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How to make a region "green"

Sustainability projects financing practices appropriate for Russian regions

In global practice, regions and municipalities have a range of instruments for financing local environmental and social projects that is wider than issuing classic sub-sovereign bonds.

ACRA has analyzed leading global practices of financing sustainability projects and assessed the possibility of their application in Russian regions for carrying out infrastructure projects.

In 2020, total capital expenditures of Russian regions amounted to at least RUB 1.8 tln. Over of third of these expenditures (RUB 600 bln) were of a social and ecological nature and could have been financed via the issue of green and social bonds. Attraction of extra-budgetary funding for such projects will allow regions to reduce their expenses. In addition, the coupon rate on these borrowings may be subsidized in the future.

Green and social project finance bonds are an optimal instruments for regions that want to meet their funding needs without adding to existing debt, including for public-private partnerships (PPPs). The potential need for financing social and environmental projects in PPPs is about RUB 160 bln for the two largest Russian concessionaires.

Global practice

According to Climate Bonds Initiative, the volume of the global market of sustainable development debt instruments[1] was USD 1.7 tln as of the end of 2020. Last year USD 700 bln worth of instruments were issued, almost double the figure for 2019. However, bonds issued by regional government bodies only accounted for 6.4% of green bonds, 6% of sustainable development bonds, and around 1% of social bonds. At the same time, the volume of instruments from the issuers supported by the government (government-backed entities), including companies with regional government participation, was much higher for green and social bonds — up to 25% and 47% of the volume of placements for the respective instruments. The best example of this sort of issuer is the French company Société du Grand Paris, which placed seven bond issues to a total of EUR 11 bln in 2020. The proceeds were used to finance the construction of new and the expansion of existing high-speed transit routes in the Île-de-France region.

In addition, project finance bonds are actively used to finance the infrastructure of regional entities. For example, municipal water supply enterprises operating in Italy's Veneto region used their own mini-bonds to create an SPV in order to issue bonds worth EUR 150 mln in 2014.

Therefore, **in global practice, regions and municipalities have a wider range of instruments for financing local environmental and social projects and are not limited to issuing classic sub-sovereign bonds.** It also includes the bonds of regional development agencies or bonds issued by SPVs.

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[1] Sustainable development debt instruments hereinafter refer to the following types of bonds: green bonds, social bonds and sustainable development bonds.

Opportunities for Russia's regions

The Government of Moscow (AAA(RU), outlook Stable) settled on issuing classic sub-sovereign bonds for its placement of green bonds, which was the first of its kind among Russia's regions.

This approach is also widespread in the world, even in the countries where, as in Russia, the "principle of cash unity" exists (for example, Canada or a number of EU countries). At the same time, given the relatively high debt load of almost half of Russia's regions (*Table 1*), only some of them will be able to finance their social or environmental projects by issuing sub-federal social and green bonds.

Table 1. The debt load of almost half of the regions exceeded 50% of their tax and non-tax revenues (TNTR) as of January 1, 2021

	Number of regions	Aggregate TNTR of regions, RUB mln	Aggregate debt of regions, RUB mln
x<50%	46	6,922,635	1,031,089
50%<x<85%	30	1,993,029	1,197,530
x>85%	9	233,845	267,427

Sources: Treasury of Russia, Ministry of Finance of Russia, ACRA

Project finance bonds may be the optimal instrument for raising funds for local projects for regions that do not want to increase their debt load[2]. In this case, issuers can support projects where the standalone creditworthiness is lower than the credit quality of the issuer itself. Regions can use a number of different guarantee instruments, both direct (classic guarantees of Russia's regions) and conditional (for example, a guarantee of minimum profitability for a project, payment of a concessor, etc., if the project is financed using PPP instruments or concessions). The latter financing method lets regions avoid increasing their debt load but actively develop infrastructure projects according to PPP principles.

ACRA understands project finance bonds as instruments secured by the cash flow from the implementation of project finance transactions, which must meet a number of basic criteria.

First, project finance transactions **must be carried out through a bankruptcy-remote special purpose vehicle (SPV)** established for the sole purpose of implementing project finance transactions. The presence of such a company in the structure of a project finance transaction (PFT) makes it possible to segregate project assets from the property of project beneficiaries, as well as minimize the risk of third-party foreclosure on assets owned by the SPV.

Second, in project finance transactions, **lenders may intervene in the course of project implementation** in the event of a significant deterioration in the project's performance to mitigate possible economic losses in the event of a PFT default. This implies one of the fundamental differences between PFT and corporate bond issues: PFTs are subject to significant restrictions on business and investment activities imposed by project documentation.

[2] According to current legislation, Russian regions whose debt exceeds 50% of TNTR cannot be regarded as borrowers with high debt stability.

For more details, see the Joint research of ACRA and the National Center for PPP.

According to Bank of Russia Regulation dated December 19, 2019 No. 706-p "Standards for Issuance of Securities" (enacted on May 11, 2020), infrastructure bonds should meet the following criteria:

- *Purpose: funding a project aimed at construction and/or reconstruction of property that is the subject of federal concession;*
- *All proceeds earned from bond issuance shall be applied for purposes associated with construction and/or reconstruction of property;*
- *The application of funds shall be monitored;*
- *Bondholders may claim early redemption;*
- *Issuer must disclose/report on the application of proceeds earned from bond issuance.*

Third, the **only source of repayments under PFTs is the cash flow** generated by the project and the liquidity reserves provided for by the PFT structure. After the completion of the construction phase and commissioning, the project usually begins to generate cash flow. Unlike corporate finance, in project finance transactions, the source of payments to bondholders is solely the proceeds from the project.

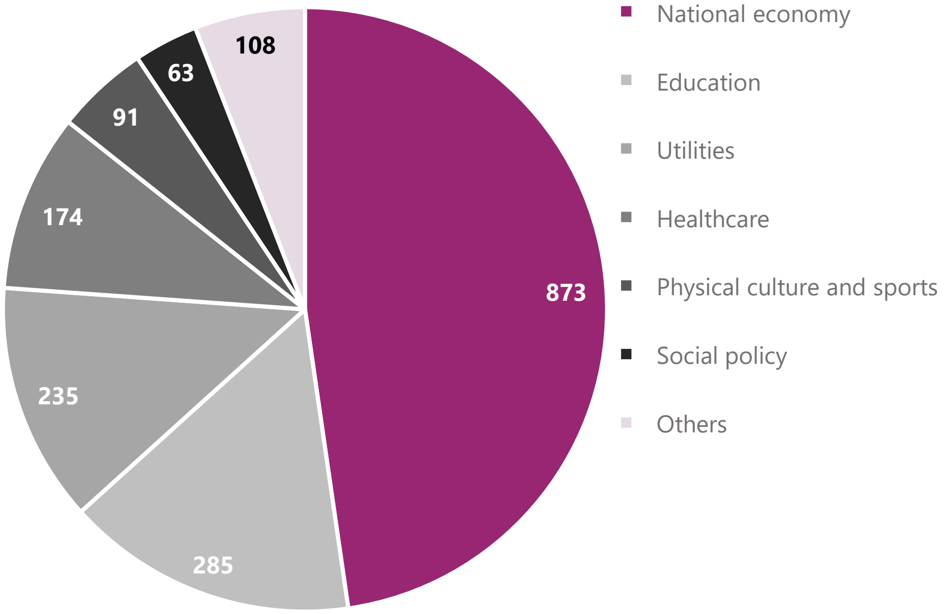
Fourth, in classical project financing, all key **risks are shared by project participants, which makes it possible to effectively manage them**. Therefore, the credit quality, experience and reliability of participants are taken into account in ACRA’s rating model. Risk sharing is the core principle of project finance.

Taken together, all four principles make project finance bonds almost an ideal instrument for obtaining green or social status due to the high transparency and quality of PFTs. At the same time, although a significant portion of project finance bonds has great potential to become instruments of sustainable funding, in order to obtain this status, an issuer must meet a number of requirements. First, it must define the list of projects to be funded in such a way that they correspond to international or national taxonomy. Second, at the pre-issuance stage, it must prepare the so-called framework (a public policy in the field of green/social financing). Third, it must complement the framework with the relevant corporate governance documents. Finally, it must pass the verification with an accredited verifier of green or social bonds.

For **regions of the Russian Federation, projects implemented in accordance with the PPP principles are the most promising type of underlying assets for funding through the issuance of project finance bonds**, which may be verified as **green or social**. The regions’ needs for financing infrastructure projects are significant: their aggregate capital expenditures in 2020 amounted to at least RUB 1.8 tln (*Fig. 1*), of which up to a third was spent by Moscow. It is worth noting that over a third of these expenditures can potentially be attributed to green and social projects.

In Russia, project finance bonds have been issued for some infrastructure projects where regions acted as public partners. These regions include Moscow (construction of the Northern Relief Road for Kutuzovsky Prospekt), St. Petersburg (AAA(RU), outlook Stable; construction of the Western High-Speed Diameter), Khanty-Mansiysk Autonomous Okrug – Ugra (AAA(RU), outlook Stable; construction of a landfill), the Ulyanovsk Region and the Nizhny Novgorod Region (construction of a sports and recreation center and an ice arena).

Figure 1. Over a third of capital expenditures of Russia's regions in 2020 may be categorized as social or green projects, RUB bln



Sources: Treasury of Russia, Ministry of Finance of Russia, ACRA

Infrastructure bonds can be considered as a type of project finance bonds issued for the implementation of PPP projects. The requirements of Russian law for infrastructure bonds (*see the box on the left on page 3*) almost fully coincide with the requirements for social and green bonds, including the targeted use of funds for certain types of projects, information disclosure, and early redemption.

According to the current portfolio of the two largest concessionaires involved in PPP projects in Russian regions, over RUB 153 bln has been invested in projects with a potentially positive social effect for the regions of presence, while another RUB 6.5 bln has been invested in projects with a potentially positive environmental impact. These projects can be funded through the issuance of green and social bonds. Moreover, some companies have already taken this opportunity: for example, VIS Group (A(RU), outlook Stable) placed its debut issue of social bonds for RUB 5.7 bln last year in order to refinance the building costs of social infrastructure facilities. The experience of issuing "marked" bonds for financing regional social infrastructure can be applied in many regions of the Russian Federation.

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