

Overview of the Law on Concessions and Its Potential Application to the Energy Sector

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Abstract

Potential application of the Law on Concessions to the pipeline transportation of hydrocarbons has been a subject of recent debate. In our view concession agreements may apply to pipeline transportation of hydrocarbons if the state directly owns the pipeline systems which will be constructed. This article also considers whether the Law will, in fact, attract foreign investment, as is one of the stated aims.

Introduction

This article presents an overview of Federal Law No. 115-FZ "On Concession Agreements" dated 21 July 2005 (the "**Law on Concessions**") with regard to its potential application to the energy sector and, in particular, to the pipeline transportation of hydrocarbons.

be decided based on various factors, such as the time needed for construction and/or re-construction of the object of the concession agreement,² the payback period, and amount. The term of the concession should be identified in the agreement itself.

The Law on Concessions does not include subsoil resources in the list of immovable property that may become the subject of a concession agreement. However, this list does include "objects of pipeline transportation".³ A broad interpretation of this term may include water pipelines, industrial product pipes, coal slurry pipelines and even pneumatic mail systems. This article concerns the potential application of the Law on Concessions to pipeline transportation of hydrocarbons.

It is unclear whether this law will actually impact the business of pipeline transportation of hydrocarbons (pipeline businesses). Some commentators believe that the implementation of concession agreements in the pipeline business is unlikely to become a reality,⁴ while others believe that such agreements may be possible in the future.⁵

The Nature of a Concession Agreement

Under a concession agreement the concessionaire undertakes, at its own expense, a project of construction or re-construction of immovable property owned by the grantor, while the grantor grants the concessionaire the rights of possession and use of that property for the time specified in the concession agreement.⁶

Russian academic legal theory establishes that in a classic concession agreement, the concessionaire must obtain property rights to every-

The Law on Concessions was adopted to attract investment to Russia, to ensure the efficient use of property owned by state or municipal bodies, and to improve the quality of goods and services provided to users.¹

The Law on Concessions includes rules for the preparation, conclusion, implementation and termination of concession agreements. It provides that the term of a concession agreement should

* These are the views of the author, not of White & Case.

¹ Article 1 of Federal Law No. 115-FZ of 21 July 2005 "On Agreements of Concession" // *Rossiiskaya Gazeta* No. 161 of July 26, 2005. This law came into force on 5 August 2005.

² Pursuant to Article 4 of the Concession Law, by objects of concession agreements, the Law means immovable property which is owned by the state.

³ See Article 4.1(3) of the Concession Law.

⁴ See *Subbotin M.* "Neither Yes Nor No: The New Law Gave the Right to Implement Concessions for Pipelines but Did Not Grant the Opportunity" // *Oil & Capital*, No. 9, pp. 22-24. (Russian)

⁵ See *Sosna S.* "On the Issues of Concession Agreements with Regard to Russian Oil & Gas Pipeline Transportation" // *Moscow Journal of International Law*, Special edition, May 2006, pp. 42-69. (Russian)

⁶ Article 3 of the Concession Law.

thing that is produced under a concession agreement, and then make agreed payments to the state in the form of taxes or other envisaged payments.⁷ Indeed, the ability of the concessionaire to obtain such property rights is one of the most important attributes of a classic concession agreement. Pursuant to Article 3.10 of the Law on Concessions, assets produced or acquired by the concessionaire in the course of fulfillment of the concession agreement and which are not the object of the concession agreement, are the property of the concessionaire unless the concession agreement stipulates otherwise. Therefore, concession agreements concluded pursuant to the Law on Concessions would appear to be consistent with the Russian legal theory on concessions.

The Law on Concessions is aimed at attracting private capital to the construction of infrastructure facilities, facilities that would then be exploited for a defined period of time by the investor to recoup his investment and then transferred to the state for future operation.

In this respect, the concession agreement defined in the Law on Concessions resembles the Public Private Partnership model that is used in Western Europe. Under Public Private Partnership schemes, a public authority buys the services of a private company or group of companies in a private consortium to design, build, finance and operate a public facility, such as a hospital or school. The private sector partner arranges financing for the scheme and the authority pays an annual fee to the consortium under a long term operating contract for the services. The Russian Law on Concessions differs from the Public Private Partnership model in that it allows the concessionaire to collect revenue created from the operation of the object from the public directly and then make separate payments to the state.

Statements made by certain government officials indicate that this law will be the framework for the development of Private Public Partnership schemes in Russia. The Government intends to use concession agreements to attract private investment for the construction of roads connecting major Russian cities. It has also been suggested that the new law will allow annual investment of 3 billion USD into the utilities sector, which is in need of substantial investment.

Nature of the Grantor

Article 5 of the Law on Concessions establishes that the parties to a concession agreement are the concessionaire and the grantor. The grantor shall be the Russian Federation, represented by the Government of the Russian Federation or the authorized federal executive body; a constituent part of the Russian Federation, represented by the executive body of the constituent part; or a municipality, represented by the local governing body.

Which state authority can act as the grantor depends on the ownership and nature of the object of the proposed concession agreement. In this respect, the Law on Concessions states that:

- ! the grantor of objects owned by the Russian Federation is the Government of the Russian Federation;
- ! the grantor of objects having strategic significance for state defense and security is the Government of the Russian Federation, acting under instructions of the President of the Russian Federation;
- ! the grantor of objects owned by a constituent part of the Russian Federation is the government authority of such constituent part; and
- ! the grantor of objects owned by a municipality is the local governing body for such municipality.⁸

The grantor has the right to exercise control over implementation of the concession agreement.⁹ As is clear from Article 22 of the Law on Concessions, the grantor is the formal/official owner of the object of the concession agreement. Consequently, the party monitoring the implementation of a particular concession agreement will be either the Government of the Russian Federation or the federal executive body authorized by it, the governmental authority of a constituent part of the Russian Federation, or a local governing body of a municipality.

Furthermore, to add clarity to the relationship between the state and the investor, the Law on Concessions states that the procedure for exercise of control by the grantor over compliance with the terms and conditions of the concession agreement by the concessionaire should be established in the concession agreement itself.¹⁰

⁷ Sosna S. "Concession Agreements: Theory and Practice" Moscow 2002. P. 39.

⁸ Article 22 of the Concession Law.

⁹ Article 9 of the Concession Law.

¹⁰ Article 9 part 4 of the Concession Law.

Implementation and Practical Effects of the Law on Concessions on the Energy Sector

Based on our analysis of the Law on Concessions, we believe that the Law will not impact oil & gas trunk pipelines that have already been constructed. The reference to pipelines in the Law on Concessions should be viewed as a reference to the construction and reconstruction of water and sewage systems, or, at the very best, to oil and gas pipelines yet to be constructed.

As mentioned above, the Law on Concessions provides that “objects of pipeline transportation” may be the subject of concession agreements. Russian law distinguishes “pipelines” in general from “trunk pipelines,” and it is unclear whether the Law on Concessions is intended to apply to trunk pipelines, other pipelines (connecting pipelines) or to both types. If the Law on Concessions applies not only to trunk pipelines but also to any other oil and gas pipeline, then the scope of its application may become very broad. Russian law does not currently contain a formal definition of a “trunk pipeline.”¹¹

Some researchers believe that concession agreements may be effectively used for inlet pipelines, which connect to trunk pipelines. Considering that the length of an inlet pipeline may be more than 3,000 kilometers, its construction may be regarded as a major investment project.¹²

At the same time, pursuant to the Law on Concessions, the potential subject of a concession agreement must be owned by the grantor which, as discussed above, can only be a state, regional or municipal authority.¹³

There are currently no trunk pipelines that are owned directly by the state; as such, the state will be unable to transfer such objects to the concessionaires. Given that, it is unlikely that Transneft’s oil trunk pipelines (owned directly by Transneft) or Gazprom’s gas trunk pipelines (owned directly by Gazprom) will be transferred to the state.¹⁴

Moreover, pipelines owned by Gazprom may not be transferred to any other party, as such a transfer would potentially violate the Federal Law “On Gas Supply in the Russian Federation” (the “**Gas Supply Law**”). Gazprom owns its system of pipelines (called the Unified Gas Supply System), and division of the Unified Gas Supply System is prohibited under the Gas Supply Law.¹⁵ In our view, then, the Law on Concessions cannot be applied to the existing pipeline network.

A substantial part of the Law on Concessions is dedicated to the procedure for holding tenders for the right to conclude a concession agreement. As such, the Law on Concessions describes the regulation of this process in great detail. Pursuant to the Law on Concessions, the tender commission will adopt a decision based on the result of a tender.¹⁶ The composition of the tender commission, the tender documentation (including the terms of the proposed concession agreement), and the procedure for concluding an agreement are all established by the grantor when the grantor makes the decision to hold a particular tender. The Law on Concessions contains provisions directed at ensuring an objective approach in the tender process. For example, article 23.3 provides that tender documentation must not contain requirements that would limit participation or create advantageous conditions for particular participants in the tender process. Nevertheless, in Russia tender processes are inevitably influenced by subjective factors.¹⁷

The Law on Concessions does not explicitly impose restrictions on the freedom of commercial activities of foreigners in the Russian Federation, as may be found in other laws.¹⁸

The Law on Concessions is a self-contained law, which does not make reference to other laws or regulations for the definition of objects having strategic significance for the defense and security of the state, or the nature of entities that would be restricted from participation in tenders for the right to conclude a concession agreement with respect to such objects. By analogy with other laws and given the current situation in Russia, it is possible that foreign companies and Russian companies that are majority owned or controlled by foreign entities will be restricted from participating in closed tenders for objects having strategic significance for the defense and security of the state. This may include transportation of hydrocarbons by pipelines if this sphere of economic activity is included in the Government’s list of industries considered to have strategic significance.¹⁹

¹¹ Historically, pipelines operated by the state-owned natural monopolists, such as Transneft, Transnefteprodukt, Gazprom, were treated as trunk pipelines.

¹² See Sosna S. “On the Issues of Concession Agreements with Regard to Russian Oil & Gas Pipeline Transportation” p. 45.

¹³ Article 3 part 2 of the Concession Law.

¹⁴ Majority stakes in both Transneft and Gazprom are owned by the state, but this does not make Transneft or Gazprom a state organization.

¹⁵ Article 14 of the Gas Supply Law.

¹⁶ Article 25 part 3 section 10 of the Concession Law.

¹⁷ For example, the conditions for participation in a tender may be set in a manner that limits potential participants only to certain companies.

¹⁸ See Article 4 section 2 of the Federal Law No. 41-FZ “On Precious Metals and Precious Stones,” dated 26 March 1998; Draft Law No. 187513-4 “On Subsoil,” submitted to the State Duma on 17 June 2005.

Advantages and Disadvantages of the New Law

The application of the Law on Concessions may have both advantages and disadvantages. Among its disadvantages one can name, *first*, the explicit prohibition by the Law on Concessions of any pledge of objects or rights under a concession agreement. Moreover, assignments and transfers of debt are permitted by the Law on Concessions, but only with the consent of the grantor and from the moment the object has been put into operation. These provisions impede the use of security instruments in the financing of concession agreements for pipeline construction.

Second, there is no provision for compensation of the concessionaire's expenditures or damages in the event that implementation of the construction project becomes impracticable or impossible due to termination of the agreement by the grantor. The absence of such a provision may impede enforcement of relevant provisions contained in the concession agreement itself.

Third, the Law on Concessions requires model agreements to be adopted before this law may actually be implemented. To date, the only model agreement to be adopted concerns road constructions. Since no model agreement has been adopted for the construction or re-construction of pipelines, no such agreements may be concluded at this point.

Finally, it has been suggested that the provisions relating to closed tenders are specifically aimed at restricting and limiting foreign participation in concession agreements for specific objects, including oil and gas pipelines.

Advantageous provisions of the Law on Concessions are as follows. *First*, termination of an agreement is possible only on the basis of a court decision.

Second, provisions on state guarantee of investors' interests allow investment risk to be minimized.

Third, Article 19 expressly states that concessionaires, including foreign companies, shall be guaranteed equal rights under the laws of the Russian Federation. Moreover, the Law on Concessions requires the grantor to change the terms of the concession agreement in the case of deterioration of the concessionaire's position due to changes in the legislation regulating tariffs used by the concessionaire to provide its services to customers.

Finally, the Law on Concessions does not limit methods for dispute resolution; hence, the concession agreements may contain any kind of arbitration clauses for dispute resolution.

Practice will prove whether the construction and re-construction of pipelines under concession agreements will be more or less advantageous than current arrangements.

Conclusion

Concession agreements may apply to pipeline transportation of hydrocarbons if the state directly owns the pipeline systems which will be constructed.

The Law on Concessions does not expressly prohibit foreign participation in concession agreements, though such participation may be limited in strategic industries. Overall, the Law on Concessions should help to attract foreign investment into the country, rather than restricting it. □

¹⁹ According to news reports, the list of industries of strategic significance, which is being developed by the RF President and Government, will include up to 39 industries. See "Economic Policy" // *Kommersant* (Russia), 2 March 2006; "The RF Government Postpones Consideration of Draft Law on Foreign Direct Investment in Charter Capitals of Commercial Entities Having Strategic Significance for National Security" // *RIAN* (Moscow), 7 March 2006.

²⁰ Article 3 part 6 of the Concession Law.

²¹ Article 5 part 2 of the Concession Law.

²² *Id.*

²³ Article 10 part 4 of the Concession Law.