

Russian Procurement Law: New Supplier Selection Rules for State-Controlled Companies and Natural Monopolies

A new Federal Law No. 223-FZ "On procurement of Goods, Works and Services by Certain Types of Legal Entities" (the "**Procurement Law**") was adopted by the Russian parliament on 18 July 2011. It introduces a legal framework for procurement by a wide range of public sector legal entities whose procurement activity was not previously regulated (e.g. state-controlled companies and their subsidiaries) and changes the procurement rules and the scope of their application for natural monopolies.

To ensure the transparency, cost efficiency and accessibility of procurement, the Procurement Law requires that suppliers of goods, works and services (with limited exceptions) to affected entities must be selected through a publicly disclosed procedure and only by way of a tender, auction or other selection method set in the procuring entity's internal procurement regulation. Although the purposes of the Procurement Law are similar to those of the Public Procurement Law No. 94-FZ, which governs procurement by state and municipal authorities, the new law differs from the latter in certain important respects.

This note gives an overview of the main provisions of the Procurement Law and identifies some of the salient issues raised by this law. .

Key issues

- Russian state-controlled companies and natural monopolies are subject to new procurement rules
- Except for certain limited carve-outs, all goods, works and services must be procured in accordance with the new Procurement Law
- Consequences for failure to comply with the new procurement rules are not entirely clear

What Companies Are Affected?

The range of legal entities which fall within the scope of the Procurement Law is wide.

It applies to the following entities ("**Procuring Entities**"):

- a) utility companies (i.e. companies carrying out regulated activities in the area of electricity, gas, heat or water supply and/or household waste, sewage or water disposal);
- b) companies engaged in natural monopoly activity (e.g. all Russian airports and ports, OJSC Russian Railways, OJSC Transneft);
- c) state companies and state corporations (e.g. VEB, Rosatom, Olymstroy);
- d) state and municipal unitary enterprises and autonomous institutions (e.g. FGUP "Russian Post");
- e) state-controlled companies (i.e. companies in which the Russian Federation and/or constituents of the Russian Federation and/or municipalities taken alone or in aggregate own more than 50% of the share capital);
- f) subsidiaries which are more than 50% owned by one or more companies referred to in (i)-(v) above and their respective 50% owned subsidiaries.

Previously the requirement for natural monopolies to conduct an open tender for the purchase of certain financial services (such as obtaining a loan) was contained in Federal Law "On Competition" No. 135-FZ, but was removed from that law with effect from 1 January 2012, simultaneously with entry into force of the Procurement Law. In the absence of

any relevant clarifications, the carve-outs available under the previous regime (e.g. for foreign lenders or for purchases of financial services to the extent they are not related to natural monopolistic activity) do not seem to be available under the Procurement Law.

No rules for calculation of the aggregate ownership of the Russian Federation, constituents of the Russian Federation and municipalities in a company's share capital and aggregate share of state-controlled companies in the share capital of their direct and indirect subsidiaries for the purposes of the Procurement Law have so far been adopted by the Russian Government. This creates uncertainty in application of the law to companies with a complex ownership structure. Some representatives of the Federal Antimonopoly Service ("**FAS**") have informally stated that the antimonopoly body did not intend to enforce the Procurement Law against companies which are indirectly state owned until the relevant regulation is in place. However this position is unofficial and not binding on the FAS.

What Are the New Supplier Selection Rules?

Internal procurement regulations

According to the Procurement Law, each Procuring Entity must select suppliers of goods, works and services on the basis of a tender, auction or other selection procedure provided for in a procurement regulation to be adopted by each Procuring Entity internally.

Although the Procurement Law leaves determination of an appropriate procurement procedure to the discretion of a Procuring Entity (and in this respect is more flexible than the

Public Procurement Law No. 94-FZ), it obliges the latter to make its selection process adhere to certain guiding principles.

The key principles to be observed in the procurement process are as follows:

- transparency of the procurement process;
- equal eligibility criteria and the absence of arbitrary requirements or discriminatory restrictions for potential suppliers; and
- value for money and minimisation of cost to the Procuring Entity.

While certain principles are developed further in the provisions of the Procurement Law by specifying certain action which must be taken by a Procuring Entity, some of them are general in nature lacking specific details. Consequently, whether or not the action of a Procuring Entity is in line with the principles of the Procurement Law may depend on how these principles are interpreted by the Russian courts and the FAS.

In particular, it is unclear whether restricted tendering is in compliance with the Procurement Law and under what circumstances the use of direct contracting may be justified. As a result, the internal procurement regulations of a very few Procuring Entities that we have seen envisage an approach where certain types of contracts or contracts under a certain value, are expressed to be exempt from the more formal tender procedures.

Deadlines for bringing procurement practices into compliance with the Procurement Law

Although the Procurement Law entered into force on 1 January 2012,

it provided for a 4-month grace period for Procuring Entities to bring their procurement practices into line with the new regime.

By 1 April 2012 the majority of Procuring Entities should have adopted and published details of their internal procurement regulations¹ and started to procure goods, works and services in accordance with these regulations. Failure to adopt and publish such regulations means they will be bound to conduct procurement in accordance with the more restrictive Public Procurement Law No. 94-FZ.

It remains unclear what rules are applicable from 1 January to 1 April 2012 in the absence of an internal regulation - whether the procedure prescribed by the Public Procurement Law No. 94-FZ or no rules at all. The approach may differ depending on the type of a Procuring Entity.

As an alternative, a Procuring Entity may elect to conduct procurement in accordance with the Public Procurement Law No. 94-FZ in which case it will not be subject to the Procurement Law.

For certain companies, including (i) those with less than 10% of their income derived from activities that represent natural monopoly or utility services, (ii) subsidiaries (direct and indirect) of state-controlled companies and (iii) subsidiaries (direct and indirect) of natural monopolies and utility companies, the grace period is longer and they will need to comply with the Procurement Law with effect from 1 January 2013. A further postponement to the starting date for these companies is currently under consideration in the State Duma (the lower house of the Russian parliament).

How is new procurement process carried out?

The procurement process must be open, and information concerning procurement which is subject to disclosure must be published on the official website for public procurement www.zakupki.gov.ru (the "Official Website").

The procurement process begins with publication on the Official Website of (i) a notice of procurement together with a draft of contractual documentation, (ii) an invitation to participate in the supplier selection process setting forth the requirements to be met by potential suppliers and (iii) the procedure for selecting a supplier. Although these rules are prescribed by the Procurement Law to be used in the context of an auction or tender, in our view, they should be followed even where a company has chosen a selection method other than a tender or auction.

Any subsequent changes to the originally published documentation must be published on the Official Website.

The procurement ends with publication of the results of the procurement and conclusion of a contract with the supplier selected from the applicants who submitted their bids within the set timeframe.

In addition, the Procurement Law requires the Procuring Entity to publish on the Official Website its annual procurement plans and certain statistical information about contracts entered into with suppliers.

There are, however, exceptions from this general requirement to publish information on the Official Website. Besides information which constitutes state secrets and which therefore must not be published, a Procuring Entity may refrain from publishing information about contracts having a value less than RUB 100,000 (circa U.S.\$ 3,000) (and Procuring Entities with annual revenues of over RUB 5 billion (circa U.S.\$ 170 million) about

purchases having a value less than RUB 500,000 (circa U.S.\$ 17,000). In addition, the Russian Government may, for procurement of specific goods, works and services, determine that information on the purchase is not required to be posted on the Official Website.

What Transactions Fall within the Scope of the Law?

The Procurement Law covers procurement of any goods, works and services except for those which are expressly excluded.

The list of exclusions is limited and exhaustive.

In particular, the Procurement Law does not apply to: (i) sale and purchase of securities and foreign currency, (ii) purchase of commodities on a commodity exchange, (iii) purchase of military products, and (iv) purchase of goods, works or services in accordance with an international treaty which provides for a different method of procurement.

Does the Procurement Law apply to derivatives?

While the Procurement Law exempts sale and purchase transactions with securities and foreign currency and sale and purchase transactions with commodities to the extent the latter are purchased on a commodity exchange, whether inadvertently or intentionally, derivatives with any of the above as underlying assets are not expressly excluded. One Russian regulatory authority is of the view that the Procurement Law does not apply to cash settled OTC derivative transactions. However, as this is not expressly stated in the Procurement Law, there is some concern as to whether this approach will be consistently applied.

¹ Starting from 1 October 2012 such regulations must be published on the official website dedicated to public procurement www.zakupki.gov.ru.

Are participatory interests inadvertently or intentionally omitted from the list of exclusions?

Another notable issue is whether participatory interests which make up the share capital of a Russian limited liability company fall within the scope of the Procurement Law or not. Although the economic nature of participatory interests means they can be assimilated to securities (sale and purchase of which is exempt from the Procurement Law), as a matter of Russian law participatory interests are not securities and therefore are not strictly speaking exempt. At the same time participatory interests are not on the list of exclusions. We hope that this issue will soon be clarified by courts or authorised regulatory bodies.

Is provision of a loan a service?

The terms 'goods', 'works', 'services', and some others like 'procurement participant' are not defined in the Procurement Law and are not defined uniformly in other Russian legislation which makes the scope of the application of the Procurement Law not entirely clear.

One of the main issues is whether granting a loan qualifies as a service within the meaning of the Procurement Law and therefore requires selection of a lender in accordance with the procurement procedure of the Procuring Entity concerned.

While there are arguments in favour of not treating the provision of a loan as a service (whether an intercompany loan or a loan granted by a banking institution), there is a general perception in the market that the Procurement Law should apply to

loans (whether bilateral or syndicated) provided or arranged by financial institutions (both Russian and foreign). In the context of loans by financial institutions to corporates there appear to be additional arguments in favour of treating certain aspects of the process of providing a loan as a service. On this view, even if the loan itself may arguably not be treated as a service, arrangement of the loan for which an arrangement fee is payable is likely to be.

At the same time, some major state-controlled banks seem to take the view that the requirements of the Procurement Law should not apply to their borrowings on the interbank market, although they acknowledge that there are no strong legal arguments supporting such view. We understand that there are currently some legislative proposals (for which the major banks as well as some other state-controlled companies are lobbying) to amend the Procurement Law in order to specifically exempt from its scope certain financial services (at least borrowings on the interbank market), but the timing and the prospects of these legislative initiatives are not yet certain.

What Are the Consequences of Non-compliance?

The consequences of non-compliance with the Procurement Law are currently not entirely clear.

It is specifically provided in the Procurement Law that any 'procurement participant' (i.e. arguably any potential supplier) affected by a Procuring Entity's failure to comply with the Procurement Law can challenge this failure in court, but the consequences of successful challenge are unclear. In particular, it is unclear whether the court can render the relevant contracts invalid

and what the consequences of invalidity would be.

There are as of now no penalties provided for breach of the Procurement Law by a Procuring Entity or its officers. However a draft law prepared by the Russian Government introduces administrative fines for non-compliance with the Procurement Law. According to the draft law, a fine of up to RUB 500,000 for a Procuring Entity and up to RUB 15,000 for their officers is envisaged for, amongst other things, selection of a supplier in breach of internal procurement regulations or the Procurement Law, breach of the requirements of the law on disclosure of information, and violations in the course of the procurement process.

Appeals to the FAS

Apart from challenging a Procuring Entity's actions or omissions in court, in certain cases the Procurement Law entitles an aggrieved tenderer to file a complaint with the FAS.

Upon review of the complaint, the FAS can either issue a binding order to the affected Procuring Entity (including obliging it to rectify the relevant violations) or cancel the results of the procurement.

Legislative Proposals

In addition to the already mentioned legislative proposals, there are a number of draft laws which envisage the exclusion of certain entities from application of the Procurement Law and extension of the grace period for certain entities. None of the proposals have yet been adopted even at a 1st reading, and the prospects of these legislative proposals and the time take for possible adoption are not yet certain.

Conclusion

This note gives a general overview of the Procurement Law, many provisions of which remain to be clarified. Therefore, it should not be treated as advice in relation to any particular transaction and it is recommended that separate advice be sought to take into account all the relevant circumstances.

There is so far very limited official clarification and court practice on the Procurement Law, and so the position described in this note is subject to potential change in the future as law enforcement practice emerges.

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