

OIL

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COMMENT SECTION

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M. Subbotin

Russia is looking for Concession Legislation

This comment explains the concept of creating a concession legislation in Russia consisting of a draft 'framework' law 'on concessions and other agreements' and a draft law 'on production sharing agreements' which is the first law in a series of corresponding 'special' laws. These laws are based on the Civil Code of the RF and expand the principles of civil law to the relations between the State and the investor in managing state property, including natural resources, and types of business activities which comprise State monopoly. The authors explain the sphere of application of the draft laws, the interrelations between them and the place of both laws in enacting Russian legislation.

On 24 November 1994 the Council of the State Duma submitted for official distribution two draft laws prepared by two groups of experts of the Committee for Economic Policy: 'On Concession and other Agreements' (A. A. Konoplyanik, L. K. Lynnik, S. A. Sosna, M. A. Subbotin, Yu. M. Umashev) and 'On Production-sharing Agreements' (A. A. Konoplyanik, A. G. Averkin, I. Sh. Amirov, E. A. Dyachkova, V. A. Grushin, M. A. Subbotin, Yu. N. Shvenberger, S. G. Shlykov). The time for submitting them for consideration at the session of the State Duma in the first reading was determined as 24 February 1995. Thus, the first serious step towards creation of the legislative basis to overcome the investment crisis in the country has been taken. If the packages of laws are passed, investors will have grounded hope for a stable legal regime ensuring not temporary privileges but long-term guarantees for a return on the capital invested in the economy of Russia.

Today for pursuing a worthwhile investment policy in Russia it is vital to establish a reliable legal environment encouraging both foreign and domestic investors to invest production capital into the Russian economy.

The Law 'On Concession and Other Agreements'

The system existing in Russia relating to the legal regulation of capital investments primarily in the sphere of the subsoil use is based on the public law under which the relations between the host country and an investor are set by regulations and other administrative acts of the state. In this respect, the contract relations in this sphere essentially consolidate terms and conditions contained in their aforesaid acts.

The influx of investments into Russia could be facilitated by the application of chiefly private legal (or civil legal) regulations under which the host country and the investor act as equal parties in the relations based on the agreement between them. The legal base for the use of civil and legal methods of regulation, including in the investment sphere, was laid in the effective civil legislation and was further developed in part 1 of the Civil Code. However, civil legal relations between the state and a non-state (private) investor which have certain specific features require additional and more thorough regulation. The Law 'On Concession and other Agreements' is to resolve this particular task.

The Law 'On Concession Agreements' becomes a certain kind of concession code of Russia, by playing the role of a direct-application law in all spheres of the economy of Russia in which the contractual use of private investment is possible, and having a partial auxiliary (that is, 'in case of default of the law') nature for those branches of economy where the licence system of the use of the subsoil has been introduced by special legislation. Drafting the Law 'On Concession Agreements' as a universal Concession Code, its authors see as their additional task to avoid being confined to the raw material orientation of the effective Russian special legislation.

A number of laws and other normative legal acts which regulate various aspects of property relations, investment activities and taxation for the use of the subsoil have been adopted of late which establish the legal environment for the implementation of investment projects in the economy as a whole and, in particular, in its mineral raw material branches. However, the effective legislation has a great number of contradictions. It ensures neither the proper guarantees for an investor nor consequently the stable conditions for conducting entrepreneurial activities, and in the taxation part it is, more often than not, 'prohibitive' for investors. In this respect a non-state (private) investor turns out to be less protected from possible arbitrary rules of administration, whereas in the entire world, it is particularly private investors who provide the main source (up to 80 per cent) of investments. The increase in entrepreneurial risk leads to the reduction of investment offers and the outflow of capital from the country.

The Law 'On Production-sharing Agreements'

Today the most vital problem is to make certain adjustments to the investment mechanism in the mineral raw material branches of the Russian economy through the wider introduction of contractual relations

between an investor and the state. The reason for that is the high capital consumption of investment projects in these branches and, as a consequence, the higher 'price' of risk involved in the investments. Besides, additional – that is, geological – risks are typical of producing branches. At the same time, it is particularly producing branches, by virtue of the 'convertible' ('currency') nature of their products and the stable demand on them, that are most attractive for potential investors. If they are attracted, the raw material balance of the country could be improved and its currency proceeds would increase the production capacities including conversion capacities which would be loaded and would contribute to the maintaining of the employment level in Russia.

Production-sharing agreements, by ensuring a stable, long-term legal basis for entrepreneurial activities and because of their wide application in the world practice of exploration of mineral and raw material resources, could become the most popular kind of production agreements for the use of the subsoil in Russia (besides, they provide flexible accounting of specific features of mineral deposits which are significantly different); however, the legal basis for their application is poorly developed. The legal norms calculated specially for production-sharing agreements are not actually specified in effective Russian legislation; such agreements are subject to regulation by the entire block of investment laws. The higher investment risk requires 'excessive insurance' from the investor, that is, inclusion of the increased rate of return in the project for operations in Russia which would have been avoided if unambiguous norms stipulated by legislation and provision of the application of production-sharing agreements existed.

That is why all drafts of production-sharing agreements in the oil and gas sphere, the preparation of which took years and tens of millions of dollars, are still at the stage of negotiations or 'frozen' after all necessary negotiations have been conducted (see Table). That is the reason for the fact that the first special law, the basis of which is the civil legal principles of the regulation of relations between the state and the investor, is the draft Law 'On Production-sharing Agreements'.

The Place of the Laws in Effective Legislation

Both Laws operate in the sphere of civil legal relations, they develop and expand the principles stipulated in 'the economic constitution of the country', that is, the Civil Code of the Russian Federation (see Figure 1).

All legal Acts effective as of today set unified 'rules of the game' for domestic and foreign investors. The formula of the investment regime in Russia is the following: the Law 'On Investment Activities in Russia' stipulates that the regime of foreign investments is determined by the relevant special law; this special Law 'On Foreign Investments in the RSFSR' sets the national regime of investments (with certain exemptions) and thus transfers foreign investors into the legal regime on an equal basis with domestic investors; the same applies to unified legislative Acts in the framework of which the specificity of the

national regime for foreign investments may be determined.

These investment laws effective in Russia by no means overlap the 'niche' of concession relations, since neither of them regulate contractual relations with investors (with the exception of joint ventures, however, even then there is no room for state participation). Both Laws formulate the general principles and basic provisions of investment activities in Russia and in this sense they, together with the Civil Code, may be considered as the investment legislative basis for concession relations; however, they cannot substitute for the law on concessions proper. In addition, the Law 'On Foreign Investments in the RSFSR', Article 40, which has already been mentioned, envisages the adoption of the law 'On Concession Agreements'.

One of the major spheres of the Law 'On Concession and other Agreements' is the use of natural resources and the use of the subsoil in particular, since, in compliance with the Law 'On the Subsoil', the subsoil is state property. In this respect, in contrast to the general, that is, contractual, procedure for the transfer of all kinds (components) of the state property to the temporary use of investors proposed in the draft Law 'On Concession and other Agreements', the Law 'On the Subsoil' stipulates a different administrative procedure for the transfer of one of the basic components of state property, which is the subsoil, to temporary use of a non-state (private) investor.

The licence system should be confined to those spheres of economy (for example, the extraction of uranium) where the permissive procedure for concluding agreements was effective as well as strict regulation of investment activities stipulated in the licence. Possible termination of such an agreement by the State was effective, essentially without any real possibility provided for the investor to appeal against such termination (the principle 'the contract is part of the licence'). With such an attitude, in most cases the investor has no guarantees to recover his funds and, as a consequence, there is no investor, that is, the problem of the large-scale attraction of foreign and domestic financial means to the industry may not be resolved.

It is a common assumption that 'the licence is a concession of the epoch of legislation and state regulation'. Actually a concession and a licence, which have different legal natures, place a private user of nature in a different position before the state. In the modern epoch, which is characterised by the transfer of the most valuable national resources under state control, the use thereof by private persons was everywhere organised by law and the concession agreement acquired the role of a major legal instrument determining the relations of the use of nature. In a large number of countries relating chiefly to the system of general (Anglo-Saxon) law, such use is implemented on the basis of licence agreements.

The contractual system should dominate in the civil society; laws and normative documents set 'the rules of the game', contests and auctions and, in certain cases, the direct negotiations between the state body and the investor should be held in the approved procedure, the details should be agreed on by the parties in the course of negotiations, an agreement should be concluded and the licence should be automatically issued which should

Table: Production-sharing Agreements in Russian Oil and Gas Complex
(in the course of preparation at various stages and/or under negotiation)

Foreign companies (country) and their Russian counterparts in the project	Commencement date	Location of field/contract territory	Current stage of preparation of the project
Exxon (USA)/ Sodeco (Japan)/ Rosneft/ Sakhalinmor- neftegaz	1976	Chaivo, Odontu and Arkuntun-Daginskoe fields, Sakhalin island shelf, (Sakhalin - I project)	Preparation of the PSA terms and conditions, negotiations in PSA underway
Marathon/McDermott (both - USA) Mitsui/Mitsubishi (both - Japan)/Shell (UK - Netherlands) = Sakhalin Energy Development Company (formerly - MMMMS Consortium)	1988	Piltun-Astokhskiye and Lunskoe fields, Sakhalin island shelf (Sakhalin - II project)	PSA signed to be enforced after adoption of the PSA Law
Texaco/Exxon/ Amoco (all - USA)/Norsk Hydro (Norway) = Timan-Pechora Development Company/Arkhang- elskgeologia	1990	Arkhangelsk oblast, Nenetsky AO Timan-Pechora oil and gas province, Varandeiskoe, Trebs, Titov fields and others	Final negotiation on PSA between investors and Governmental Commission
Elfneftegas (France)/Inherneft	1990	Volgograd oblast, land plot 65 thous.sq.km on the south-west cheek of Prikaspiskaya cavity	Awaiting adoption of PSA Law
OMV (Austria)Takt	1991	Republic of Sakha- Yakutia, land plots in Kempendyiskaya cavity (14 thous. sq. km.) and Nevsko- Botuobynskaya Anticlisa (7 thous. sq. km.)	Postponed
Total (France)/Rosneft	1991	Khariaginskoe field, Arkhangelsk oblast, Timan- Pechora oil and gas province	Awaiting the adoption of PSA Law
Amoco (USA)/Yuganskneftegas /Yugraneft	1992	Priobskoe field Khanty-Manseysk AO	Expert analysis of feasibility study
Shell (UK - Netherlands)/ Evikhon	1992	Zapando- Salymyskoe, Verkhne- Salymyskoye and Vadelupskoye fields, Khanty-Manseysk AO	Preparation of FS and PSA
Urals-ARA (Netherlands)	1992	Khulturskoe and Slavinskoe fields, Khanty-Manseysk AO	Preparation of FS and PSA
Mobil/Texaco (USA)	1993	Kirinski block of Sakhalin island shelf (Sakhalin - III project)	Preparation of FS and PSA
Exxon (USA)	1993	Vostochno- Odoptinski and Ayashski blocks of Sakhalin island shelf (Sakhalin - III project)	Preparation of FS and PSA

have the registration nature (the principle 'licence is part of the agreement'). In this case the parties should be equal before the Civil Court, which is the essence of the submitted draft Laws 'On Concession and other Agreements' and 'On Production-sharing Agreements'.

Interrelations between the Two Laws

Common features

An agreement (contract) is concluded between the state and the investor; the laws are applicable in respect to Russian and foreign investors; the non-discriminatory nature of relations with investors is ensured; and the 'two keys' principle (the Russian Federation and its subject) in respect to the object of the subsoil use is effective. The special feature of taxation which includes granting required guarantees for a stable taxation regime for the entire period of operation of the agreement, the contractual nature of relations with the investor, possible waiver of the state of immunity, are effective, the investor is allowed to assign the rights, and the possibility of pledge is provided and so on. It is common knowledge that relevant amendments and alterations to effective legislation are required in both cases (for example, introduction of an Article stipulating the reference to the special procedure for the calculation of taxes for concluding concession agreements and production-sharing agreements to the Taxation Code being drafted at present).

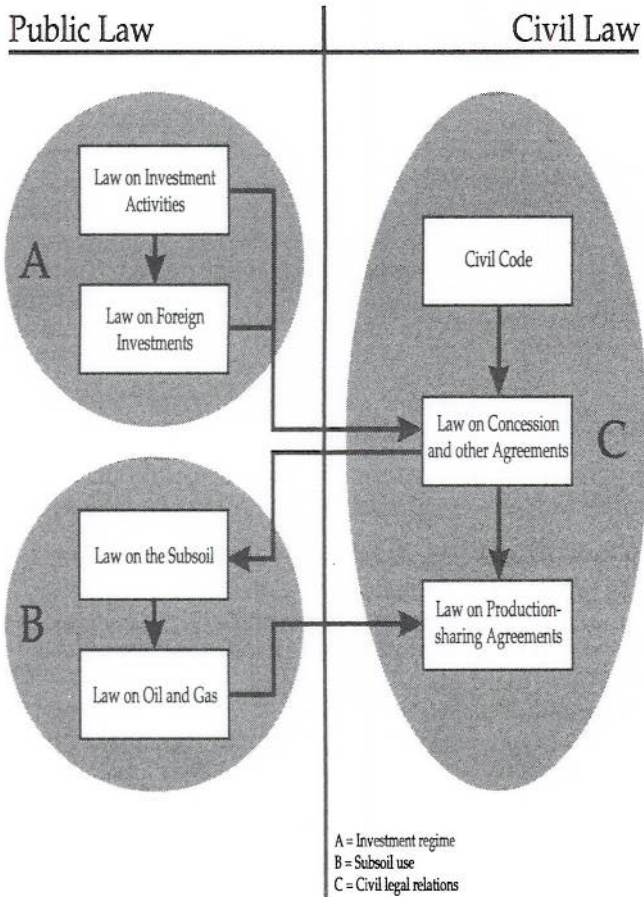


Figure 1: Proposed Subordination of the Group of Laws Regulating the Issues of Investment Activities in the Mineral Raw Materials Branch Industries

The legal structure submitted by the experts of the Committee for Economic Policy of the State Duma is essentially 'an umbrella-type structure', which consists of 'framework' Law 'On Concession and other Agreements' and a number of 'special' laws, the first of which is the Law 'On Production-sharing Agreements'. The 'framework law' covers all principal issues related to the transfer of the right to use objects of state property (both tangible objects and natural resources) to the non-state (private) investor, and the kinds of activities on which the state has imposed its monopoly. The system of contractual relations in the use of the subsoil included three basic kinds of production agreements between the host country and the investor: concessions proper (or the 'tax plus royalty' agreements), service contracts (risk and without risk) and production-sharing agreements ('PSA'). The latter is a subject of the relevant special draft Law 'On Production-sharing Agreements' (see Figure 2).

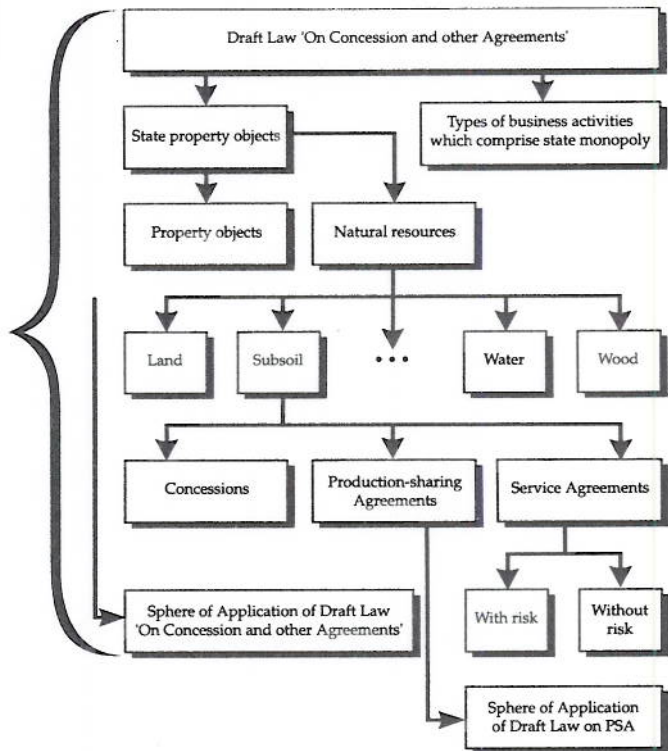


Figure 2: Subordination of the Spheres of Application of the Draft Laws 'On Concession and other Agreements' and 'On Production-sharing Agreements' (Expert Group of the State Duma Committee on Economic Policy Version)

Different features

The Laws differ by their nature of effect: 'On Concession and other Agreements' is a framework law which stipulates the rights and obligations of an investor who

signed with the state a contract for a long-term use of the object owned by the state or who carries out the kinds of activities which are under the state monopoly (what is allowed and what is prohibited) and state guarantees; whereas the Law 'On Production-sharing Agreements' is a law which is clearly oriented towards the use of the subsoil and contains the mechanism for implementation of the agreement (obtain the right for development of a deposit, find mineral raw materials, forthwith pay the state a certain percentage of production, recover all expenses from the extracted production, receive profits, share 'profit' the production with the state, pay profit tax). All the details are contained in the agreements. As far as the scope of the Law is concerned, the concession agreements, as was mentioned earlier, apply chiefly to the processing industry, transport services and so on. As a consequence, special attention is paid to the lists of concession objects, the procedure for their compiling and revision, the procedure for profits coming to the State Treasury: directly on conclusion of the agreement (in the case of use, including leasing) or after receiving profit production (in case of production-sharing agreements).

Who will Support the Laws?

Formulating the Law 'On Concessions' as the universal concession code, the authors saw their task to overcome the one-sided raw material orientation of the effective Russian special legislation and accordingly to eliminate the common misconception that Russia's non-renewable natural resources are almost the sole large-scale source of private investments in the Russian economy. The Law can contribute to the liberation of a large creative potential: the object of concessions may be, in particular, state enterprises subject to economic improvement programmes, modernisation and demonopolisation and so on. Concessionary private capital may be, in various conditions, attracted even to the branches of the military-industrial complex. The conclusion of a great number of various contracts with foreign investors in order to obtain technologies, to share production, to provide for 'turn-key' construction of objects as well as service and other contracts is possible.

The Laws 'On Concession and other Agreements' and 'On Production-sharing Agreements' contain a number of legal mechanisms which allow the relations between the investor and the state to have civil legal contractual nature and thus ensure real equality of the parties to the agreement. At the same time, the Laws do not affect the functioning of the state. On the one hand, it is a partner of a foreign investor and, on the other hand, it has control over his activities.

Finally, what is especially important in today's social and political situation is that the submitted draft laws solve the problem of reconciliation of interests of the Russian Federation and its subjects as well as the co-ordination of legislation of the Federation and its subjects in the sphere of concession agreements.

One can see an extremely rare case when the real possibility of easily passing the submitted draft laws is actually possible. Parties and factions in the Parliament with completely different political beliefs, that is,

advocates of the interest of Russian entrepreneurs and supporters of large-scale attraction of foreign capital in the country, supporters of radical reforms and guaranteed employment (for minimisation of unemployment), representatives of the military-industrial complex and the fuel and energy complex are objectively interested in the earliest appearance of this group of laws and as a consequence, the implementation of large investment projects ensuring employment and salaries for many sectors of the population.

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The Indian Energy Sector and State Guarantees

This comment gives a brief overview of the circumstances extant in the Indian energy sector that necessitate guaranteeing payments under the power purchase agreements to foreign entrepreneurs and outlines the features usually found in sovereign guarantees. The comment also touches on some alternatives to guarantees.

Background

It is estimated and widely accepted that there will be an annual growth in demand in India for power of 7,000 to 8,000 MW. So far, nearly the entire installed capacity is provided by the public sector. If the demand is to be met, it is necessary to privatise Indian power. This has now been done. The total financial investment estimated is of the order of US \$100 billion over the course of the next eight years. The government has assured the investors a post-tax return of a minimum of 16 per cent in dollar terms on a plant load factor (PLF) of less than 70 per cent and higher if the PLF increases. (see Appendix). The Government of India (GOI) has promised counter-guarantees to the first eight 'fast track' projects. Of the eight 'fast track' projects, guarantees for the Dabhol and Ib Valley projects are now in place. The Dabhol guarantees were signed first amidst much fanfare in September 1994 and the financial closing took place in March 1995.

Why Sovereign Guarantees?

The private power companies will initially supply power into the main grids of the State Electricity Boards (SEBs) in each state. These boards do not have a track-record of meeting their financial obligations on time