitable activities and, over the last ten years, the incomes generated by the subsector comprise an increasing share of national GDP. Horticultural export earnings have also surged in recent years, growing from $US 373 million in 2006 to $US 1.16 billion in 2010. In the same year, an additional 240 thousand hectares of land was reassigned to horticultural production under new government policies. Despite its small footprint, the economic impact of the fruits and vegetables subsector is large, accounting for 50 percent of the value of crop output and over 35 percent of export earnings.

The Government of Uzbekistan announced an aggressive development strategy with the objective of becoming a middle-income country by 2030, which implies a ten-fold increase in per capita income. The Government's shift from direct interventions to market-reliant support has generated positive benefits, whether measured in output, export earnings, farm incomes or resource productivity. Although work needs to be done to build the special institutions needed to enter high-value markets consistent with the high-quality horticultural goods Uzbek farmers produce, important steps have been taken to support the subsector's market channels as well.

A recent **Horticulture Policy Note for Uzbekistan** developed by the World Bank finds that horticultural crops generate bigger levels of employment compared to cotton or wheat. Even after orchards are established and fields prepared, on-farm labor inputs are higher for horticultural crops than they are for wheat or cotton. Since the work is seasonal, it can fit in well with dehkan livelihood strategies, where incomes are diversified. For private farms, given the seasonality, there is some scope for spreading out labor requirements, by sequencing early season crops, or crops grown in tunnels or greenhouses.

The Policy Note also focuses on costs of Uzbek horticultural goods along the value chain based on an example of sweet cherries. Thanks to favorable climate conditions, early crop maturing, a free trade agreement with Russia and inexpensive labor, Uzbekistan exports significant volumes of sweet cherries. Recently the first exports to South Korea were made through air transportation. Sweet cherries could be exported virtually to any country in the world, given proper production, pre-cooling and packaging technologies are utilized. International fruit trade Univeg provided the local firm Unigreen, with hydro-cooling equipment and x-tend technology that can preserve cherries for 45 days or longer. Nevertheless, work is still needed in this area, along with upgrading of cherry production technology to boost productivity. There are also technologies for extension of cherry season, as, currently, it is only about 20 days long. Production of cherries in high tunnels in the southern regions could help extend the season and increase the value of the product, since prices for early cherries are higher.

Uzbekistan is famous among the FSU countries for its melons. Melon exports bring $US 50-60 million to the country each year and make it second export item after table grapes. Uzbekistan still grows traditional varieties and it is the only seed segment where there is virtually no imported product. Farmers have developed traditional ways of storing melons, which effectively extends the season until the end of March. During field visits, farmers suggested that storing melons in the modern cold storage was more difficult. Nonetheless, Uzbekistan could potentially supply melons almost year around. First early melons could be available at the end of May and the last melons in March, or even April with small improvements in storage techniques. There is significant scope for Uzbekistan to expand melon production and exports, targeting EU countries, specifically with off-season products. Significant exports to Korea are beginning to take place as well. Dried melons could also be another attractive category. To summarize, this is a product to focus on with a significant potential.

The use of horticultural goods for processing is another source of growing demand. In Uzbekistan, horticultural products are processed by 149 large firms, and numerous small processing enterprises. Processed horticultural products include canned and dried fruits and vegetables, tomato paste and juices, as well as grape wines and liquors. Over 15 percent of total horticultural crops are processed (including drying). Between 2000 and 2010, the volume of vegetable processing rose six-fold, fruit processing rose threefold, grape processing rose about twofold. In 2010, the volume of processed grapes in total volume of grape production was 24.4 percent, vegetables: 11.3 percent, fruits: 18.2 percent.

A recent Horticulture Policy Note for Uzbekistan developed by the World Bank finds that horticultural crops generate bigger levels of employment compared to cotton or wheat. Even after orchards are established and fields prepared, on-farm labor inputs are higher for horticultural crops than they are for wheat or cotton. Since the work is seasonal, it can fit in well with dehkan livelihood strategies, where incomes are diversified. For private farms, given the seasonality, there is some scope for spreading out labor requirements, by sequencing early season crops, or crops grown in tunnels or greenhouses.

A key ingredient to the success of horticultural industries in a number of countries has been their success at building a reputation for quality, safety and reliability that extends beyond the reputation of individual firms and farms within the industry. Putting in place the investments and institutions needed to support quality, safety and reliability is the first step. Besides building a brand name can complement public and private investments in quality controls and a robust certification. Creating awareness that, for example, Uzbek melons are preferred by consumers because of their more favorable and stringent safety standards can open up new markets for melons. Furthermore, organized efforts can also have a positive spillover effect on a wide range of Uzbek products, as buyers familiar with melons begin to think about other Uzbek fruits.

The Bank's current investment Rural Enterprise Support Project is increasing the productivity, financial and environmental sustainability of agriculture and the profitability of agribusiness. Rural finance component of the project issues loans and leases to finance investments in agricultural machinery, food processing equipment, storage, packaging, provision of agricultural services and inputs. A number of farms have diversified their business and are currently dealing with fishery, apiculture or cheese processing.

The proposed **Horticulture Development Project** is an incoming opportunity which aims at strengthening the horticulture subsector by facilitating investments along the value chain to improve productivity and quality on the farm, reduce post-harvest loss and food safety hazards; ensuring the flow of information about best practices on farm and along the value chain; and by facilitating the adoption of a supportive policy framework for the subsector.

The potential investment also complements efforts made by International Finance Corporation (IFC) which probably will help in attracting investors/operators to finance, build, own and operate refrigerated warehouses in Uzbekistan.

Kazakhstan's Bet on Innovation

Interview with Zhumatay Salimov, Deputy Chairman of JSC "NATD"

The Republic of Kazakhstan, being considered as the country of "raw materials appendage", is building an open economy and is betting on innovations. There are many development institutions in the country now. They are created to promote innovative development of the economy. Mr. Zhumatay Salimov, the Deputy Chairman of the Board of the JSC "National Agency for Technological Development" will share his view about the latest developments in innovation.

Our task today is to provide the entry of Kazakhstan into the list of technologically developed nations with high standards of living through radical modernization, innovative industrialization and diversification of the economy.

How do you rate the overall level of innovative development of the country?

Innovative system of Kazakhstan today introduces new principles and approaches to the intensive development that is relevant to the challenges and requirements of the time.

Within a short history of industrial-innovative development, the country has established legal framework and developed a number of mechanisms that enable innovators to implement their ideas.

Innovation support mechanisms are formalized on legislative level, including the Law "On Science", and the Law on "On state support of industrial-innovative activities".

Kazakhstan government defined long-term vision and plan for further action in the field of innovations. Also, the Concept of innovative development until 2020, adopted in 2013, reflects the long-term guidelines for the development of innovations in the country.

Gradually we expand the range of innovative infrastructure. Today there are 8 regional technoparks, 4 industrial design offices, 21 offices of commercialization at the universities and research institutes, and 4 technology transfer centers. Two innovative clusters, the Park of innovative technologies and Nazarbayev University, are successfully being developed under the coordination of the Government of the country. Among the key elements in the reforms I can mention institutional changes. A specialized institution was created - National Agency for Technological Development, which acts as an integrator of state-support measures for all participants in the innovation system.

In general, in 10 years we have managed to identify more than 3000 innovative projects, 600 of them received practical support in implementation.

If we talk about the key performance indicators, in 2012 Kazakhstan reached a historic maximum on most of them.

Compared to 2009, private sector expenditure on technological innovation increased more than 5 times – up to U.S. $ 2 billion (from 393 to 2,103 million dollars).

The volume of innovative products and services increased more than 4-fold – up to 2.5 billion dollars (from 529 to 2,445 million dollars). The share in GDP rose up to 1.3% (2009 - 0.51 %, 2011 - 0.86%).

Expenditure on R&D increase annually (in 2012 amounted to over 322 million dollars, three times higher than in 2003).

Which sectors are of great interest? Do oil and gas sector projects dominate?

In general, the priority areas of the economy are identified in our of Intensified industrial -innovative development plan (2010-2014). Besides oil and gas sector, they include mining and metallurgical sector, chemical industry, agriculture, energy, atomic industry and others.

Historically it happened so that in these particular sectors we have strong resource base, accumulated experience and professional skills and we still have a great potential for growth.

Statistics show that the largest number of projects is presented in such priority areas of grants provision, as advanced technologies in chemical and petrochemical industries, mining and metallurgy and agro-industrial complexes, in machinery building and biotechnologies. And this list is not exhaustive.

Today the Strategy adopted in Kazakhstan till 2050 assumes Kazakhstan's entry into the top 30 developed countries of the world. And we clearly understand that it is impossible without strengthening the trend of innovative industrialization.

Currently, the Government initiated the development of the next phase (2015-2019 years), the second five-year program of accelerated industrial-innovative development. The program assumes more focused development of the processing industry in priority sectors, such as oil and gas chemistry, metallurgy, food production, agricultural chemistry, motor vehicles manufacturing, agricultural and railway equipment manufacturing, manufacture of construction materials and others.

It also assumes building a science-driven economy and the development of new industries such as mobile and multimedia, nano- and space technologies, robotics, genetic engineering, search and discovery of energy of the future.

This time the focus will be on the support of science and innovations through changes to the legislation and development of new instruments to support the business and investors.

What kind of tasks has the innovation system of Kazakhstan for the future?

The main activities will be focused on upgrading the instruments of support of innovative activities, increasing their effectiveness in terms of optimization of the schemes on providing state support measures, development of regional innovative systems, stimulating the demand on innovations, improving the mechanisms of technology commercialization and venture financing.

There will be a new type of grant provided for the development of strategic technologies through financing large-scale applied research together with the business and with the involvement of the domestic science.

In perspective we plan to broaden the geography of the National Agency in order to activate the international cooperation and integration into the world innovative system. It is planned to create new international centers for technology transfer that will provide access to innovations and technological information, search for new partners, trend analysis in the field of science and technology and assist the exit of domestic developments on world markets.

And finally , probably a lot of projects went through your Agency, could you please name with the most successful ones, which made a significant contribution to the development of Kazakhstan's innovation ...

I would like to note that today we support all types of innovations. These are not just products, but also process, management and marketing innovations.

There are a lot of unique projects that proved their relevance and importance not only in its homeland, but also found practical application outside of our country.

For example, in the chemical industry the project financing was given to LLP "Agrofos SOUTH" to organize the production of phosphate fertilizers from industrial waste of phosphorus derivatives. The project is notable because it has a pronounced environmental focus and creates additional incentives for its further development and promotion.

Innovations in production helped to reduce energy consumption of the "Almaty fan factory" to 40%. By implementing the state-sponsored project on expanding the production capacity worth 3,387 million dollars, now the company produces central air conditioners with energy-saving technologies, including systems using adiabatic cooling, heat recovery ventilators with reduced energy consumption.

In addition, lean manufacturing technology has allowed to increase the productivity by 70%.

Plant customers are enterprises of chemical, oil and gas, energy, machinery, food, pharmaceutical, light, woodworking and other industries.

Another example, currently in Western Kazakhstan “Minifactory for vacuum-wave conversion of organic compounds on cyclic and acyclic chemicals and motor fuel” is being constructed (LLP "Zhan Ami and K"). Project cost is 1,695 million dollars, including 830 697 dollars financed by the JSC "NATD", period of project implementation is 7 years.

Feature of the project: vacuum, vibration, and electrical discharge form microfractures and intrabubble boiling of the liquid. The generator of magnetoelectric field, used for this process, has a high intensity and penetrating capacity to break the chemical and intermolecular and interatomic bonds of hydrocarbon compounds.

The uniqueness of the project is that the electromagnetic nanomolecular reactor performs the process of hydrocleaning from sulfur and mercaptan and resins. Another feature of the project is that it helps to reduce two or more times the volume of involved supplements and additives that improve the performance properties of the fuels without reducing their marketable quality.

As a result, innovative technology will allows to produce world-class quality petroleum products in accordance with the Euro-4 and Euro-5 standards.

On the territory of the Special Economic Zone "Park of innovative technologies", the project named "Transfer of advanced equipment and software for production of high-quality computer graphics and visual effects" (LLP «Kazakhstan Computer Graphics») is being implemented, the cost of the project amounts to 200 000 dollars, including 18 064 dollars financed by the JSC “NATD", project duration is 6 years.

Last year one a company named «Alpha network» became one of the members enrolled in a Special Economic Zone "Park of innovative technologies". This is a joint Kazakh-Korean venture for the production of passive optical components - splitters, patch cords , cross , etc. (Splitter is a signal power splitter that is used by the operators to divide the optical fiber in the cable networks).

«Alpha Network» was founded in 2010 and is the leading manufacturer of fiber optic production in Kazakhstan. The main goal is to develop the telecommunications networks in Kazakhstan. Alpha Network is also a partner of South Korean company LS Group, which is ranked the 3rd in the world for the production of fiber-optic cables.

Of course I can name many of the implemented ideas and projects. We constantly do market research, trying to have our finger on the pulse. Asradical modernization of the enterprises should be performed on the base of high technologies (information, nano -, bio-, quantum, etc.) in order to produce competitive products with high added value both in domestic and global markets of innovative products.

And that is why our support tools are continually being improved and tuned. It is obvious that the innovative potential of our country is great and our future steps will be directed to support science-driven economy.

NATD
national agency for technological development
технологиялық даму жөніндегі ұлттық агенттік

IFC Support Economic Diversification and Growth in Kazakhstan

Interview with Moazzam Mekan, IFC Regional Manager for Central Asia

Moazzam Mekan is IFC's Regional Manager for Central Asia covering Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

What is the current state of the IFC's investments in Kazakhstan, and what are the IFC's investment priorities moving forward?

IFC's purpose is to create opportunity for people to escape poverty and foster inclusive economic growth by leveraging the power of the private sector. IFC has been helping businesses in developing countries create and preserve jobs by providing loans and investments to enable them to grow quickly and sustainably, and by providing advice that helps them to innovate, raise standards, and mitigate risks.

In Kazakhstan, IFC actively supports the government's diversification agenda, which focuses on increasing non-oil sectors' contribution and the share of small and medium-sized enterprises (SMEs) in the economy. Infrastructure, real sectors, and financial market development have been the main focus for our investment activities in Kazakhstan. We are also focused on SMEs, which are often less able to attract much-needed capital.

About 50 percent of IFC's involvement in Kazakhstan is in the financial sector, focusing on better access to credit. IFC has provided over $500 million in investments to Kazakhstan's commercial banks, microfinance institutions, and leasing companies. Improved access to finance is essential for SMEs to grow, generate more output, and create much-needed jobs. Increasing access to finance for SMEs is best achieved by increasing the depth and breadth of local financial markets and boosting the competitiveness of the financial sector. To support this, IFC invests in and provides advice to financial intermediaries to help expand their services to SMEs.

In the real sector, we see investment opportunities including agribusiness and food processing, construction materials, and a broad range of consumer services industries, such as retail, affordable housing, healthcare, and education. Our recently financed projects include a cement plant, a medical insurance company, a freight railway company, a bank, and a shopping mall.

But investments are not the only thing we do. Private sector development requires more than finance. We have a very strong advisory services practice, which is funded by our income and our donor partners. Our work includes advising governments on how to improve their investment climate and strengthen basic infrastructure. Our advisory services help companies improve corporate governance and risk management and become more sustainable – financially, environmentally, and socially.

Going forward, IFC will continue to promote private sector development through investment and advisory operations in support of economic diversification and growth. IFC's strategy in Kazakhstan focuses on access to infrastructure, strengthening the financial sector, and supporting diversification and competitiveness. More efforts will be dedicated to the establishment of best practices in international banking, improving corporate governance and the regulatory environment, SME development, increasing investment in value-added manufacturing, agribusiness and services, and supporting energy efficiency.

An IFC priority has been working with banks to finance SMEs. How do you assess today the development of this business segment in Kazakhstan in comparison with other IFC countries?

Private sector participation in the economy continues to grow in Kazakhstan, which is good. However, there is a need to grow this sector further because this is where job-creation and innovation occur. Private enterprises create nine out of every 10 jobs in developing countries. Thus, the story of the growth of SMEs is the story of Kazakhstan's development and diversification away from dependence on natural resource sectors.

Yet SMEs in Kazakhstan face several challenges. Access to financial services remains severely constrained. Logistics costs are high and the country's infrastructure (bridges, roads, railways, airports) and communications systems need considerable investment to better connect people internally and across the region. Trade restrictions and customs clearance delays contribute to high goods and services costs. Finally, there is the issue of transparency and reporting. While Kazakhstan has done a tremendous job improving its business enabling environment – as evidenced by the latest Doing Business Report – there is more to be done in this area.

Further efforts are needed to strengthen market competition and stimulate private sector innovation, particularly in export-oriented sectors. Central to sustained improvements are the strengthening of the business climate, providing greater room for private sector expansion, expanding infrastructure connectivity, and promoting SMEs.

How do you think PPPs can be used to boost the country?

There are two main reasons to undertake public-private partnerships: to supplement fiscal budgets; and to improve the delivery of public services. Kazakhstan epitomizes the need for PPPs. It is a vast, landlocked country, facing challenges related to insufficient and aging infrastructure. Given its size and need for connectivity, it requires new and better infrastructure (roads, railways, airports, airlines, power and gas distribution networks, and more). This requires a great deal of money. Thus far, Kazakhstan's infrastructure has been funded by public bodies, which all face fiscal constraints. PPPs add

the considerable financing power of the private sector. But PPPs should not be viewed as a replacement or substitute for the government, but as an off-balance sheet tool to increase investments in infrastructure and other areas of interest.

Perhaps more importantly, effective PPPs improve the quality and efficiency of public services – mainly by putting new services in place. Well-structured PPP projects rationalize project costs and help reduce project completion times. PPPs are a good way to avoid building white elephants as private sector investors seek a return on their capital. This is why nearly every country in today's world has some sort of PPP program, including Kazakhstan. You may ask, if PPPs are such a great tool, why are there so few examples of successful PPPs in the developing world? The answer is that PPPs work best under stable and predictable frameworks and require a strong commitment from government.

IFC intends to facilitate infrastructure development through PPP advisory work and direct investments with both private sector and sub-national sponsors. In fact, IFC and EBRD are currently advising the government on its first large-scale PPP project for the Almaty Ring Road, which we hope will provide an excellent opportunity for private capital to invest in Kazakhstan's infrastructure sector.

IFC is advising Kazakhstan on corporate governance. How would you rate the enforcement of sound corporate governance locally?

IFC is committed to improving corporate governance as a way to promote sustainable private sector investment and strengthen capital markets in emerging markets. Corporate governance development is a pressing issue for companies in Kazakhstan due to several factors: to help the company go public; to attract domestic and foreign investment; and to enhance operational efficiency and image. The outlook for corporate governance standards' implementation could be considered positive because both the government and the business community recognize the necessity for improving corporate governance practices in Kazakhstan.

Good corporate governance is about far more than minimum compliance with laws and regulations. When implemented effectively, good corporate governance brings significant benefits to companies, particularly in terms of long-term sustainability. We therefore believe it is important to develop practical ways of encouraging companies to do more than comply with regulations in order to bring them the very real benefits good governance brings.

IFC is a recognized global leader in the promotion of corporate governance standards and has developed a globally-respected and well-tested methodology for evaluating corporate governance practices, risks and opportunities. In Kazakhstan, IFC and its two local partners offer corporate governance services for companies and financial institutions, including thematic training, tailored 'diagnostic' reviews, consultations on specific corporate governance matters, and in-depth assessments with implementation plans.

What is your vision for Kazakhstan in the medium term?

Kazakhstan is doing very well economically. The economy is expanding, and it is expected to continue at 5-6 percent over the medium term, which is very reasonable. If you split that growth between the oil-based economy and the non-oil based economy, you will have a more accurate portrait of where the country is heading. However, I believe that this country offers many opportunities to investors, and there is a lot of room for investment, particularly in infrastructure. We will see that happen in the next few years; we will see that investment increase. With the World Expo 2017, there is going to be significant development in Astana. Connectivity is going to be very important.

ufi Approved Event

AMM

ASTANA MINING AND METALLURGY
CONGRESS

A MAJOR CONGRESS FOR GEOLOGISTS, MINERS AND METALLURGISTS

12-13 June 2014

Astana, Kazakhstan

The next meeting of International Organising Committee of the World Mining Congress will be held within the framework of "AMM 2014"

www.amm.kz

FORUM • EXHIBITION • GOLDEN HEPHAESTUS AWARDS CEREMONY

Governmental Partner:

Ministry of industry and new technologies of the Republic of Kazakhstan

Organisers:

ORGANISED BY ITE THE ITE GROUP

ITeca

Valentina Michaelson • +44 (0) 207 5965 137 • mining@ite-events.com

The Morning After

By Sabit Khakimzhanov, Halyk Finance, Head of Research, Member of the Management Board

On Feb 11, the NBK suddenly stopped defending the exchange rate at USDKZT 156, let it weaken to 160 and within minutes showed a huge bid at 185.
In the press-release that soon followed, the NBK stated:

- the new target for USDKZT is 185 plus-minus 3;
- the NBK will continue to intervene in the foreign exchange market;
- the NBK will continue to provide liquidity through repo market.

The press-release listed the following reasons for the devaluation:

- devaluation of EM currencies;
- liberalization of USDRUB by CBR;
- weakening of the external accounts;
- the need to restore the competitiveness;
- plans to transition to inflation targeting monetary policy framework.

This note examines the motives for the devaluation.

HAS TENGE BEEN OVERVALUED?

At the low and volatile interest rates in Kazakhstan's money market USDKZT was overvalued at 156 by about 5-10%. Since the devaluation of 2009, KZT appreciated in real terms against the USD by about 15%. Before the devaluation, the NDF rates were relatively low, hovering at 7-8% per year. Had the NBK raised the interest rates to this level (7-8%), then the pre-devaluation exchange rate would not have been overvalued by more than 5%, a difference small enough to align it with the USD after a year of moderately high interest rates.

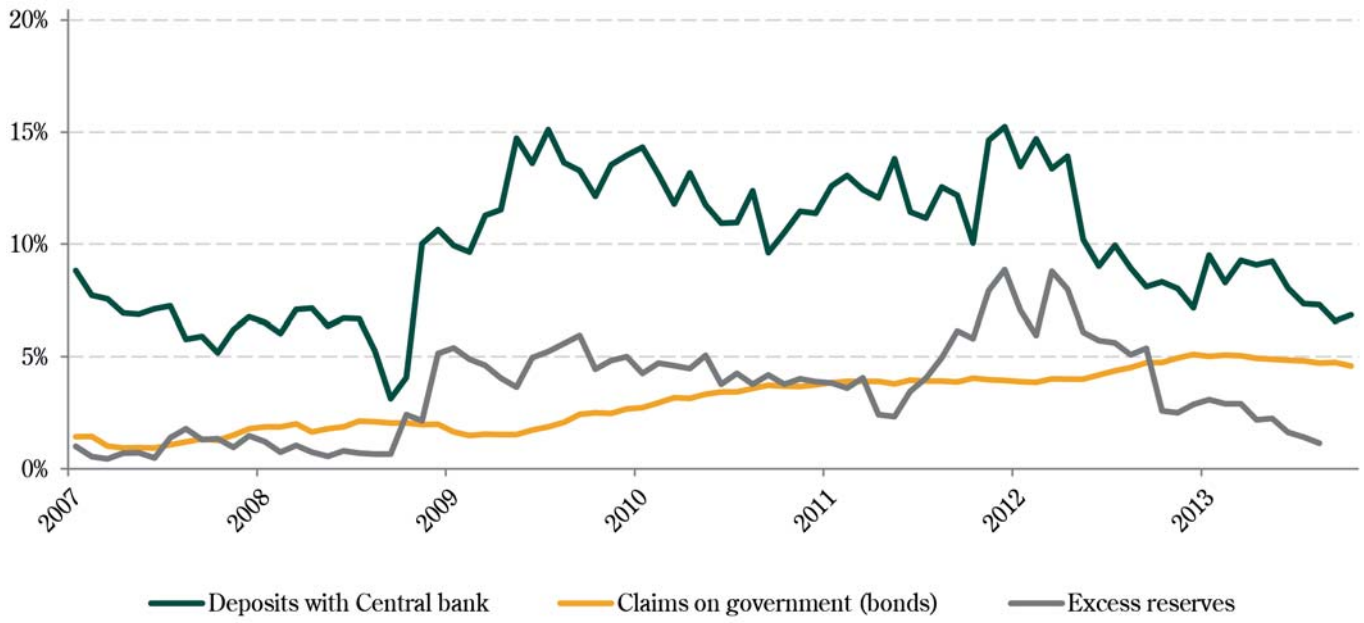
HOW THE EXCHANGE RATE WAS DEFENDED

The defense of the exchange rate as practiced by the NBK was inconsistent. Demand for Tenge during the attacks was maintained largely by precautionary motive, the risk of a sharp decline in the availability of Tenge during the tax week (the week ahead of the tax due date). During the last two tax weeks the overnight interest rates rose to 50% and for overnight currency swaps – up to 200%. After the tax week the interest rates would fall to 1% for overnight repos and 3-4% for the currency swaps. Neither low interest rates, nor the extremely high interest rates were conducive to the credibility of the exchange rate. Had the NBK maintained the interest rates at a stable level of 7-8% during the eight months before the devaluation (in order to discourage the covered interest rate parity arbitrage), the pressure on the exchange rate would have been much weaker, the loss of foreign currency reserves by the NBK smaller and KZT would have been less overvalued because of less inflation. In effect, the devaluation reflected the inability of the NBK to muster a consistent and deliberate interest rate defense.

COMPARE AND CONTRAST: TWO DEVALUATIONS

We compare the yesterday's devaluation with the devaluation of 2009. It reveals mostly differences. In 2009 the economy was under strong pressure to devalue because of a huge terms-of-trade shock in 2008, a 'sudden stop' in 2007, collapse of the housing bubble, and high inflation in 2007. Tenge was severely overvalued and it took a devaluation by 20% to right it. The interest rate defense would have been futile. The implied interest rate for 1m NDF (non-deliverable forward) was close to 30 - 60%. To discourage short positions in Tenge the interest rates would have to be raised and kept at that level for years, until the wage and price level deflation could weaken the real exchange rate by 20%. But banks with weak balance sheets would not be able to sustain such interest rates for longer than a week or two.

Fig 1. Banks got rid of the excess reserves before devaluation
Banking system balance sheet, % of assets



To avert the financial meltdown, the central bank had to inject liquidity into the system at very low rates. The choice between a devaluation and a collapse of the banking system was obvious, in favor of the banking system. This logic was obvious to the offshore currency traders who quoted the rates for NDF contracts. The devaluation was as expected as it was unavoidable. If anything, it was two months too late. But after the devaluation of February 2009, demand for Tenge recovered. The exchange rate remained heavily managed, and that was the reason for Tenge becoming undervalued in 2010, when oil prices rose to a record level, but that is a different story.

The devaluation of February 2014 was very different. External debt of banks was much lower, capital cushion much safer, fiscal position of the government more stable, with the National Fund providing the freedom to engage in fiscal stimulus. True, the current account was deteriorating, but it was very close to being balanced. At the low interest rates that prevailed in the market in the last two-three months, Tenge was overvalued by maybe 5-10%. The pressure on the exchange rate was manageable with 3m NDF rates at about 7% for the most part of 2013 and in January 2014. The misalignment of the real exchange rate could have been corrected within half a year of during which the money market interest rates had to be maintained at the level of NDF. Banks could easily tolerate such conditions, provided the interest rate was stable. All fundamental factors suggested that the interest rate defense would have been credible and successful at defending the exchange rate in a sustainable manner while supporting low inflation. Instead, the government opted to devalue by 20%. As a result, Tenge became undervalued by at least 10%. The gap will translate into inflation very quickly, feeding the cycle of inflationary expectations, real appreciations and periodic resets of the inflexible exchange rate.

BALANCE SHEET EFFECTS

Direct balance sheet effects on banks are going to be fairly small because banks maintained fairly small open interest in any foreign exchange (less than 12.5% of the statutory capital, and for all currencies less than 25%). Most banks were long in USD and EUR in anticipation of the devaluation. Those few banks that that were long in KZT, accumulated the earnings from the high interest reverse repos and other types of long-on-KZT positions in the months leading to the devaluation.

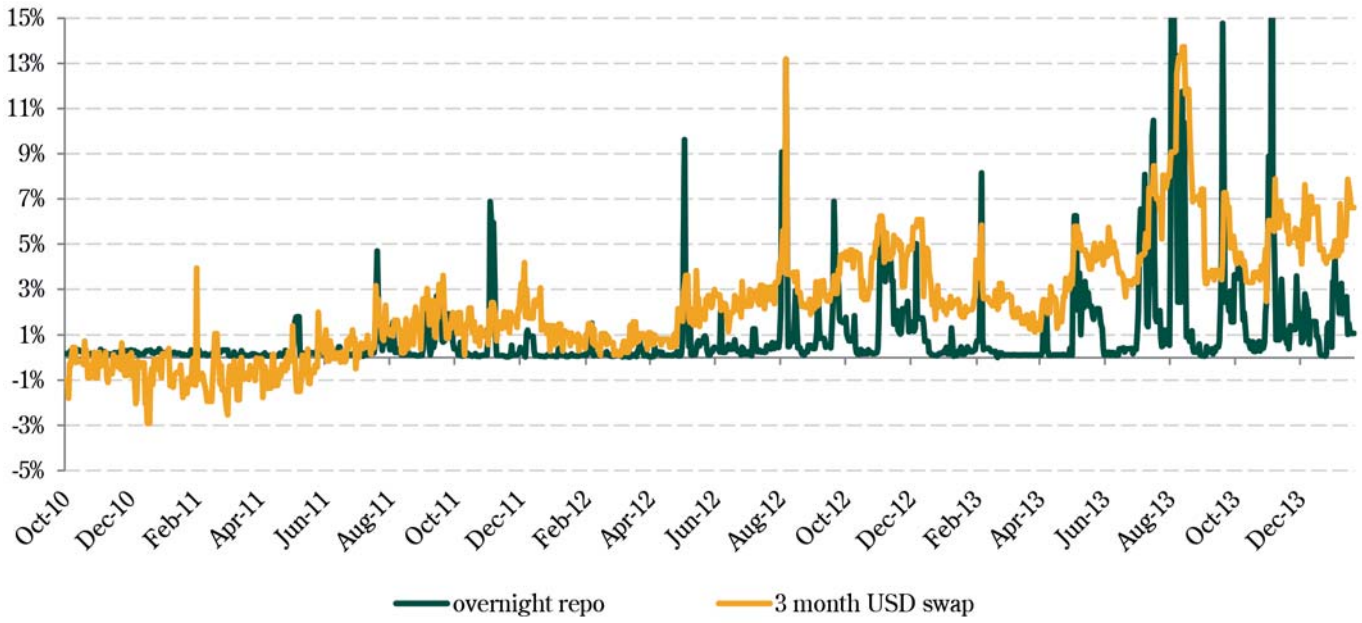
The secondary effects, acting through bank asset quality, are probably more important. The banks exposed to real estate and USD- denominated loans will suffer the most, but given the fairly deep capital cushion, it should not have much impact on their creditworthiness. About 30% of the banking system's loans are foreign currency denominated. These are predominantly corporate loans and we believe predominantly pre-2008. The corporates were preparing for devaluation as well, substituting USD for KZT deposits in May-June 2013, when the share of fx-denominated deposits rose from 24% to 33%.

MONEY MARKETS

Dollarization was driven by corporate deposits, and the monetary base simply accommodated the clients, but being much smaller, the relative dollarization there was much more dramatic. We estimate it to have exceeded 50%. This process will now reverse, we expect, as banks will begin to refill their excess reserves and their corporate clients will turn into the still high-yielding Tenge.

So, the short-term effects for the credit conditions are positive. The short-term (up to 1 year) currency swaps will become much cheaper, falling from 7-8% to under 2%, and possibly below zero. This should lower the opportunity cost of holding Tenge for the next 12 months by at least 5pp, but not much is going to happen in terms of the yields on corporate and government securities. Demand for Tenge-denominated paper will grow.

Fig 2. Low and volatile money market rates supported arbitrage and fed in devaluation expectations



However, the devaluation will not lower the costs of forward swaps (beyond 1 year) and longer term swaps. The devaluation did not change the regime of managed floating, only reset the level at which it promised to maintain the exchange rate. After the inflation makes USDKZT fair valued at 185, the game of exchange rate defense will start again.

So, the long term effects are definitely negative. Credibility of the NBK as an institution that can coordinate long-term expectations of the market will suffer further. Devaluation recidivism has lifted the long-term component of devaluation risk – the one that reflects the institutional capacity of the monetary authority – by a notch or two. This devaluation, unwarranted and unexpected, made things more difficult for the central bank in its transition to inflation targeting (IT).

THE MOTIVES FOR DEVALUATION

A mention of IT as a motive for the devaluation is not credible given that a much smaller devaluation would have improved competitiveness just as much with much lower inflation. Today, the head of the NBK reiterated the commitment to IT and announced plans "to lower the level of dollarization" as part of the preparation for the transition. This was supposed to boost the credibility of the plans for the new monetary policy paradigm, but was compromised by another signal. Today the president announced government plans to raise public sector wages by 10% and recommended that state-owned enterprises considered the idea as well.

Barraged by confusing signals, we were unable to decipher the message or identify a coherent policy behind the announcements and the devaluation. This translates into more medium-term policy uncertainty about the short-term interest rates, credit growth, exchange rate flexibility and inflation. In the short run we believe the NBK will continue to manage the exchange rate, will refuse to stabilize the interest rates, but the liquidity risk and interest rate volatility will decline for a few more months. We do not expect that the devaluation will the banking system to create long-term KZT funding on market terms.

A mention of IT as a motive for the devaluation is not credible given that a much smaller devaluation would have improved competitiveness just as much with much lower inflation. Today, the head of the NBK reiterated the commitment to IT and announced plans "to lower the level of dollarization" as part of the preparation for the transition. This was supposed to boost the credibility of the plans for the new monetary policy paradigm, but was compromised by another signal. Today the president announced government plans to raise public sector wages by 10% and recommended that state-owned enterprises considered the idea as well.

COMPETITIVENESS

Has the devaluation improved Kazakhstan's competitiveness ahead of the anticipated devaluations in emerging markets which the head of the NBK was talking about a week before the devaluation? If iot happens within the next three months – the exchange rate pass through is very quick in Kazakhstan because of high proportion of imports – preemptive devaluation might work, but beyond that time frame the effect is going to be limited.

THE OUTLOOK

We expect

- a normalization of conditions in the liquidity market,
- a recovery in demand for Tenge,
- the yields on most Tenge-denominated instruments will drop,
- NDF rates will fall to under 2%, and maybe even below zero,
- non-residents may try to bet on strengthening of Tenge and very low risk of default by buying KZT-denominated government debt,
- the National Bank will begin buying foreign exchange and will buy about $5bn in the next 3-6 month

But, all of these effects will be temporary. The rates will start to rise again when inflation eliminates the effect of excessive devaluation (about in a year). The long-term Tenge funding on market terms will not become significantly cheaper.

The main loss for the economy and the financial sector is that periodic devaluations have now become pretty much institutionalized as part of the normal conduct of the monetary policy. But of course the trick could be used once, at most twice. The credibility of the monetary policy will suffer.

Another common loss is that the economy missed a great opportunity to change the process and the mechanisms of the monetary policy. During 2013 there have been tremendous changes in the understanding by the market of the importance of liquidity risk and its connection with the devaluation risk. Demand for Tenge began to depend on the liquidity risk in addition to the traditional risk of devaluation. The interest rates began to reflect the balance between these two risks. During those liquidity crunches the clearers learned a few lessons in liquidity risk management. The money market and the deposit market began to move closer to each other, which benefitted the deposit market and it became more efficient: the spread between foreign currency and Tenge-denominated deposit rates widened while the spread between corporate and retail deposits narrowed. Because of wider spread the dollarization of deposits stopped. Liquidity crunches saw a number of corporates to mobilize liquidity from deposits in order to earn through the reverse REPO. The NBK demonstrated its ability to directly influence the money market rates by interventions in the repo market. Inflation declined, although caused mainly by fiscal tightening, rather than because of real appreciation of Tenge.

This prepared the soil for restoring the credibility of Tenge. Only one final step needed to be made - to manage the interest rates in a systematic and consistent fashion. The devaluation squandered this opportunity. The exporters, of course, are the winners, but the positive impact will be short-term.

The Customs Union:
Customs View from Kazakhstan (Three Years After)

By Sholpan Dossymkhanova, Manager, Tax & Legal Department, Deloitte Caspian Region

Time zips along. An impetuous and heady torrent of new knowledge and advanced technologies rushes into our life, new products are created, international trade in goods, work (services) extends, countries converge and borders broaden.

The creation of the Customs Union between Kazakhstan, Russia and Belarus can be also compared to the beginning of new times and a new epoch opening new opportunities and plans for future to us. The extent to which our hopes will be realised depends, of course, on many factors and the striving of each participant. But we trust that we will manage to overcome successfully any difficulties we meet on our way if we move together in the same direction and listen to each other, choosing only the best experience and providing equal opportunities for achieving the target to everyone.

Almost three years have passed since the official launch of the Customs Union and enactment of the Agreement on the Customs Code of the Customs Union, the Agreement on the Principles of Levying Indirect Taxes at the Export and Import of Goods, Execution of Work and Provision of Services within the Customs Union (hereinafter — the Agreement on Indirect Taxes) and other international agreements that have become an indispensable guide for many of us.

Formation of the Customs Union led to elimination of customs declaration of goods between the Customs Union member states, elimination of customs tariffs in the trade between the member states and, after one more year, elimination of customs control on the borders between the states. Despite all the difficulties that arose at the first stage of the customs alliance, in general, the country and businesses have managed to achieve the targets. The mechanism of free circulation of goods within the integrated customs territory started working as it had been intended to for the first stage.

Objectively, the business community now does not have to worry about payment of customs tariffs and taxes while delivering goods from Russia and Belarus to Kazakhstan, there is no need for mandatory storage of goods in the temporary storage warehouses and incur expenses on storage and on payment for services of customs brokers/representatives, etc. One can list many advantages gained by Kazakhstani business from the Customs Union. However, we cannot neglect certain issues that have been discussed at round tables, meetings, and asked by business associations. As time has shown, some questions were resolved quickly, while others got postponed for an indefinite time.

LEVYING INDIRECT TAXES IN MUTUAL TRADE BETWEEN THE CUSTOMS UNION STATES

We understand that indirect tax payment mechanisms in mutual trade should work simply and accurately, and the rules for their application should be clear and realizable. For instance, while importing goods from the Customs Union member states it is now required to fill in 2 documents instead of one customs declaration: a declaration on indirect taxes on the imported goods and a Statement on Import of Goods and Payment of Indirect Taxes (there is place for simplification of tax reporting). It is necessary to take into account that submission of a Statement on Import of Goods and Payment of Indirect Taxes is regulated by the Agreement on Indirect Taxes and the rules of its execution are strictly agreed by the parties. While some entrepreneurs were learning to complete the fields of the mentioned Statement in practice, others needed to quickly figure out the definition of the date of recognition of imported goods which initially did not take into account all the situations regarding import of goods, though it directly determined the indirect taxes declaration submission date and payment of indirect taxes itself. Then the entrepreneurs who had hardly had enough time to understand when to recognize imported goods received a new surprise: for some reason the value of their imported goods had to be adjusted according to a special method and significantly increase causing a corresponding increase in the amount of VAT paid. It should be noted that the voice of taxpayers was heard in time and state bodies made appropriate decisions that stabilized the tense atmosphere in the business community.

Looking at the mechanism of levying indirect taxes in mutual trade in general, we need to admit that confirmation of the export of goods from Kazakhstan into the Customs Union countries for the purposes of applying zero value added tax rate has become more complicated. Before launching the Customs Union, to confirm export into Russia it was necessary to provide a copy of the export customs declaration with marks of the customs body made at the customs border of Kazakhstan and other documents.

However, after the launching of the Customs Union, under the Agreement on Indirect Taxes Kazakhstani entrepreneurs became dependent on their counterparts in the Customs Union

states. Today when our entrepreneurs export their goods they cannot apply zero VAT rate without a copy of a Statement on Import of Goods and Payment of Indirect Taxes marked with the customs bodies of Russia and Belarus. Probably, time will show the extent to which this issue can be simplified via data exchange between the Customs Union states.

Furthermore, we suppose that legislation should take into account the specific issues of international supplies connected with change in the amount of goods during transportation caused by deterioration of goods, change in the value of goods resulting from transfer of title to the goods on their way and many other things.

It should be noted that in mutual trade between the Customs Union states we lost some advantages of the customs legislation, such as the customs procedure of customs warehouse which is one of the most widely spread procedures in international trade for promoting goods closer to a customer.

We hope that all issues will be resolved more promptly.

INTEGRATED CUSTOMS LEGISLATION FOR THREE

The Customs Code of the Customs Union (hereinafter the Customs Code) was drawn up within the shortest possible period, and the Kazakhstani party was the one responsible for its development. Despite the fact that at that time there was a successfully functioning national customs code prepared in line with international principles and agreements, the new Customs Code and a new understanding of the customary rules brought a lot of surprises for the Kazakhstani business and foreign investors.

We will not digress to investigate the causes for introducing such "innovations", and will just enumerate some of them for entrepreneurs to be able to avoid them without damage and trouble to their business if they face them.

Thus, the period of temporary import and export of goods was unexpectedly reduced from three to two years and now prolongation of the stated period after two years is impossible. At the same time, a limited list of goods was introduced providing for a special period of temporary import (permission) for certain types of goods exceeding that provided by the Customs Code. However, it covers a narrow list of goods and amending the Decision of the Customs Union Commission is a rather lengthy process.

In this situation, to avoid breaches of the customs regulations, businesses had to find a new optimal solution, replacing the customs procedure of temporary import with the procedure of release for domestic consumption without changing the title to the goods. Due to the established "stereotype" about the release for domestic consumption, it took some time for the customs bodies to start using the approach that allowed applying this procedure to all types of agreements/contracts. But finally a solution was found though each entrepreneur reached it in his own difficult way.

In this context, we suppose it would be reasonable to remember that Kazakhstan ratified Istanbul Convention on Temporary Import in 2010 (Law of the Republic of Kazakhstan #346-IV from 3 November 2010) and joined some of its addenda. This Convention allows simplifying clearance of temporarily imported goods for exhibitions, expositions, concerts, and sport events. However, the Convention does not operate in Kazakhstan because there is no guaranteeing body, while in Russia and Belarus it functions to full extent. We suppose that application of the provisions of the Istanbul Convention would enable Kazakhstan to position itself properly at EXPO-2017 exhibition and would enable entrepreneurs to spur up trade and exhibition activity both in Kazakhstan and abroad.

The next aspect that raised a storm of various feelings was inclusion of license fees (royalty) into the customs value of imported goods, though their amount is generally unknown at the time of customs clearance and release of goods.

Despite the fact that Kazakhstan always applied basic principles of establishing customs value in accordance with international agreements on customs value within GATT (WTO), after 1 July 2010 changes were introduced in customs bodies' approach to application of the customs value establishing mechanism regarding the use of the first method when license fees are included into the customs value.

Thus, in the customs bodies' opinion, importers of products of companies that hold title to internationally acclaimed brands paying a license fee (royalty) to the rightholder (licensor) are required to include such payments into the customs value of the goods and pay duties and taxes arising from import of the goods to the territory of the Customs Union.

In this case the concerns of the business are caused by the fact that in practice the amount of license fees may be unknown at customs clearance and can be proved by documents only after sale of the goods, i.e. after customs clearance declaration is issued by the customs bodies.

From the perspective of the customs, if documents on the amount of license fees are not available during customs declaration it casts doubt on eligibility for applying the first method for establishing customs value or binds the declaring importer to submit a customs value adjustment form, which has corresponding customs consequences. It forms a situation where business becomes a "hostage" of the situation from the start.

Unfortunately, draft Decision of the Eurasian Economic Commission Council "On Deferred Determination of Customs Value" has been being negotiated by the parties for the second year already. The draft enables deferring determination of the customs value in the specified cases when some of its elements can be adjusted and clarified only after release of goods.

At present, customs authorities of the Customs Union member states are actively discussing the Protocol on Amending the Customs Code. Official bodies state that these will be technical and editing corrections only, though we consider that the amendments made to the aforementioned Protocol go beyond editing corrections and contain substantial changes which the business will learn about only upon ratification of the Protocol, having come "a way of bitter mistakes".

Nonetheless, we are optimistic and hope that rational thinking will take over and new amendments will be really aimed at improvement of the customs legislation and simplification of the customs procedures.

How to Boost Sales and Cut Costs: IFC's Advisory Work to Improve Food Safety in Kazakhstan and the Kyrgyz Republic

Agribusiness is a vital contributor to Central Asian economies and, particularly in rural areas, a primary employer. To help these communities prosper, it is vital to help producers access broader markets. A key hindrance to increasing the competitiveness of food producers is substandard food safety practices. IFC is working with producers, industry experts, and government officials to address food safety in a systemic and sustainable way. This will help firms in Central Asia improve risk management, increase sales, and reduce costs, spurring greater investment and helping the agribusiness industry realize its full potential.

"Food safety represents a key operational risk for the food producing industry," said Sarah Ockman, head of IFC's Agribusiness Advisory program in Europe and Central Asia. "When a food producer has implemented a modern, internationally recognized food safety management system, it sends a good signal to the investment community: it means the company is committed to minimizing operational risks. For the food industry, this is of paramount importance. It takes years to build a strong, reliable brand and win customer trust – all of which can be lost literally over-night."

METRO Cash & Carry is a leading international retailer, with shops across 29 markets in Europe and Asia. Its main objective is providing safe, high quality food, enhancing their brand while protecting customers to ensure the greatest possible business success. In Kazakhstan, METRO partnered with experts from IFC to launch a new program to help Kazakh food producers learn about international best practices in food safety. IFC and the retailer are reaching out to producers across the country, offering assessments, workshops, and advice.

"As a large wholesaler, we are responsible for delivering high quality food to our customers," said Lyazzat Sarbassova, head of the Quality Assurance Department at METRO Cash & Carry Kazakhstan. "This project will help us work with our suppliers to ensure we deliver the safest food possible."

IFC's work is helping retailers like METRO and other big international brands, as well as smaller players, for which the enhanced standards are presenting new opportunities and increased sales. IFC's food safety support helped Celinnaya Fabrika Delikatessov, a small, Astana-based meat producer, become a supplier to KFC, one of the world's leading fast food chains. The company also reported improved operational efficiency – thanks to the food safety program.

This work with retailers and more in-depth support to food producers are both part of IFC's Agribusiness Standards Advisory program in Europe and Central Asia, which helps local companies apply food safety, environmental, and social standards throughout the agribusiness value chain.

Over the years, IFC's experience with agribusiness clients across the region has shown that implementing internationally recognized food safety standards is in fact good business, as it helps increase sales and profits. In addition, companies become more competitive and are able to add new export markets.

Supported by the Austrian Finance Ministry, IFC's advisory work on food safety has helped attract more than $156 million of investment in over 80 IFC clients in Europe and Central Asia, generating $323 million in increased sales, in addition to greater efficiency and cost savings and improved waste and risk management and brand value.

"Food safety represents a key operational risk for the food producing industry," said Sarah Ockman, head of IFC's Agribusiness Advisory program in Europe and Central Asia. "When a food producer has implemented a modern, internationally recognized food safety management system, it sends a good signal to the investment community: it means the company is committed to minimizing operational risks. For the food industry, this is of paramount importance. It takes years to build a strong, reliable brand and win customer trust – all of which can be lost literally over-night."

KEY ENGINE FOR CENTRAL ASIAN ECONOMIES

Agriculture is one of the main economic engines in Central Asia. It is also critical for employment, food security, and poverty reduction in rural areas.

Though figures vary from country to country, nearly two-thirds of Central Asians live in rural areas and depend on agriculture for their livelihood. The United Nations' Food and Agriculture Organization estimates that nearly 47 percent of the people of Kazakhstan live in rural areas; in Kyrgyzstan the figure is 65 percent. Agriculture accounts for more than 45 percent of all jobs in Central Asia and nearly 25 percent of regional

GDP. Even in Kazakhstan, with its strong energy sector and less agrarian economy, agricultural employment makes up 30 percent of the workforce.

The agribusiness sector in Central Asia suffers from sluggish growth. In Kazakhstan, production fell 0.5 percent from 2007 to 2012; in Kyrgyzstan increased 0.9 percent over the same period. To help Central Asian economies grow, it is essential to expand market access for the sector.

The primary hurdle remains the minimal implementation of internationally recognized food safety standards. For example, in the Kyrgyz Republic, rising incomes resulted in increased food imports despite the country's advantages in agriculture and food processing. The government's priority now is to increase production in order to reduce import dependence on certain products, such as vegetable oil and sugar, and increase production of export-oriented products like dairy.

Improving food safety regulations is necessary, but not sufficient. Strengthening capacity at all levels is also needed. IFC experts are working to address the most pressing regional challenges, including raising awareness on food safety issues. The program also works with local market players to develop the capacity for implementing environmental and food safety practices and helps food producers with more in-depth advice on food safety practices.

About IFC

IFC, a member of the World Bank Group, is the largest global development institution focused exclusively on the private sector. Working with private enterprises in more than 100 countries, we use our capital, expertise, and influence to help eliminate extreme poverty and promote shared prosperity. In FY13, our investments climbed to an all-time high of nearly $25 billion, leveraging the power of the private sector to create jobs and tackle the world's most pressing development challenges. For more information, visit www.ifc.org.

About the Austrian Ministry of Finance (MOF)

External Economic Program - MOF's external economic program supports the development and transition process in Southeast and East Europe. The program aims at promoting sustainable investments to support economic growth, create jobs and improve the business environment. Supporting local and foreign investments helps to improve the livelihood of people and the progress towards a stable and prospering region. Our goal is to contribute to private sector growth through capacity building, SME support, facilitation of investments, and building business partnerships between Austrian and local investors.

The Global Pharmaceutical Market

By Ardak Tashenov, MS in Economics and Management, Head of Strategic Analysis and Monitoring Unit, Strategy and Research Department, EDB

The pharmaceutical market is a strategically important sector in any developed economy and the foundation of security in the area of healthcare and medical supplies. Today the global pharmaceutical market is developing in a dynamic fashion and it is one of the most profitable sectors. However, it would be premature to talk about it having reached a high level.

In December 2013, the Eurasian Development Bank published a Pharmaceutical Market sector report no.18. In this article the main findings of the study, an overview of the global pharmaceutical market, the changes and latest trends in this sector are provided.

According to IMS Health Consulting, an international research company, in 2012 the size of the global pharmaceutical market reached $940 billion. In monetary terms it grew by 6%. In the future the sector is expected to grow at no less than 3% to 4% a year and if this happens the market will reach $1.2 trillion in 2016 and up to $1.5 trillion by 2020. Another research company, Business Monitor International, has made a forecast for the size and geographical composition of the global pharmaceutical market in 2020 (see Figure 1).

Geographically, three regions remain the leaders of the sector. These are North America, Western Europe and Japan. However, while in 2006 they accounted for 73% of the global market, in 2012 this figure fell to 48% and by 2020 it will reduce to 33%. What has caused this fall?

The global demographic, epidemiological and economic changes are transforming the pharmaceutical market. The world population is growing rapidly and is projected to rise from 7 billion in 2011 to 7.7 billion in 2020 and 9.6 billion in 2050, hence an increase in the demand for pharmaceuticals.

The ageing process also affects the demand. By 2020 about 9.4% of the world population (719.4 million people) will be 65 or above, compared with 7.3% (477.4 million) in 2005 (UN, 2013). Clinical advances reinforce this trend. The improvements of the past few decades have already converted some previously terminal illnesses into chronic conditions, thus increasing long-term demand for therapies to manage these diseases. Older people consume more medicines than younger people: four in five of those aged over 75 take at least one prescription product, while 36% take four or more. Therefore, the population age structure makes it possible to forecast an increase in the demand for medicines in this age group.

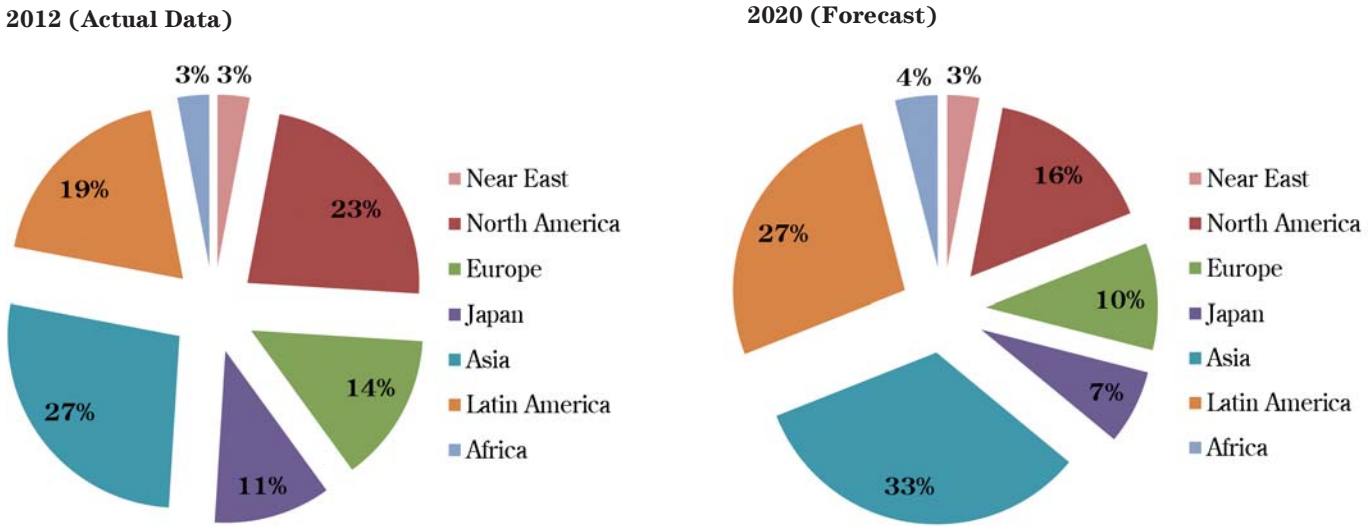
The demand for new antibiotics is also mounting, with the development of drug-resistant strains of some existing illnesses. Medical research has exposed problems that were previously unidentified – including risk factors like metabolic syndrome and conditions like chronic fatigue syndrome, which recent evidence suggests is linked to changes in gene expression in the white blood cells. New diseases, including mutated forms of old diseases, are surfacing.

Urbanisation and greater mobility have contributed to the introduction of new pathogens, some of which spread very fast and are very difficult to treat. The severe acute respiratory syndrome (SARS) moved from Asia to North America and Europe in a matter of days. Similarly, the H5N1 avian flu virus has spread from China and Southeast Asia to the Middle East. The human cost has been tiny so far, but the impact of an avian flu pandemic could be enormous.

Environmental pollution and other environmental problems can also affect considerably healthcare in developing countries. An increase in the incidence of respiratory diseases such as asthma and bronchitis is a significant threat.

The markets of the developing world are altering even more radically than those of the developed world. Infectious diseases remain one of the main causes of deaths, in particular in sub-Saharan Africa and South Asia. But, elsewhere, chronic diseases are now the leading cause of death, a pattern that will become even stronger as the population of the developing world gets older, fatter and less physically active. In 2004, an estimated 639 million people living in developing countries suffered from hypertension. By 2025, the number is forecast to reach at least one billion. The number of people with diabetes in developing countries is expected to rise from 84 million in 1995 to 228 million in 2025, with India, the Middle East and Southeast Asia bearing the worst of the burden.

Figure 1. Global pharmaceutical market (%)



Source: Business Monitor International, 2013

The demand for medicines that treat illnesses formerly associated almost exclusively with the developed world is thus expanding in the developing world. Poverty reduction and economic development will improve the financial conditions of people in developing countries and the actual demand for pharmaceuticals will grow accordingly.

This trend is confirmed by the growth rates and sizes of the pharmaceutical markets of the leading countries (see Figure 2). This chart shows that China, Brazil and Russia, which were not among the top 10 as recently as five years ago, are moving forward and outrunning the "traditional pharmaceutical leaders".

This, coupled with global and regional economic integration and the removal of many historical barriers to free trade, is incorporated in the development strategies of major pharmaceutical producers. The sector leaders are strengthening their positions in new markets and creating manufacturing facilities in or relocating to the main growth centres.

At the same time, health expenditure continues to mount all over the world. In particular, health expenditure as a percentage of the gross domestic product (GDP) is increasing in all countries (see Figure 3) and this pattern is the most significant in the mature markets that account for the largest part of the sector's income. As a rule, the wealthier the country, the more it spends on health.

However, the pharmaceutical market faces some barriers. The production technologies for new products get more sophisticated while the volume of innovations goes down and the regulation of the market as well as the requirements for medicines and testing become stricter.

There is already limited innovation introduced to the market and the R&D productivity is low. Over the past ten years the annual volume of medicines that are at the R&G stage has actually stagnated (see Figure 4).

The development and promotion of new medicines has become increasingly expensive. Between 1995 and 2005, the percentage of total corporate spending accounted for by R&D rose from 15% to 17.1%, while the percentage accounted for by sales and general administration rose from 28.7% to 33.1%. Sales and marketing is by far the biggest corporate expense. This increasing expenditure on sales and marketing could be seen as yet another sign of the paucity of innovative medicines reaching the market, since it is arguable that products for which there is real demand do not need to be promoted.

Many companies focus their efforts on disease investigations. Limited resources and high competition force them to concentrate on certain areas of production, shrink their product portfolios and toughen their approach to recruitment or prefer cooperation with the best specialists in the respective areas of research. The leaders of the industry acknowledge the advantages of "open innovations" and cooperate with universities. Some companies join outofcompetition federations where public and private institutions combine their resources to overcome common research problems.

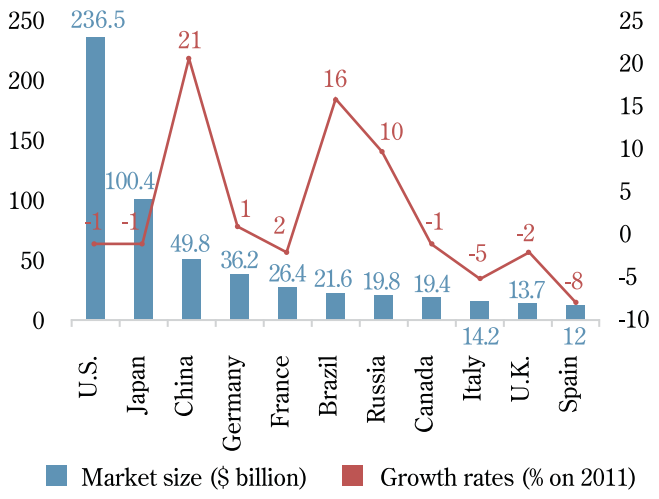
The regulatory framework becomes stricter with the growth of the global trade. The European Medicines Agency (EMA) has introduced recently a new triune approach to managing adverse reactions. The US Food and Drug Administration (FDA) is developing a proactive medication safety surveillance system for the U.S. market (the so-called Sentinel Initiative). Another important factor is stricter price regulation. Most developed economies make use of direct and indirect methods to control the prices of medicines.

The situation in sales and marketing is even tougher. Many producers of original medicines will have their patents expire very shortly. This "patent cliff" and the mass production of generics will cause a significant reduction in prices as a result of which the income of the pharmaceutical market will decrease by $148 billion between 2012 and 2018 (PriceWaterHouseCoopers. From vision to decision Pharma 2020, 2012).

The companies that have a key medicine that accounts for a lion's share of their sales will face the most difficult changes (see Table 1) - this is another confirmation that the invention of new pharmaceuticals is a pressing need.

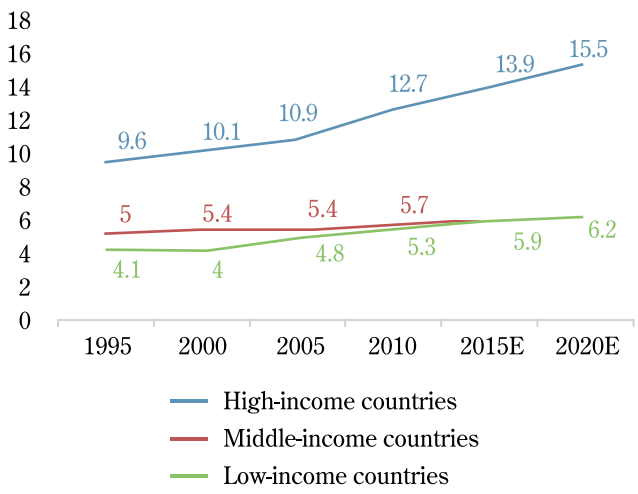
The above table shows that today large pharmaceutical producers are deeply dependent on the sales of one or two medicines they call "blockbusters" if their sales exceed $1 billion. ABBVIE's Humira, for example, accounts for 45% of the company's sales. It goes without saying that the expiry of the patent protect for this medicine will threaten their entire

Figure 2. Sizes and growth rates of the leading retail pharmaceutical markets in 2012 ($ billion; %)



Source: DSM Group, 2013

Figure 3. Health expenditure (% of GDP)



Source: The World Bank, PriceWaterHouseCoopers. Pharma 2020: The Vision. Which Path Will You Take?
Note: Actual data is provided for 1995-2010 and forecasts for 2015-2020

production. The table makes it clear that all pharmaceutical companies are rather vulnerable in this respect. In 2011 blockbusters accounted for an average of 20% of the total sales of the top ten companies. Market specialists estimate that this figure varies from company to company but in general it will not change significantly by 2016 and will presumably remain at the level of 20%.

Companies face significant problems and barriers when they introduce innovations to leading markets. Boehringer Ingelheim, for example, failed to have its Trajenta, a new anti-diabetic medicine, included in the highest priced category in Germany. The registering authority concluded that Boehringer Ingelheim had not proved the additional benefits of Trajenta compared to standard treatment. For a product to be included in the higher price category its benefits must be confirmed and, as a result, Boehringer Ingelheim decided not to introduce Trajenta to the German market.

All these factors affect the financial results of pharmaceutical companies. The years of 2011 and 2012 demonstrate the situation best (see Table 2)

(the crisis of 2008 and 2009 and the post-crisis recovery of sales in 2010 distorted the actual picture of the market).

This table demonstrates the various trends. The companies' performance confirms the significance and seriousness of patent cliffs. In 2012 Pfizer (the U.S.) alone expected a fall in the sales of its blockbuster Lipitor (Atovastatin) from $9.58 billion to $3.95 billion.

Novartis, MSD, GlaxoSmithKline, Astra Zeneca and BristolMyersSquibb had the same problems. It seems that large pharmaceutical players are now at different stages of restructuring and overcoming their internal problems. Corporate savings programmes launched by most companies in 2011 have produced the first positive results on the net profit side.

In general, pharmaceutical companies pursue the following three paths to prevent a fall in income from being caused by the patent cliffs:

1. further consolidation and concentration by means of mergers and acquisitions (M&A);
2. further diversification of their business (with different approaches in this area); and
3. geographical expansion to markets with better development and growth prospects.

Some companies have demonstrated significant improvements as early as in 2012. Sanofi (France), for example, has resumed growth after a period of stagnation. Its CEO Chris Viehbacher considers that the patent cliff has been overcome. Since 2008 the patents on six out of the seven Sanofi blockbuster drugs, including Plavix, have expired. On the whole, Sanofi has managed to come through the changes with better results than its competitors, including Pfizer, Glaxo, Astra and Lilly. The new management has undertaken the following:

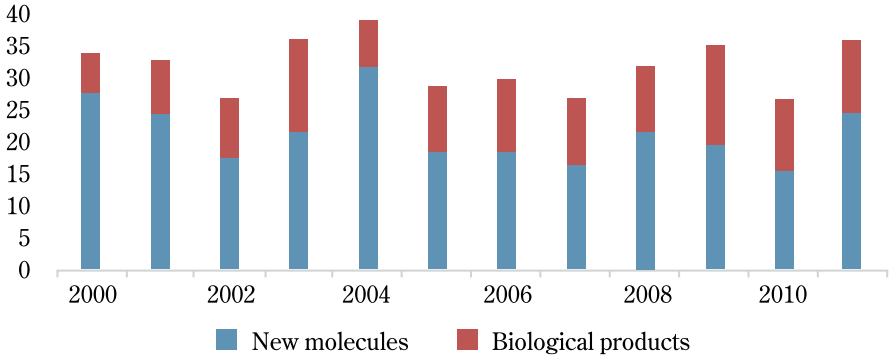
1. bringing new diabetes and cancer drugs to the market. It plans to introduce sixteen new products before 2015;
2. acquisitions in the area of biotechnology (Genzyme, a U.S. company) and over-the-counter (OTC) business and, thereby, further diversification of its integrated business in the area of health; and
3. significant investments in R&D.

Not all pharmaceutical companies are that consistent and successful in solving their current problems. In 2012 they sought solutions in the further consolidation of the sector.

A total of 128 M&A transactions were closed in 2012. Their overall value was significantly lower than a year earlier, reaching about $101.1 billion (-54.5%). The separate transactions also cost less, with only fourteen of them exceeding a threshold of $1 billion. It seems that large players have paused to "digest" previous acquisitions. However, the M&A process will continue to be one of the key trends in the global pharmaceutical industry in the future.

There is also an opposite trend in the strategies of large pharmaceutical companies in this area. Some companies, primarily U.S. transnational multi-sectoral corporations, begin to split the conglomerates they have created over recent years into separate companies. Abbott (U.S.), for example, stated towards the end of 2012 that it intended to spin off its core pharmaceutical unit. A new company, ABBVIE, was founded which unites Abbott's global pharmaceutical business with the sales of $17 billion and 21,000 employees. Abbott, which has been pursuing an aggressive expansion tactic in recent years, has changed its strategy radically in making this decisive step.

Figure 4. Number of registered products



Source: Evaluate Pharma, 2012

Table 1. Pharmaceutical companies' dependence on a key medicine

Producer	Key medicine	Sales (2011, $ billion)	Percentage of total sales (%)
ABBVIE	Humira	7.93	45
GlaxoSmithkline	Seretide	8.12	23
Johnson& Johnson	Remicade	5.19	21
Eli Lilly	Zyprexa	4.70	21
Astra Zeneca	Crestor	6.62	20
Roche	Rituxan	6.49	18
Pfizer	Lipitor	9.58	17
Sanofi	Lantus	5.45	14
MSD	Singulair	4.87	11
Novartis	Diovan	5.66	11

Source: Farmvestnik, No. 3, 2013, Moscow

Abbott's management explained that the spin-off and clear delineation of business sectors add flexibility and, in the eyes of investors, a clearer business profile and broader development prospects.

Large pharmaceutical companies are continuing to look for ways to support and improve their performance and mitigate the above negative effects on the industry. Considerable efforts are invested in enhancing the shares of large companies in developing markets. However, because of the lack of significant assets for acquisition, governmental protectionism and registration barriers in these markets, this choice is a rather complicated, protracted and controversial path.

As a result, the sector is expected to continue to consolidate by means of M&A and this will remain the leading trend. However, an increasing number of acquisitions involve companies with a high rate of innovation and higher profitability (such as biotechnologies) and lower governmental intervention (such as the OTC sector and diagnostics).

Table 2. Global pharmaceutical producers rated by sales and net profit

Rating	Company	Sales			Net profit		
		$ million		growth	$ million		growth
		2011	2012	%	2011	2012	2012/2011%
1	Pfizer	65.259	58.986	-9.6	10.009	14.570	45
2	Novartis	58.566	56.673	-3.3	10.998	11.511	5
3	MerckSharpDohme	48.265	47.300	-2	11.697	11.743	0
4	Sanofi	43.973	46.025	5	11.583	10.771	-7
5	GlaxoSmithKline	44.394	42.845	-3.5	14.270	13.503	-5
6	Roche	35.991	38.667	7.5	14.713	16.998	15
7	Astra-Zeneca	33.591	27.973	-17	13.167	10.430	-21
8	Johnson&Johnson	23.738	25.400	7	6.406	6.075	-5
9	Abbott Laboratones	22.435	23.133	3	5.199	6.263	20
10	Elli Lilly	24.286	22.603	-7	4.348	4.089	-6
11	Teva	18.312	20.317	11	3.109	2.205	-29
12	Takeda	18.583	19.088	3	1.529	1.909	25
13	BristolMyersSquibb	21.244	17.621	-18	6.981	2.340	-46
14	Amgen	15.582	17.265	11	4.858	5.119	5
15	Boehringer Ingelhem	18.012	N/A		3.067	N/A	

Source: Companies' annual reports for 2013, Handelsblatt, 2012

Table 3. Largest M&As in the pharmaceutical industry in 2012-2013

No.	Buyer	Country	Target	Country	Business	Transaction value ($ million)
1	Bristol Myers Squibb	U.S.	Amylin	U.S.	biotechnology	7.000
2	Alliance Boots	U.K.	Walgreens	U.S.	wholesale	6.700
3	Watson	U.S.	Actavis	Switzerland	generics	5.600
4	Baxter International	U.S.	Gambro	Sweden	biotechnology	4.000
5	Hologic	U.S.	Gen-Probe	U.S.	biotechnology	3.700
6	GlaxoSmithKline	U.K.	Human Genome Sciences	U.S.	biotechnology	3.600
7	Valeant Pharmaceuticals	Canada	Medicis Pharma	U.S.	dermatology	2.600
8	Bristol Myers Squibb	U.S.	Inhibitex	U.S.	biotechnology	2.500
9	Agilent	U.S.	Dako	Denmark	biotechnology	2.200
10	TPG Capital	U.S.	Par Pharmaceuticals	U.S.	generics	1.900
11	Novartis	Switzerland	Fougera	U.S.	dermatology	1.530
12	Reckitt Benckiser	U.K.	Schiff Nutrition Int.	U.S.	OTC drugs	1.400
13	Astra Zeneca	U.K.	Ardea Biosciences	U.S.	biotechnology	1.260
14	China Pharmaceuticals	China	Robust Sun Holding	Hong Kong	CNS drugs	1.200
15	Amgen	U.S.	Micromet	Germany	biotechnology	1.160
16	Takeda	Japan	URL Pharma	U.S.	generics	800
17	Amgen	U.S.	Mustafa Nevzat Pharma	Turkey	generics	700

Source: SCRIP 100, 2013, IMAP report

New EBRD Strategy for Kazakhstan

New Kazakhstan strategy prioritises diversification, balancing role of state and market, and sustainable energy

The European Bank for Reconstruction and Development (EBRD) has adopted a new 3-year strategy for its activities in Kazakhstan.

Kazakhstan is one of the largest countries of operations of the EBRD, with about US$ 6.5 billion invested over the last 20 years. In terms of reforms, Kazakhstan is the most advanced country in Central Asia, and is demonstrating strong economic growth supported by high oil prices. However many challenges remain, especially in the banking sector in the aftermath of the crisis, and corporate governance and business climate need to be further improved.

CHALLENGES

Kazakhstan faces a number of strategic challenges. The global economic and financial crisis highlighted its excessive dependence on primary industries and commodity exports: it is necessary to diversify the economy towards value-added industries. It is also important to reform the financial sector and ensure that it emerges from the crisis with a sustainable business and funding model. Remaining transition gaps in the country's infrastructure, including shortages and imbalances in power and energy, and transport bottlenecks, also need to be filled.

The strategy, which guides the Bank's work in the country, defines the following priorities:

Diversification and support for the non-resource sector. The EBRD is already the largest investor in the non-oil and gas sector of the economy. The Bank will continue to support the development of other sectors by financing projects that enhance productivity in the corporate sector, improve the business environment, promote modernisation of the agribusiness sector along the entire value chain and facilitate growth of the SME sector. The Bank will also work to further develop the banking and non-banking financial sectors.

Balancing the role of the state and the market. The Bank will seek to assist the Kazakh authorities in balancing the roles of the state and the market by supporting growth of private sector enterprises. The Bank will also support policies aimed at commercialising public enterprises and making them more efficient, as well as upgrading infrastructure ensuring appropriate sharing of risks between the private and public sectors.

Promoting low-carbon growth and energy efficiency. The Government's recently announced Green Economy Strategy is a top national priority and the Bank will assist in implementing key aspects of the strategy through projects in energy, renewables, agriculture, water, waste management, transport, and other sectors.

The EBRD is already working to address these issues. Thanks to the Bank's support, nearly 60% of Almaty's urban transport is now environmentally friendly. The Bank is working with clients in agribusiness sector such as RG Brands; supporting private sector's involvement in infrastructure, such as Olzha, the rail car provider; helping to contribute to the energy efficiency of the power sector by financing clients like CAEPCO; and working on renewable energy both in terms of policy dialogue and project financing. The EBRD's Small Business Support programme has provided consulting support over a thousand private enterprises, and with donor funds from the Kazakh government is now present in 7 regions of Kazakhstan. The Bank is working on expanding its programme of SME financing through local partner banks.

Big Energy Efficiency Improvements for Kazakh Railways, KTZ

EBRD provides US$ 40 million for energy-efficient and renewable technology in lighting and heating

The EBRD is supporting Kazakhstan Temir Zholy (KTZ), the national railways company, in its drive to radically improve energy efficiency across its operations.

A US$ 40 million loan (US$ 700,000 of which will be provided by the Clean Technology Fund) will finance a series of new technologies to reduce energy consumption, from an upgraded lighting system to alternative heating solutions such as heat pumps, solar water heaters and boiler upgrades. The programme will allow the company to reduce its greenhouse gas emissions by 80,000 tonnes per annum.

"We support the country's green economy drive, as does KTZ, for the benefit of its passengers and the whole of Kazakhstan," said EBRD First Vice President, Phil Bennett, at the signing of the deal at EBRD headquarters in London. "We are very pleased to be able to support the company's ongoing efforts to save energy and to reduce greenhouse gas emissions. We have been working with KTZ to identify new opportunities for energy efficiency, such as installation of LED lighting across more than 100 depots and stations, and to finance their introduction. We are especially proud of the innovative aspects of this project such as the employment of renewable energy in the form of solar water heaters."

Kanat Alpysbayev, KTZ Vice President of Logistics, said: "Railways are strategically important for Kazakhstan's economy. KTZ operates one of the largest rail networks in the world. Our goals coincide with the government goal of developing a green economy, and our cooperation with the EBRD will allow us to take a major step in that direction. In this regard, one of the priorities is to improve energy efficiency, namely to purchase and install energy efficiency components such as heat pumps, solar water heaters and gas boilers".

The EBRD has pledged strong support for the Kazakh authorities' green economy strategy, which envisages reducing the energy intensity of the country's economy by 10% until 2015, compared with 2008 levels.

Since 2006, the EBRD has invested about €13 billion (over US$ 17 billion) in sustainable energy projects across all of its countries of operations.

Press releases by the EBRD