1. Country and Sector Background

Russia has made substantial progress in virtually all areas of economic reform, although housing and communal services (HCS) reforms are still far from complete and pose significant impediments to creating market mechanisms in the delivery of housing and utility services. The housing privatization program and changes in the legal codes to date have been substantial. The challenge now lies in the successful implementation of the laws and regulations that support reform of the HCS sector.

Significant budget resources flow into the HCS sector from both the federal and sub-national governments—for example, municipalities generally spend anywhere from 20-40% of their annual budgets on the HCS sector. Despite these resources that flow into the sector, the deterioration of the housing stock and the poor quality of the communal utility networks providing communal services continues. The high public spending is supporting the grossly inefficient management and maintenance municipal companies including their suppliers, and broadly subsidizing privatized tenant-owners with little regard to their means-tested needs. If left unchecked, the continued depreciation of assets implies higher future operation and maintenance costs, and also makes it more difficult to recover the cost of service provision from users. For instance, highly energy inefficient buildings and network infrastructure compound the costs of providing energy in cold climates.

The deteriorated state of the housing and utilities stock suggests that fixed investments are of high priority. However, without comprehensive policy reforms, it will be impossible to place the sector on a sustainable path. Given the vast investment needs and limited loan funds, the project would generate greater value added by focusing on policy reforms. Implementation of the Federal Government’s HCS reform strategy at sub-national levels requires special focus on selected key policy areas, which will be supported through this HCS Development Policy Loan. The emphasis of the HCS Reform Program is on the management and maintenance of the existing housing stock, improved social protection for the poor and vulnerable, and the efficient operation of utilities, namely water supply, sewerage, heating, and hot water services.

2. Operation Objectives

The DPL’s objective is to support implementation of federal reforms of the HCS sector at sub-national levels, by shifting from relying overly on government provision of services to market-based mechanisms for competitive
service delivery. The proposed program will focus on reforming the institutional relationships within the whole HCS sector, from housing management and maintenance to utility enterprises. The proposed project would seek to help implement a comprehensive set of reforms in the HCS sector, thereby placing it on a more sustainable path where there is less reliance on government finance and support.

The Federal Government has enacted an impressive array of legal and regulatory acts designed to introduce market competition into the sector, as well as encourage privatized tenant-owners to assume all rights and obligations that come with private property. The main strategy for reform of the HCS sector is articulated in the Federal Government’s Sub-Program “Reforming and Modernization of HCS Sector of the Russian Federation”, which is a part of the Federal Targeted Program “Housing” for 2002-2010.” The HCS Sub-Program formulates the vision and goals of the state policy in the housing and communal service sector for the period from 2002 to 2010, and sets short, medium and long term priorities for its implementation. The main directions of the program have also been echoed in speeches made by Prime Minister Fradkov, with particular emphasis on assuring market-based competition in the sector and protection for the poor.

The DPL is designed around three key areas of reform for the HCS sector as identified by both the Government and the Bank, namely: (i) the financial viability of sector enterprises; (ii) improving the social protection of HCS consumers; and (iii) creating a competitive market for housing management and maintenance services. The project will seek to provide incentives and support to three stakeholder groups—municipalities, enterprises and consumers—to implement reforms. The reform program that Regions and their selected municipalities will be expected to implement is listed in the Policy Reform Matrix. The Matrix has been extensively discussed with all relevant ministries of the Federal Government and Russian experts. On October 7, 2005 Minister Yakovlev (MRD) formally submitted the final version of the Policy Reform Matrix to the Bank.

While the Technical Assistance (TA) is not part of any conditions in the Policy Reform Matrix, it will be needed to support implementation of the three areas of the policy reforms outlined in the Matrix. The TA is needed to finance the operational costs for the Project Implementation Unit (PIU) that will be managing the Contest and implementation of the HCS reform program in behalf of Rosstroii and MRD. The capacity building provided through TA will assist with advancing the implementation of the reform programs in the Regions and municipalities.

3. Rationale for Bank Involvement

In February 2002, the Government—Gosstroi (now the Federal Agency for Construction and HCS - Rosstroii, which reports to the new Ministry of Regional Development) and the Ministry of Economic Development and Trade—requested that the World Bank analyze the major issues in the HCS sector. In particular, the Bank was to assess the constraints faced by local governments, who are responsible for the sector, and the progress made in the regions. The Bank submitted a short policy note to the Russian Government in June 2002, which was based on visits to thirteen cities in April 2002 by World Bank and Russian experts. A draft of the longer final report was sent to the Federal Government in mid-January 2003, and was discussed at two regional conferences with local governments (oblasts and municipalities) in Samara and Novosibirsk. The report was finalized and submitted to the Government in May 2003, and became the basis of discussions for the design of a HCS Reform Program DPL.

The April 2002 fieldwork and regional conferences revealed that no municipality had implemented a comprehensive set of reforms. Various aspects of reform, with varying degrees of success, have been implemented in different municipalities. The main reasons given were sensitivity to political repercussions, lack of information on implementing a comprehensive strategy, and a shortage of resources, both human and financial. Local authorities also need clarity and consistency in Federal policy regarding HCS reforms, as Federal laws, regulations and guidelines help cities in designing their HCS reform programs. World Bank support, in collaboration with the Federal Government, could help local governments design and implement comprehensive HCS reform strategies.

The value added of Bank support in pursuing the Federal Government’s HCS reform agenda will be in helping to create market-based relationships between consumers, service providers, and local governments. The project should therefore not only focus on reforming the communal (utilities) sector, but should also address the creation
of effective building-level management structures and a competitive environment for housing maintenance services. In all spheres of the HCS sector there is a lack of financing sources to both push the reform agenda and sustain needed investments. Public coffers have insufficient funds, and private capital in Russia is still uncertain about investing in the sector. The Bank’s project would therefore not crowd out private investment, but would rather fill an existing finance gap, while also making the sector more attractive to private capital through the creation of market-based relations. The Bank’s involvement could also act as a demonstration effect for private investors and other cities.

4. Financing

The World Bank will disburse the loan to MOF in three tranches based upon the Conditions of Disbursement. The HCS Reform Program DPL totals USD 200 million, of which USD 5 million will be for the TA component, with Government counterpart funding for the TA component of USD 15 million. The Loan will disburse in three tranches to MOF: USD 50 million, USD 100 million, USD 45 million.

5. Institutional and Implementation Arrangements

The World Bank’s relationship is essentially with the Federal Government, so money from the Bank is transferred to the Federal Budget. The Federal Government then on-transfers grants to the Regions (and their municipalities) based upon their successful implementation of agreed-upon reforms as specified in the Policy Reform Matrix. The HCS Reform Program DPL is designed as follows: (i) Bank lending to the Federal Government in the form of budget support; and (ii) provision of technical assistance to support the Federal Government and Regions in preparation and implementation of the program. The Technical Assistance (TA) component is designed to support the implementation of the HCS Reform Program DPL in the participating Regions and municipalities.

The Federal Agency for Construction and HCS of the Russian Federation (Rosstroi) will be responsible for the implementation of the DPL, including progress reports and coordination with parties concerned. The Ministry of Regional Development will oversee operations of Rosstroi in implementing the project. A Project Implementation Unit (PIU) will be selected to assist in day-to-day implementation of the technical assistance component of the Project. The PIU will be hired following competitive tender for an organization to provide all the resources necessary for the project. The PIU will function according to an operational manual which will be approved by the Russian Inter-ministerial Working Group and the Bank. On behalf of Rosstroi, the PIU will deal with the necessary procurement activities, project accounting and financial management in the course of implementation of TA Program activities.

6. Benefits and Risks

Lack of political will to implement reforms at federal or local level. HCS reforms remain politically challenging especially in terms of buy-in from regional or local leaders who may find they benefit more from the current situation, especially in terms of control over resources and jobs in the HCS sector. Additionally, the Russian political environment changes rapidly. The Federal Government has shown commitment to HCS reform over a long period, since the mid-1990s. At the local level, regions will not be selected, but will choose whether or not to compete for participation in the DPL, which will be an important indicator of local ownership. Successful implementation of the program at the local level could also be jeopardized if the TA program is not delivered as planned.

Increased social tensions. If tariffs increase while service quality deteriorates, or if poor households are not protected from tariff increases, social tensions may grow. The DPL seeks to mitigate this risk by addressing the institutional environment in which service providers operate in order to make it more competitive, by limiting tariff increases and enhancing the existing social protection program. Social impacts will be closely monitored over the life of the project.

Failure to establish competitive markets in the HCS sector. The complex and interconnected nature of HCS reforms results in a risk that the project will be completed without competitive markets in building management and maintenance being established. This would suggest that the financial condition of the sector has not
improved sufficiently and that services would continue to deteriorate, as private investment in the sector would be unlikely. The policy actions have been designed in close consultation with Government and other stakeholders in order to mitigate this risk by focusing on three closely related areas of reform affecting the three main stakeholders: central and local governments, utility providers and households.

7. Poverty and Social Impacts and Environment Aspects

Substantial work related to poverty and social impacts of the policy program has been carried out as part of the overall HCS sector reform program in Russia, which has been going on for over a decade. Relevant PSIA activities include extensive analytical work, as well as regular consultations with local government, civil society, and donors, which have been involved in the dialogue since the early transition years. As part of project preparation, a summary of recent PSIA activities related to the three key reform areas was undertaken and is available in project files. Recent and on-going analytical work forms an integral part of the broader poverty dialogue with the Government of Russia.

The primary stakeholders include federal, oblast and municipal governments, HCS providers, private companies, and residents/households. Reforms are expected to positively affect all levels of government (by reducing the need for subsidies), HCS providers (by efficiency gains and improved revenues), private companies (by improving access to new lines of business in housing management and maintenance) and households (by improving service quality). Poorly managed HCS providers may be affected negatively, however, if they cannot compete with private companies.

As tariffs for HCS are likely to increase over the life of the project, the project has been designed to include a series of policy actions to improve targeting, funding and delivery of housing allowances. Housing allowances are the primary mechanism for protecting the poor from tariff increases as they are designed to limit expenditures on HCS to a maximum share of household income. Selected indicators will allow regular monitoring of impact on households, for example, by monitoring adequacy of funding for housing allowances and l’goty, number/share of households receiving housing allowances, level of housing allowances, adequacy of program administration, etc. The TA component also includes funding for additional impact assessment work.

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