"It appears as if the process has moved inexorably towards its final strategic goals of a competitive energy generation and transmission market"

Paul Tumminia, Counsel, Chadbourne & Parke, highlights the legal issues to be considered in contemplation of an investment in the electricity sector in Russia

The process of reform and restructuring in the Russian power sector has been characterised by several bouts of fits and starts since the Government of the Russian Federation ('GoR") announced such intentions several years ago. To a large degree, the size and the complexity of the country's electricity sector and the various competing commercial, political and local interests combined to precipitate delays and revisions. By some estimates, Russia is the world's fourth largest producer of electric power, with its generation capacity reliant upon a dizzying array of energy sources such as thermal, hydropower, coal-fired, gas-fired and nuclear. Constrained by obsolete equipment and technology, the GoR recognised that without implementation of structural reform, the sector would not be able either to meet growing demand for electric power spurred on by economic expansion, nor would it be able to attract investment needed to modernise and expand.

Despite an erratic earlier pace, in recent months it appears as if the process has moved inexorably towards its final strategic goals of a competitive energy generation and transmission market. The dominant player in the sector, the state-owned Unified Energy Systems (RAO UES) which controls stakes in various assets throughout the system, including power plants, vertically integrated energy companies, the federal high voltage transmission grid and the energy dispatch system, has detailed plans for the reorganisation of the sector and ultimately its own wind-up and dissolution. Several of the share issuances of the generation companies which have been spun off from UES have been sold and have garnered some mixed interest among investors.

Given these positive events and the sheer size and opportunities which exist, many investors may be currently considering strategic or portfolio investments into the sector. While it is clear that the implementation of the restructuring plan will create new opportunities, it is important to note that the Russian electricity market will continue to be highly regulated with respect to transmission, distribution and tariff policy for some time to come, and will continue to include significant state activity and control.

Legal Framework

In July 2001, the GoR announced its intention to implement reforms in the electricity power sector with the Decree on Restructuring the Electric Power Industry of the Russian Federation. This was followed by several key legislative initiatives for reform, most notably the Law on the Electric Power Industry (Federal Law No. 35-FZ). In the last several years, the GoR has also issued several regulations dealing with specific segments of the industry, including the wholesale electricity market, the retail electricity market, and the tariff rate regime for electricity and heat.

These normative acts must of course be read in conjunction with other key legislative acts that would govern any investment into the sector, including the

Civil Code of the Russian Federation, the Law on Joint Stock Companies (Federal Law No. 208-FZ), and the Law on Natural Monopolies (Federal Law No. 147-FZ), to name but a few. Finally, it should be noted that the discussion below applies only to non-nuclear generation capacity. The Federal agency RosEnergoatom will continue, under current legislation, to own, operate and control all of the country's nuclear power facilities.

Key Actors

One of the cornerstone principles of the GoR's reorganisation plan was the disaggregation of generation capacity assets from the transmission and distribution assets. The Board of Directors of UES approved several decisions in 2006 which set the stage for the complete restructuring of the electricity sector and the wind-up of UES. The plan envisioned the creation of several different categories of generation companies which would be privatised and open for foreign investment, while at the same time prescribing the consolidation of transmission and grid assets into separate corporate entities which would continue to be largely controlled and regulated by the GoR.

Wholesale Generation Companies: The restructuring plan calls for the consolidation of various heat and power generation companies throughout the territory of the Russian Federation. Currently, seven OGKs have been established. According to information from UES, six of these OGKs contain thermal plants. One OGK consists only of hydroelectric power. The configuration of these facilities was approved by the GoR in accordance with its decree RF Decree No 1254 (as amended in October 2004). The goal of these consolidations was to create companies roughly equal in installed capacity, asset value and equipment obsolescence. Another key feature of the plan was to assign assets to each company in different regions of the country in order to prevent any possible monopolistic practices after the implementation of the reorganisation plan.

Territorial Generation Companies (TGC): Territorial Generation Companies will be created from regional generation companies (energos) and consolidated on a regional basis. Each TGC will consist of a stand alone operating company with its ownership interest initially held by UES, but which would soon thereafter be privatised.

The main source of revenue for the company will be through tariff revenues earned from the transmission of power through the national grid

Federal Grid Company (FGC): The Federal Grid Company is a wholly-owned subsidiary of UES established in 2002. FGC acts as the manager of the Unified National Electric grid, the high voltage backbone transmission and dispatch grid of the entire power system. It is contemplated that FGC would at some point in the future become an independent company from UES, and that pursuant to the Law on the Electric Power Industry, the GoR's share in the company would increase to 75% plus one share (signifying complete control). The main source of revenue for the company will be through tariff revenues earned from the transmission of power through the national grid. It is anticipated that the company will be responsible for modernising the existing national grid and constructing new transmission and distribution capacity.

Systems Operation-Centralised Dispatch: The Systems Operator would be responsible for securing the sustainable operation of all of the technological aspects of the transmission system and would provide services, transmission and equipment to individual generation companies. It is contemplated that the Systems Operator would also become an independent company from UES, and that the GoRs stake in the company would be increased from its current level to 75% plus one share, signifying complete control by the GoR.

Wholesale and Retail Market

In September 2006, the GoR announced new rules with respect to the wholesale electricity market. In accordance with the new model, the wholesale market was to be characterised by a system of regulated contracts to be concluded between buyers and sellers. The contracted price for the sale of such electric power would be regulated by the Federal Tariff Service. Beginning in 2007, buyers and sellers would be entitled to conclude contracts with a length of between one to three years. The contracts would be concluded on a "take or pay" basis, with tariffs comprising both a capacity and a usage component. Purchase and sale of electric power which was not sold on this long term basis would be available for sale either through bilateral contracts where the contracting parties themselves determine prices and supplied volumes, or on the spot market of sorts, where buyers and sellers determine prices and volumes one day ahead of actual deliveries.

The retail market would be characterised by the creation of new supply companies which had been formerly part of vertically integrated generation companies called energos. These entities will be responsible for supplying electricity to end-users who may not be able to enter the wholesale market for their energy needs. It is believed that the new supply companies would be able to provide this electricity to customers on a fairly competitive basis.

Guarantee Mechanism

In 2005, the GoR adopted a resolution initiated by the Ministry of Industry and Energy on the creation of Investment Guarantee Mechanisms for the Construction of Generation Facilities. The Ministry gave further details on this initiative in its Order No 136 of 28 July, 2006 and Order No 137 of 29 July, 2006.

Pursuant to the resolution, investors in energy projects would be selected through a tender process to be held and managed by the Systems Operator which would also include participation of representatives of local authorities. The guarantee for investors would consist of a fixed level of availability payments in new power projects, which would be paid by the Systems Operator. These fixed, long-term availability payments were intended as a means of attracting investment into the sector by providing long-term certainty as to revenue streams. The costs of the guarantee would be defrayed by the Systems Operator through the imposition of fees charged to all participants in the power grid system. The maximum aggregate capacity which the GoR contemplates could be constructed under this mechanism was slated at 5000 MW.

Recent Events

In November 2006, Wholesale Generating Company (OGK-5) based in Irkustk in eastern Siberia announced that it had raised $459m through an initial public offering (IPO). The company indicated that the demand for its shares greatly exceeded the supply of shares offered by at least five times. The shares represented a 14.4% stake of the company. The price per share was set at $0.09. Based on this share valuation, the market value of the company would be calculated to be $3.2b. According to various reports, many large investors such as Gazprombank, Novatek and Enel of Italy participated in the share purchase, as well as the European Bank for Reconstruction and Development, which announced plans to acquire up to a 10% stake in OGK-5 (Source, Economist Intelligence Unit).

In March 2007, Wholesale Generation Company (OGK-3) sold 18b new shares at a price of $0.17 per share to Norilsk Nickel, Russia's metal giant, in a bid process won by Norilsk. The purchase increased Norilsk's stake in the company from 14% to approximately 44%.

In March 2007, Territorial Generation Company (TGK-6), which had been spun off previously from UES, announced plans to place new shares worth approximately $1.5b. TGK-6 controls generation and distribution facilities in central Russia.

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Other companies preparing and implementing projects for issuing additional shares include the WGCs as well as TGC-1, WGC-3/Mosenergo (TGC-3), TGC-4, TGC-5, Volzhskaya TGC (TGC-7), TGC-8, TGC-9, TGC-10, Kuzbassenergo (TGC-12), OGK-4, OGK-6, TGK-1 and Hydroelectric power company Hydro OGK.

Legal Issues

It may be premature at this stage to measure the interest of international investors and financiers in Russia's power sector, based upon the recent share issuances. OGK-5 did attract portfolio investors from a wider spectrum while OGK-3's issuance was most likely snared as a strategic investment. Certainly, confidence in Russia's legal and regulatory environment will be a significant factor in measuring risks involved in such long-term investment. While there have been key improvements in the legal enviroment, it would still be advisable for any strategic or portfolio investment in the sector to be supported by full and complete due diligence and careful deliberation in order to minimise any potential risks.

Any party considering an investment in the electricity sector must choose between the acquisition of an existing company or the establishment of a new generation (newco) company. Each strategy has advantages and disadvantages. In acquiring a stake in an already existing company, an investor gets immediate access to infrastructure, client base, supplier relationships, licences and permits, etc. Conversely, however, acquisition of an existing company also means the purchase of all hidden liabilities as well, minority shareholders, tax issues, possible environmental issues, etc. An investor wishing to establish a newco would eliminate the acquisition of these latent problems, but on the other hand, must be ready to accept the costs and time which will be required to build infrastructure, develop relationships with suppliers, obtain licences and permits, etc. Certainly, a greenfield project will also require services agreements for dispatch and transmission to the national grid.

In either case, due diligence will be essential in managing these risks. For example, in the case of investors acquiring equity stakes in existing companies, the focus of the diligence will be on corporate governance, review of share registration of the issuing company, tax matters, anti-monopoly review, review of validity of licences and permits, review of the company's assets and liabilities, to name but a few. rir