Will the Concession Agreement Become One of the Possible Legal Forms to Exploit the Subsoil in Russia ?

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Two conferences, sponsored by the magazine "Oil, Gas and Law", were held recently: "OIL GAS LAW – 2002: problems of legal regulation of Fuel and Energy Complex (FEC) and natural resources in Russia and CIS countries" and "Concession. Contract Between The State and an Enterprise: Advantages and RIsks". The issue of optional forms of attraction of domestic and foreign investments into the oil and gas complex of Russia drew heated discussions. Special attention has been devoted to such a form of contracts as a concession agreement.

It is a common knowledge that foreign investments are considered to be one of the most important factors to improve and develope the Russian economy. Investment in the oil and gas industry is one of the main sources of currency earnings in our country.

It was repeatedly underscored that in order to restore and promote the development of the fuel and energy complex (including attraction of the capital investments) it is required to promptly shape the legal basis to facilitate regulation of the relationships in the area of attracting the investments into the extractive industry.

Considering the fact that Russia has to compete with many countries rich in natural resources, but, with a shortage of funds to finance the exploration projects, creation of a reliable legal environment, which serves as a necessary prerequisite to encourage foreign investors to invest the production capital both into the country economy and into the oil and gas complex should be considered as one of the main tasks.

With a goal to attract the investments, Russia adopted specific legislation, consisting of the ground laying acts such as the Federal Act "On Foreign Investments in the Russian Federation" and the Federal Act "On Investment Operations in the Russian Federation Performed in the Form of Capital Investments", and special Federal Act "On Product Sharing Contracts" regulating the investments into the fuel and energy complex.

The adoption of the above legislative acts was undoubtedly a positive sign for further regulation of investing in Russia in general, and those earmarked for oil and gas industry, in particular. Nevertheless, despite the value of adopting special laws regulating the investment operations, the inflow of the investments remained insignificant. Lack of any mechanism to provide guarantees to the investors, specifically, foreign investors, declarative nature of the majority of the provisions of the Acts as well as the need for their further revision reflecting the experience of investments' attraction accumulated over the decade in Russia are the reasons for such a situation.

Despite the fact that currently the system of mineral wealth exploitation is based on an administrative relationship, the contractual forms of mineral wealth exploitation have been introduced and validated as a legal form of relationship between the state and any entity exploiting the mineral wealth. The latter happened due to the fact that the practice of recent years proved the inefficiency of the current licensing system for the state and its unattractiveness for private investors.

The analysis of the applicable legislation on subsurface rights showed that a large-scale attraction of investments in the fuel and energy complex may be implemented only when stable legal regulation is available and contractual forms in the mineral wealth exploitation, where the state and a private investor would stand as equal parties to a contract, are widely employed.

At present, various contractual forms of mineral wealth exploitation are used around the world, including concession contracts, their modern variations product sharing agreements, service contracts risk-involved and risk-free.

In our country, the product sharing contract (PSA) is one of the first contractual forms in the field of exploration and extraction of natural resources so far.

Russia has already adopted a number of special federal acts to grant rights to use mineral sites on the territory of the Russian Federation and its continental shelf, which mandate the development of the minerals on PSA conditions. However, only four contracts of such kind have been signed today. Moreover, only one contract – on development of Samotlor oil and gas condensate field – has been entered into on the basis of the 1995 Federal Act "On Product Sharing Agreements" .

The state recently started to attach huge significance to the attraction of foreign and domestic investments into the oil and gas sector including those based on PSA. The President of the Russian Federation V.V. Putin, during the first international conference "PSA-2000" in Yuzhno-Sakhalinsk, declared "We regard the product sharing contracts as one of the priorities of the investment policy. At any rate, PSA may and must become the most important instrument of the state investment policy".

In order to ensure necessary conditions for attraction of the investments, including on the basis of the concession contracts, it is necessary to shape the legislative basis by adopting the Act On Concession Contracts.

From the legal point of view, the concession contracts, product sharing agreements and other contracts in the area of the development of hydrocarbon fields grant the subsurface user, along with the permissive system, greater freedom when investing the capital and managing the project.

Currently, the attraction of large-scale investments into the Russian economy and creation of necessary conditions for subsequent improvement of the investment climate in Russia depends upon speedy creation of the concession legislation.

Determination of the legal nature of the concession contract and its elaboration in the Act On Concession Contracts is one of the essential problems facing the legislators.

The concession contracts, along with the already existing contractual form in Russia, product sharing agreements, should constitute the system of contractual relationships in mineral wealth exploitation, which may and must become an alternative to the currently existing permit system for provision of mineral wealth for use.

The concession contract ought to be regarded as nothing but a civil contract. The equation of the concession contract with the civil contract would enhance the investor guarantees granted by the state within the framework of the investment legislation.

It is the contract that may provide the parties with the highest guarantees for due execution of the obligations assumed by the counteragent, with applicable remedies against unsubstantiated breaches of their rights under the contract, and reimbursement of damages resulting from undue execution or an absolute failure to execute the contractual obligations.

If one acknowledges the existence of such a contractual form as a concession contract, one should agree with the standpoint of M.I.Braginsky and V.V.Vitryansky, who reasonably believe that a contract ("deal") may exist exclusively between the subjects, who hold equal positions in the specific case. The very existence of the relationships of power-and-subordination between the parties ultimately precludes any possibility of application of both the Civil Law rules and a contract structure of the contract per se.

While analyzing the legal nature of the concession contract it may be inferred that the said contract should not be regarded as an agreement of a mixed nature, meaning presense in it of the elements originating in private as well as in public law (though such an approach did exist during the Soviet era). It should be treated as a civil contract, however different it may be from other usual types of civil contracts.

Undeniably, a concession contract has its specificity, which keeps it from being attributed to a particular type of the traditional civil law contracts. Nevertheless, the legal science knows a great deal of examples of the so-called atypical nature in the relationships regulated by the civil law.

When analyzing the legal nature of a concession contract rather than talking about the mixed nature of the concession contract, it would be quite relevant to speak about the existence of the atypical contractual relationship between the parties, i.e., relationship going beyond the scope of the typical legal relationships as mandated in the civil law legislation.

As it had been quite some time ago pinpointed in V.A.Oigenzikht' s interpretation of the concept of atypical contractual relationships, "such institutes, though preserving a certain degree of similarity with the typical ones, are notable for a significant deviation, the fact that determines specificity of their legal regulation". The author emphasizes that "undoubtedly, in most typical relationships certain pecularities not fitting, to a degree, within typical boundaries may appear. The issue boils down to the degree of anomaly. One also cannot but take into consideration the fact that while reg-

ulating most relationships the civil law interacts with other branches of law, thus composing a respective complex structure".

V.A.Oigenzikht, for instance, distinguishes the following features as those related to the atypical nature of the contractual relationships:

1. similarity, to a variable extent of the arisen legal relationship with the respective typical civil-law contract;

2. complexity of the elements of various legal relationships;

3. weakening of the civil law character of the relationships (wedging in of administrative and other relationships; existence only of certain elements of the main civil law relationship);

4. application of the arisen civil law relationships to non-civil law relationships;

5. discrepancy with the ordinary concept of the contractual relationships, and other.

Nevertheless, it should not be inferred from the above-stated provision that the atypical legal relationships between the parties within the framework of a concession contract may not be regarded as the contractual ones. As V.A.Oigenzikht underscores, "the law may not leave such relationships not only without protection, but without a mere regulation per se as well. That wouldn't be in the interests of the market and law and order. The necessity of applying not merely the analogy, but the direct application of the respective norms is obvious. Otherwise, there arise plenty of unsettled issues causing considerable problems in the practice of courts and courts of arbitration. The legal ground for acknowledgement of such relationships as contractual relationships is the recognition in the Soviet Civil Law of the existence of atypical contracts, as one of the grounds for the creation of the obligations".

It seems that such an approach may be employed when solving the issue of the legal nature of a concession contract.

It should be noted that Russia has already gained experience in managing on the concession basis. Active use of the concession forms to attract foreign capital helped, to a large extent, to the transformation by the beginnig of the 20th century of a semi-feudal pre-revolutionary Russia into one of the most highly industrialized countries of the world.

The experience of application of the concession contracts in oil production and oil processing to promote the formation and development of those lines of industry in tsarist Russia deserves special attention. Thus, the share of the concession forms of investing into the extractive industry accounted for nearly 48.5%.

During the 20th century attraction of the foreign investments on the basis of the concession contracts concluded with private investors by the new Soviet state played a significant role in the elimination of the consequences of the economic collapse and development of a young socialist country.

The experience of Russia in the early 20th century is a valuable asset not only from the point of view of order and terms for concessions, including the ones for use of natural resources, but also from a perspective of approaches towards the problem of the legal nature of such concessions.

First of all, it would be interesting to learn, what the concept of concessions did really imply in the Soviet law? M.Reichel, for instance, gave the following definition of the concessions: "the concessions, in the general sense of the word, may be understood as a mere permit from the appropriate state authority to conduct this or that type of economic activity". The author further pinpointed that normally such a permit was required for a specific type of activity (for instance, sales of hazardous material). In practice, such procedure was used in the comparatively narrow areas and was confined to the issue of the respective permit. No concession contract has ever been concluded with a firm in such a case and the terms and conditions of its activity have not been generally regulated in any special way.

In the narrow sense of the word, the concession, according to M.Reichel, shall be construed not as a mere permit for engagement in economic activity, but rather as a permit, accompanied by the establishment of special terms and conditions to exercise such an activity. The establishment of such terms and conditions was performed in the form of conclusion of the, so-called, concession contract, though it could be executed in the form of a unilateral act of the authorized governmental agency. The concessionaire, for the concession was not compulsory, was supposed to express his consent in some form.

Due to the fact that the concept of a concession included a permit to conduct a certain type of activity, only such an economic activity, which was completely or, at least, for a given group of persons withdrawn from the area of free market.

Another prominent scientist of that time B.A.Landau defined that a concession constituted a deed of public authority, granting an item (goods), which has been withdrawn from circulation under the ge-

neral rule (*rex extra commercium*) into a private possession on certain conditions for the purpose of public benefit.

Thus, various views on the nature of concessions existed during the Soviet epoch. Some lawyers believed that a concession represented an administrative act (permit) to exercise a certain type of activity, thus reflecting the tendencies of that time that were expressing themselves in strengthening of the administrative approach to the legal nature of the concessions. Other jurists had a slightly different approach to this issue and maintained that the concession could be granted through entering into a contract.

Nevertheless, it should be noted that based on a civil-law concept, views on concessions were predominant in the post-revolutionary Russia. Most lawyers regarded concessions as a lease agreement. Klassen, author of numerous articles about concession law, believed that the peculiarity of the Soviet state's attitude towards the concessions is linked to the fact "that our language about granting to a concessionaire of some or the other items, excluded from the general circulation, would have to be replaced for the language about a long-term lease".

I. Stepanov, another scholar of that time, also adhered to the civil-law based view on the concession contracts and regarded them as a lease. I. Stepanov believed that the lease contract establishes terms and conditions to enjoy the leased rights, and enables enforcement for violation of the terms and conditions of the contract and including the recovery of the damages. In his opinion, such terms are sufficient to put the concessions in such a shape and attach such a line to them, which are the most desirable by the state.

In his work "Concessions and Mixed Communities" A.V. Venediktov also adhered to the opinion that, in terms of their legal nature, concessions constitute lease contracts. But their distinction from the ordinary lease contracts he drew in a prolonged period and broader scope of rights granted to the concessionaire regarding pre-term termination of the contract by the state.

Since that time, jurists pointing to the advantages of the private nature of legal relationships between the state and concessionaire when based on the concession contract, drew a conclusion that the contractual form, as distinct from the state issued to a concessionaire public deed (permit), allows greater protection of the concessionaire's interests.

In particular, the advantages of the contractual relationships between the state and a concessionaire include the fact that the state is limited in its right to unilaterally change the terms and conditions of the concession contract or to unilaterally refuse to comply with such a contract. And should such a unilateral action become necessary, then it would occur in certain cases (in the public interest) only and on the condition of reimbursement of the damages to the concessionaire. So, M.Reichel, referring to the French lawyer Bonnard, emphasizes: "The French court-administrative practice and partially the legislation went further, and, in general, although with certain limitations and caveats, they do acknowledge the right of the state to unilaterally change the concession relationships, provided that the obligation to reimburse the concessionaire the incurred costs is imposed. A special doctrine was contrived. According to it, the state is bound by the obligation not to distort the "financial balance" of the concessionaire ("equilibre financier"), but in case of compliance with such a condition the state may unilaterally change the concession contracts (deeds) in the public interest. By providing the respective rates the concessionaire is granted an opportunity of earning a certain percentage of profit, and the opportunity to earn such a percentage, constituting, as it were, a concessionaire's remuneration, should remain inviolable".

By the way, the principle of preserving the economic equilibrium of a private investor, even in the case of unilateral dissolution or change of the terms and conditions of a concession contract by the state, is considered to be one of the basic guarantees for the investor and should be provided by the legislation on concession contracts.

The stability of the terms and conditions of the contracts may to a larger extent be reached by including the condition on periodic revision of the provisions of the contract into the concession contract and by achieving the economic equilibrium in the context of the contract.

Consequently, even in case of a unilateral change to the terms and conditions of the contract, the contract is to adhere to one of the fundamental principles underlieing the concession contracts, – that is the principle of immutability of the balance of property interests or economic equilibrium. Such a principle, in particular, implies that if a concessionaire incurs extra costs related to the fulfillment of terms and conditions of an unilaterally modified concession contract, the state is liable to reimburse the concessionaire his losses caused by such changes.

It seems relevant to draw attention to one more issue, which was extensively discussed on the pages of the legal magazines of that time. The articles of certain authors provided for a possibility of applying the term "public service" (*service publics*)

to the concessions in the sphere of municipal economy and railway transport in Russia. In particular, such an idea was proffered by E. Nosov in his article "On the Crisis of the Concept of a Concession Contract". It is remarkable that the editorial staff of the magazine, which published the article, expressed a wish that this issue should be widely discussed on the pages of "Sovietskoe Pravo".

In E.Nosov's opinion the crisis of the concept of concession contract consisted of the extermination of its purely civil-law forms and transition, at least, in concessions that served the needs of the population, to the forms of direct commissioning of the concessionaire with the execution of certain state assignments. By stating the history of such a "crisis" in the West, the author attempted to prove that this "crisis" may be witnessed in Russia as well and that the only way out of the existing situation was to acknowledge the concessions as the contract of "commission of the public service".

However, as S.A.Sosna rightly emphasizes, except for France and some other countries, where the traditions and values of the theory of "public service" strongly prevailed, neither in the USSR nor in other countries had the view on the concessionaire as an entity, substituting the public administration, ever developed deep roots.

As M.Reichel says, the doctrine qualifying the concession enterprise as a "public service" doesn't conform to its broad scope of legal phenomena and suffers from apparent narrowness. If to follow the logic proposed by E.Nosov, one may equally well apply the concept of "public service" to any private enterprise, existing at that time and running its business operations not on the basis of the concession, guided by the principle that, for instance, such enterprise was serving a publicly beneficial goal and was exposed to regulation and control on the part of the state.

M.Reichel rightly points E.Nosov to the fact that any non-concession private enterprise, extracting or producing such necessities as food products, fuel, clothes and others, in terms of public benefit, importance of serving "the needs and benefits of the population", would be highly competitive with any concession enterprise. In particular, there is no difference between the private enterprise exploring the mineral deposits without concession, and the foreign enterprise, doing the same under the concession contract. The object of activity, the capacity of the enterprises, and the equipment and marketing conditions and other material conditions may in both cases be equal, however in one case the concession would exist, in the other – not. It is because the issue lies not in what needs the enterprise satisfies, or what "public service", in the broad sense of the word, it performs, but somewhere else. The issue is that in one case the law does require the conclusion of the concession contract and in the other case – it doesn't , in one case a special permit order is established and in other case it is not.

It should be noted that the concessions used in the sphere of urban and municipal economy to a considerable degree differed from the concessions exploiting natural resources.

In the foreign literature it was customary to draw the line between the traditional and upgraded concessions in the area of exploration and development of minerals.

The traditional concessions constituted the initial type of contracts in the world oil-producing industry. The first formalized by legislation concessions appeared as early as in the late XVIII century, particularily, in France. But it is generally acknowledged that the first concession in the history was issued to William d'Arcis in Persia in 1901 (known as "d'Arcis concession"), though in literature one may come across the mention of earlier concessions in the former Dutch West Indies. Thus, oil concessions in the world practice have over an 100-year history.

The basic distinctive features of the traditional concession contract, as a rule, included:

1. grant of a permit by the host party to the foreign oil company for oil production in the territory, transferred into concession;

2. a large territory of concession, covering in certain cases the entire territory of the country or, at least, its most promising in terms of oil production;

3. an extended term of the concession (up to 99 years);

4. absense of a provision to return to state ownership unused and non-promising mineral wealth segments before the maturity of the concessions;

5. full and sole control by the concessionaire of all aspects of economic activity within the framework of the concession;

6. practical estrangement of the host state from participation in management of the concession;

7. direct financing by the foreign company of all exploration works, development of deposit etc. within the framework of the concession,

8. insignificant financial deductions from the concessionaire's earnings in favor of the host state, which were confined, as a rule, to a symbolic

fee for the right to developt mineral wealth (royalty), usually, in the form of the fixed production charge at the maximum rate.

The traditional concessions remained the sole and, in essence, unchanged type of contract in the international oil industry up to 1948, when Venezuela initiated the process of their modification by introducing in practice the division of profits of the foreign investor in proportion 50:50, meaning corporate profit tax. Since then most of the provisions inherent in the traditional concession contracts, which were disadvantageous for the host countries, have been dramatically changed. It should be noted that currently the traditional type of concessions has virtually ceased to exist.

Nevertheless, it doesn't mean that the concession system itself ceased to exist as well. On the contrary, it survived in many developed and developing countries and is widely applied in the oil and gas industry, albeit frequently under a different name. For instance, G.Barrows writes that "concessions may be known as a "permit", "license" or "lease". They are the oldest and widely used oil contract so far".

Now let us discuss the basic features of the "modernized" concessions, which replaced the traditional concessions.

At present, the "modernized" concession contracts are widely used in Great Britain, Norway, Thailand, the United States of America and in Australia. In the countries of the Middle East, where there is no any special concession legislation (except for Iraq), the concession contracts are granted on the basis of holding the negotiations directly with the governments of the above-listed countries.

The profound studies of the modern concession contracts were conducted both in the foreign and domestic literature. In our country, one of the last analyses was conducted by S.Djachenko, who singles out the following distinctive features of the "modernized" concessions.

From a perspective of the project figures, **first,** the territories transferred into concession are not that vast in comparison to the traditional concessions. As for the continental shelf, a concessionaire frequently obtains the rights to only 250 sq.km. as in the case, for instance, of Great Britain, and even to 25 sq.km. as in the case of the continental shelf of the USA. The possibility of preserving the rights to the extensive areas is retained only in respect to the insufficiently explored or completely untested for the purpose of availability of oil reserve territories.

Second, the majority of the modern concession contracts include the provisions on gradual return to the state ownership of some of the areas transferred for use. As a result the territory under contract is quite often reduced two times or more.

Third, the state, as a rule, refrains from transfering into concession the entire territory or even sizable and contiguous areas, especially, if the prospect of discovering the commercially significant accumulations – of hydrocarbon resources are sufficiently realistic. The customary practice, as S.Djachenko emphasizes, is to transfer for the concessionaire's use separate and possibly not adjacentsites, and, if possible, in such a manner that the results of the exploration of the existing fields conducted on each of the concession-transferred segments (areas) the state could also receive the information on the reserves available on the neighboring sites adjacent to the concession territory (so-called "chess-board" method). The advantages of receiving the additional information on the hydrocarbon reserves seem quite obvious for the state.

Fourth, the terms of such concessions in comparison with the traditional ones were significantly reduced. If in the past the concessions were granted for up to 99-year period, now, as a rule, their term has been reduced down to 20-40 years. Besides, the comparatively short periods (5-10 years) are established for the exploration of the contractual territory. Should the discovery of the commercially developable hydrocarbon deposits occur within that period, then a different, extended period earmarked for exploration and commercial exploitation of the deposit starts to run. If the commercially developable hydrocarbon reserves are not discovered until the expiration of the exploration periods , the respective concession contracts become null and void. Consequently, such mechanism ensures an accelerated pace of exploration and, in the case of a failure, there is prompt return of the site to the state. In certain cases, with a view of involving the companies in the exploration and development of the deposits in a complex environment, extended periods of up to 50 years are allowed.

Fifth, it should be noted that the modern concessions stipulate that the concessionaire gains the ownership of the extracted oil resources only at the moment of their extraction, while the ownership title to oil deposits per se belongs to the host state, which grants to a concessionaire only subsurface use rights.

Sixth, the payments to the state may be briefly qualified as taxes plus royalties. In addition, it is noted that the financial conditions of the conces-

sion contracts are highly complex and sophisticated in comparison to the traditional concessions.

In many foreign countries, the state carries out its direct control over the execution of the projects not only through promulgation in the legislation but by stipulating directly in the contracts of the provisions on mandatory reporting by the concessionaires on the production levels, compulsory preliminary coordination by the state of the expense items of the companies – concessionaires, plans and schedules for the development of the deposits.

At present, as the analysis shows, the state also actively participates in carrying out the activities within the framework of the concession contracts. Often the majority of the concession contracts have the provisions on a share of the state (as a rule, through its state-owned oil companies) in the activity on the projects. For instance, Norway through its state-owned oil companies, which participate in various contracts both inside the country and abroad, has secured itself, starting in 1985, a direct participation estimated at 47 to 73% in the development of all new deposits.

The following should be considered the basic features of the modern concession contracts.

First, the contract serves as the basis of the legal relationship between the state and a private investor.

The modern concession contracts might be fully regarded as an independent type of a civil contract between the state and a private investor.

The civil-law nature of the concession contract is featured in the fact that the state enters into contractual relationships with a private investor. No contract is required for the state to exercise its authority. To this end, a license, permit or any other act of granting a right for exercise of any type of activity would suffice. As known, the attempt to combine in Russia the licensing (or authorization) system of relationships with the contractual system in the area of subsurface use rights hasn't brought the desired results. Being supposedly an integral part of the license authorizing to exploit the mineral wealth, the licensing contract between the state and the entity – subsoil user, has never become a full-fledged civil-law contract, where both the state and investor stand as equal parties.

Second, the state, being an equal party, holds a share in the results of the economic activity. As G. Barrows emphasizes, the main drawback of the old-style concessions lay in the fact that the government of the host state had less chance of direct involvement in the management of oil operations within the framework of the concession contract, less leverage in such important aspects like training staff of the host country, as well as understanding the processes occurring in the international oil business, what is of no small importance for the state.

Third, the modern concession contracts provide for the limited grounds of unilateral change of the terms and conditions of the contracts by the state, or unilateral refusal to fulfill the state's obligations. In distinction to the authorization system applicable in the area of mineral wealth exploitation, upon entry into a concession agreement the state has neither the right to change the conditions of how the private investor conducts business nor to ban exercise of any type of activity. The establishment of the specific conditions, under which the state in exceptional cases is entitled to unilaterally change or totally refuse to comply with the contract (for instance, if the investor's activity would threaten the safety of the state or otherwise violate the public interests), enables it to ensure protection against the arbitrary and capricious actions on the part of the state.

The distinctive feature of the current development of the concession relationships abroad is the fact that they are built on the basis of the elaborate legislation on concessions, and the distinct regulation of the obligatory relationships in the civil law. That allows for equal protection of the interests of both the concessionaire and the state.

Since the concession contracts are currently playing a tremendous role in the area of attracting the foreign investments, the managers of the World Bank urge all the states with a transitional economy to develop special laws regulating the concession relationships. In particular, as the deputy manager of the World Bank I.Schikhata, noted "in the countries, where the executive power prevails and oppressive actions on the part of the administration are an usual case, the regulation just on the legislative basis is unlikely to be viable. In such cases it might be reasonable to develop a systematic code of rules related to the license and concession contracts".

For Russia the prompt adoption of the Law on concession contracts would enable it to attract considerable volumes of both domestic and foreign investments into the Russian economy as well as to ensure all the necessary conditions for further improvement of the investment climate.

While drafting and adopting the Law On Concession Contracts, it would be wise to adhere to the concept of a civil law origin of a concession contract, because that would substantially strengthen the investors' guarantees granted by the state. □