guest opinion

Russia Beckons

ELECTRIC INFRASTRUCTURE NEEDS INVESTORS

BY JAMES J. BALASCHAK

THE TIME IS ripe for investments in the electricity sector in Russia – all the right messages and signals are being made both by RAO UES and the government. The sector cannot survive and the future of the current Russian economic miracle may be at risk if these investments are not made. These investments are coming in five forms: private financing of power development, direct private ownership of power assets, portfolio investment through global IPO or additional issuance of shares on local exchanges, bond issuance, and corporate lending.

The power sector reform program in Russia now appears to be on track. To many observers, this unbundling of one of the world's largest collections of power assets serves as a proxy for any free-market-driven reform in President Putin's government. The government is proceeding with its plan to unwind RAO UES. The complexity of remaining regulatory and legal issues leaves many questions yet to be resolved, which helps to create delays and uncertainties for investors. Success of the reform process will be measured by the successful creation of a competitive wholesale electrical generation market and a transparent transfer of some of the assets to the private sector. The fact that the share price of UES has risen five times in less than two years could be viewed as indicating increased investor confidence in the restructuring.

The Russian economy is reaping the rewards of the mass privatization of the 1990s. RAO UES as currently structured cannot finance the massive investments required for the coming decades. Introducing a market mechanism in the form of a competitive wholesale generating market and privatizing these assets will increase efficiencies. Greater transparency of the newly created entities will allow the capital markets to work, and private firms will find the much-needed investment for new technology and plant modernization.

The macro-economic drivers for reform are overwhelming. Russia has an implicit policy of doubling GDP this decade. After declines in electricity production in the 1990s, consumption has started to grow. Forecasts on the conservative side place power consumption growth at one-half the GDP growth rate. We have seen demand grow 4.5 percent in the first half of 2006. While output has risen to match this demand, reserve margins remain thin. Even under the conservative growth scenario, the necessary level of investment for new capacity is estimated to exceed $200 billion over the next 20 years. Yakov Urinson, deputy chief executive of RAO UES, estimates that the annual investment needs to be $20 billion between 2007 and 2020. Urinson also stated that the lion's share of investment will come from additional share issues by generating companies, including IPO's and private credits. The Russian power sector will not be able to satisfy demand by the end of the current decade if it doesn't attract private, external investment. For Russia, the time is now.

Investment opportunities abound. But you need to be on the ground. The situation is fluid and changes almost daily. There is no doubt that the government and UES are saying the right things about privatization and attracting foreign and domestic capital. But this game is not for the faint of heart.

The stakes are extremely high for the government. If the privatization and capitalization efforts are not successful, the sector will continue to deteriorate and eventually become a drag on the economy and a black eye for the administration. However, there are tremendous new asset and investment opportunities promised to the private sector. How this turns out is still anyone's guess.

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