



INTERVIEW
MIKHAIL POLONSKIY,
President, PROMSTROI GROUP CJSC

Last year Group of Companies PROMSTROI carried out works within the framework of the construction of the first stage of the ESPO pipeline system, including construction of Oil Pumping Station No.4 and industrial pipelines and installation of onshore and hydraulic facilities of the Kozmino sea terminal.

The Company is currently performing turnkey construction services of the branch line pipe from the ESPO to China's border.

President of PROMSTROI GROUP CJSC Mikhail POLONSKIY gave an interview to "Vertical" about specificity of working in the Far East and its relationship with the customer.

Ed.: *What are the specific features of the "Eastern" construction?*

M.P.: If we compare three construction projects of the same capacity, technical solutions and combination of installations situated in the European part of Russia, Western Siberia and Far East, they will be essentially different in the terms of strategy of their execution, risk management and cost.

The main problem of the construction process in the East, without taking into consideration vast distances and wicked climate conditions, is underdevelopment and, in fact, lack of the local contracting market, in particular in relation to installation works and the market of local construction materials and services. Only those contracting companies which are

able to perform most of the work with their own resources can operate successfully there.

Local subcontractors represent small teams unable to obtain prequalification in "Transneft" according to such criteria as experience, personnel qualification, availability of their own technical resources, financial standing and ability to minimize financial risks.

Ed.: *Far East is a region with difficult mining and geological conditions...*

M.P.: ... That is why quality of engineering survey is of particular importance there. For example, while performing earth works for oil processing facility (oil pipeline "Skovorodino – the PRC's border") in accordance with the engineering survey we were to deal with the grounds not exceeding the fourth category (and it was so on the part of the site). However, after the completion of the

main part of foundations for the facilities and installation of the equipment, we faced the hardest rock folding that had to be exploded with little efforts upon availability of reliable information. But it was impossible to perform drilling and blasting operations. There was a risk to damage facilities that were already completed. We had to collect high power hydraulic hammers urgently from all parts of the Far East.

Mobilization, demobilization, downtime of subcontractors and round-the-clock work in order to "fight" with the rock resulted in significant wasteful expenditure not foreseen by the project.

Ed.: *Didn't Transneft compensate these expenses?*

M.P.: Customer usually accepts additional expenses related to design errors. But who benefits from it?

Ed.: *How is it possible to minimize such risks?*

M.P.: Today analyzing mistakes we realize that at the offer

The main problem of the construction process in the Far East, without taking into consideration vast distances and harsh climatic conditions, is underdevelopment and, in fact, the lack of the local contracting market

preparation stage we were to assume the risk and carry out engineering survey, or to convince the customer to include it as additional expenses into the preparatory period. It is a bad and expensive solution, but other solutions are even worse.

Ed.: *Transneft has repeatedly presented claims to contractors...*

We came to Eastern Siberia with Transneft in 2006 and tried to avoid any substantial schedule delay

M.P.: We came to Eastern Siberia with Transneft in 2006 and tried to avoid any substantial schedule delay. Our OPS-4 was the first facility of ESPO-1 that was presented to the acceptance commission.

It is not easy for contractors, especially for new ones, to work with Transneft. The company imposes high requirements to work organization and quality, requires daily reports on physical volume of work and performance bank guarantees from the top ten banks (we, in particular, work against the guarantee of Sberbank). The system is rigid, and not all contractors adjust themselves to it easily, some contractors give away.

However, it is a planning and management system for construction and technical upgrading that has been developing during many years in the course of the realization of unique projects and that was maintained.

Problems arise with almost every customer, because construction

is a complex process and it can not take place without problems between the customer and the contractor. After all, it is the customer who builds, not the contractor.

Today Transneft is a most mature customer. Over the past 10 years, the company has implemented several major infrastructure projects and has acquired unique experience.

ESPO project is an example of a very high level of mega project management. Not all even best Western companies would be able to cope with the project taking into account terms and conditions of its implementation. Preparation and implementation process of such a large-scale project would take considerably more time abroad than for Transneft.

ESPO design and construction process – from decision making at the end of 2005 till tank shipment on December 27, 2009 – deserves appreciation. However the situation was extremely tense at every construction stage and Transneft had to solve numerous problems. The path was not strewn with roses.

Ed.: *Mr. Polonskiy, customer usually gives little time to contractor in order to prepare an offer. How can a contractor calculate everything and assume risks for hundreds of millions of dollars in a three-four week period?*

M.P.: Contractor spends hundreds of thousands of dollars for the preparation of an adequate offer for the construction of a large-scale project, and the process takes him several months. Contractor is to perform development of network activities schedule for construction, procurement and financing, carry out value and technical expertise of tender documentation and marketing of suppliers of equipment, study local markets of contractors, building materials, services, transportation schemes, technical specifications for the connection of temporary buildings and facilities, etc.

A large number of experienced and high paid specialists during relatively a long period of time (often three – four months, sometimes up to six months) work on this. Expenses for the

preparation of an offer of a serious project may amount to 300,000 – 400,000 USD and sometimes even more. And when there is a tender for the construction of a project totaling to several hundreds of millions of dollars while the period for the submission of bids is 10 days, this causes nothing but perplexity.

Ed.: *Why is the period of tender preparation so short? Is it an imitation of a tender? Is it a creation of "crowd" in order to legitimize victory of the designated captive company?*

M.P.: Often it is a failure of internal deadline of the preparation of bidding documents by the customer. One of the ways to "fix" the situation is to reduce time for preparation and submission of the offer by applicants. Moreover, I would not make a fetish of tenders for the construction of large-scale projects. It is not like buying a loaf of bread in a supermarket.

In Western countries they are relatively transparent, and maybe currently in this country this is less evil these captive companies against a large number of irresponsible, "ready" to perform any volume of work, professionally unsound dumping candidate-vagabonds, Especially against the background of well-known transient processes in the systems of technical regulation and licensing in the construction, immaturity of the customer, lack of local building materials in a number of regions that are proposed by subcontractors.

When I'm talking about the period of preparation of the offer and its cost, I mean that inside or outside contractor is to bear these expenses at the beginning for avoiding the project becomes very expensive at the end.

To provide the contractor preparing the offer with all available information benefits the customer contrary to popular belief: provide the contractor with as little information as possible, hide all budgets, sugar-cover the real facts in order to get lower price. Unfortunately, this is a typical position of officials of Capital Construction Management, Capital Construction Department, and

top management seeking to show themselves, and often in all honesty, to be more Catholic than the Pope. The price of eradication of illiteracy of such managers can be very high for their employers.

Ed.: *Did you engage subcontractors or use only your own resources?*

M.P.: We engaged and continue to engage subcontractors. We do this in order to meet quality and cost of work provided by the contract. We have strict internal rules as to engagement of subcontractors. And our own companies have to compete as to terms and prices with their colleagues that do not form part of the Group.

We intentionally create competitive conditions for our companies. Otherwise, effectiveness of general contract projects might have been affected, because it is the project that is the profit center.

Without competition with external environment, management of internal subcontractors is "getting fat" quickly and it loses its tonus and professionalism.

Ed.: *How often do outside contractors win?*

M.P.: Quite often. Our external partners-contractors are to take prequalification, that is to confirm the possibility to perform certain types of works in accordance with the requirements of the customer and with requirements of our Group of companies to bank guarantees for securing obligations, qualification of personnel, availability of their own technical resources, financial status, occupational safety, industrial and environmental safety, project management system, reporting, etc.

Contracts of intents are signed with subcontractors who have passed prequalification which basically is the condition for the beginning of commercial negotiations.

Afterwards the tender on commercial terms of the contract is held. If an external contractor offers a lower price than our subsidiary, our subsidiary has two options: to reduce the price to the amount offered by the external contractor, or to lose and seek for external contracts independently. In the latter case,

the company enters into a contract with an external subcontractor.

It is worthy to note that on the stage of selecting subcontractors the idea of anti-dumping cut-off price is used. We are well informed on the cost of resources on the contractor market and prices, we know the prices and we understand the primecost of a subcontractor. Thus, there is minimum price in each subcontract lot. And if we get an offer below that minimum price we stop negotiations with such contractor. Long-term experience has demonstrated to us that we will have nothing but problems with such a partner in the future. And there is no such thing as a free lunch.

Our subsidiaries have the responsibility to implement business plans for certain volume of works, profit and cash flow. Under the right of freedom of contract they have preferences against external subcontractors such as: no necessity to pass prequalification and to provide a bank guarantee. Unfortunately, sometimes despite the prequalification we make mistakes when selecting an external subcontractor. In this case, we always have the opportunity to take an administrative decision and to engage our own specialized contracting facilities for this volume of work. Of course it is a bad decision. We rarely use it, because general contractor, who made mistake by selecting an inadequate external contractor, covers all actual expenses.

Ed.: *What contracting capacities are there in your Holding?*

M.P.: In our Holding there are companies that render services on installation of industrial pipelines and equipment, manufacturing and installation of metal structures, installation of automation systems and electrical equipment, mechanization and completion with all types of materials and equipment.

Today analyzing mistakes we realize that at the offer preparation stage we were to assume the risk and carry out engineering survey, or to convince the customer to include it as additional expenses into the preparatory period

All these companies are companies of the former Minmontazhspetsstroy and Minneftegazstroy that were oriented to work in the interests of oil and gas industry, oil and gas refiners, power engineers and steel workers and that can be quite easily retargeted for performing works on their core competencies in other industries.

ESPO project is an example of a very high level of mega project management. Not all even best Western companies would be able to cope with the project taking into account terms and conditions of its implementation.

According to Western perceptions, it is quite inadequate set of products. Unthinkable. General contractor usually takes these services on the market there – there is installation and special construction works market, procurement market, etc. When a company specializing in project management gets a contract it does not think about where to get a subcontractor for this or that type of works. General contractor or EPC contractor depends on subcontractors to a much lesser extent.

Without competition with external environment, management of internal subcontractors is "getting fat" quickly and it loses its tonus and professionalism

There is practically no subcontracting market in this country, especially in the Far East. Assuming risks for the end product, general contractors often become dependant from subcontractors. In order to

reduce this dependence and to manage risks better, we had to form a polyproduct assets profile. At that, we are trying to open internal market for the access of external subcontractors to the maximum.

Ed: *What are you going to do with your subcontractors if the markets appear.*

We are well informed on the cost of resources on the contractor market, we know the prices and we understand the primecost of a subcontractor. Thus, we have a minimum price in each subcontract lot.

M.P.: If we see a steady offer which will be highly competitive in terms of quality and price with the products that we have in the Holding today, then we will think what to do with these assets: to sell control to a strategic investor, to enter the stock market, to sell to management, etc.

Ultimately, we would like to focus on more highly-marginal and technological products such as design, management and consulting.

We had a surprisingly good 2009, and we can even say that we did not notice the crisis. But it was probably confluence of circumstances – we had a lot of interesting work

Ed.: *How quickly can this happen?*

M.P.: Depending on how quickly the situation on the contracting market will change. And in the meantime, from our point of view, “subsistence economy” is justified, and we are planning to buy assets specializing in the installation of high-voltage electrical and thermal equipment and design.

Ed.: *What significant changes, from your point of view, are expected on the contracting market in the coming years?*

M.P.: Positive changes.

Ed.: *Are you an optimist?*

M.P.: In our profession pessimists do not stay long. Market is huge in terms of volume, it will develop. I think that consolidation of contracting assets will continue. There will be less domestic contractors, but they will be much stronger, there will be more major customers, and the management role of the state will lessen.

Requirements to the efficiency of capital costs and quality of construction will be upgraded. The competition will grow in the low-tech segment on the part of the Chinese contractors, and in the high-tech segment – on the part of the Western contractors. Traditional general contracting tenders will be gradually replaced by EPC.

Ed.: *How did PROMSTROI GROUP pass through the crisis?*

M.P.: We had a surprisingly good 2009, and we can even say that we did not notice the crisis. But it was probably confluence of circumstances – we had a lot of interesting work.

Of course we could not avoid the reduction of general and administrative expenses that we cut down in the 4th quarter of 2008. The approach was the following: give up everything we can live without. Today there are 100 employees in our managing company including drivers. It is a good indicator for a company with such geography and 4500 employees.

Our company does not have excessive profits, but it shows good sustain dynamics in the course of recent years including in 2008 and 2009.

Among the major projects of the last year we can mention the Extension of Yuzhno-Balykский Gas Processing Complex, the customer is SiburTyumenGaz. The project was completed and

put into commission in December 2009. In addition, our subsidiary companies work for dozens of other clients as subcontractors, including metal and steel, petrochemical, oil refining and energy companies in Russia and Kazakhstan.

Ed.: *How did the prices for contracting services change last year?*

M.P.: The prices fell as throughout the whole industry. In our segment several processes are taking place simultaneously: firstly, we constantly feel pressure from customers that try to optimize their expenses by means price cutting. Secondly, inflation stayed. And finally, major customers impose high requirements of health, safety, environment, reporting, etc. To put it all into the same price is possible only through negotiations and compromise.

Ed.: *Does PROMSTROI GROUP have a mind to buy any assets?*

M.P.: I have already mentioned the “multiproduct” scheme in our company. In order to complete it we need three more product divisions: assemblers of high-voltage and thermal equipment and our own design capacities, preferably with Western technologies. We leave open the possibility to acquire necessary assets. Meanwhile, we are carrying out cautious negotiations.

The difficulty is that due to the crisis there is no understanding of the real value of assets. De facto, we can speak about non-monetary acquisitions. But as a rule, shareholders do not want to be taken over without any money consideration. This resulted in a significant reduction in mergers and acquisitions transactions from the second half of 2008. But we continue to negotiate with our partners, to discuss different strategic prospects with the investment bankers and we are optimistic about the future.