

# Economic Ground of Mechanism Experience for Implementation of Investment Projects within the Framework of Concession Agreements in the Development of the Mineral Industry of Russia

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## Abstract

The article deals with increase in the investment appeal of the economic systems specialized in mineral resource by means of forming a modern innovation infrastructure through the implementation of socially significant investment projects in the format of concession agreements. It justifies that the committed partnership mechanism existing in Western countries in the relations between the state and business entities within the concession agreements, reflecting the economic aspects of the liberal concept of development and provisions of the stakeholder theory and based on the principles of public-private partnerships, is recognized as an effective economic mechanism for implementation of investment projects relating to the efficient use of infrastructure. It is stressed that in Western countries, such a mechanism is formed in the presence of an appropriate institutional environment and legal framework which ensures the functioning of the partnership relations. The article reveals organizational and legal nature of the concession mechanism: the main principles of organization and basic schemes for investment project implementation under concession agreements are described. It is argued that it is possible to use the represented mechanism in the Russian conditions to create and reconstruct the infrastructure facilities necessary for the development of the specialization sectors of economic systems and the mining industry enterprises, which form the basis of industrial agglomerations. In order to employ the world experience in implementing similar projects in the Russian environment, the analysis of the organizational and legal nature has been carried out and the possible concession scheme for project implementation in accordance with applicable law have been described.

**Keywords:** Concession Agreement, Concession Object, Concession Scheme, Investment Appeal, Investment Project

## 1. Introduction

Innovation scenario of sustainable socio-economic development in the long run is characterized by enhanced investment focus of the economic growth of territorial systems and strengthening of Russia's position in the global economy. According to the Long-Term Forecast for the Socioeconomic Development of the Russian Federation up to 2030<sup>1</sup>, a mission of financial and economic support to the country's initial transition to the innovative development path is imposed on the Russian economic

systems of the mineral resource specialization; effective application of this mission depends on the sustainability, increase in social and environmental parameters of industrial production operations<sup>2</sup>. One of the lines of sustainable development for the economic systems of the mineral resource specialization and increase in their investment appeal is consolidation of the existing production units in the economic structure with common infrastructure and the appropriate alignment of interests between government agencies, the business community and public organizations. The global experience proves

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that concession mechanism, enabling to concentrate and use the funds of the concession process participants for the purposes of innovative development of economic structures is an effective economic mechanism increasing investment appeal of economic systems through the implementation of socially significant federal and regional projects on the principles of Public-Private Partnership (PPP).

Formation of the organizational-economic mechanism of PPP under concession agreements when implementing socially significant projects in many countries (USA, UK, France, Germany, Canada, Argentina, Brazil, New Zealand, etc.) occurs in the presence of the appropriate institutional environment, as well as legislative framework, which ensures the functioning of the partnership relations. Moreover, the organizational and legal nature of the concession mechanism: the legal framework, the principles of organization; the basic schemes for investment project implementation, despite the universal character of the application, has its own specific features in each definite country, which is emphasized in the scientific papers of scientists from different countries: Jeffery Delmon<sup>3</sup>, Neil Kinnock<sup>4</sup>, Michael Geddes<sup>5</sup> (Great Britain); *Frédéric Marty*, Sylvie Trosa and Arnaud Voisin<sup>6</sup> (France); Heinz Werner<sup>7</sup>, Michael Bürsch and Klaus Funken<sup>8</sup> (Germany); Edward R. Yescombe<sup>9</sup>, Albert N. Link<sup>10</sup>, Stephen H. Linder<sup>11</sup> (USA), Vela F. Medall<sup>12</sup>, Cañeque F. Casado<sup>13</sup>, Alessandro Reginato<sup>14</sup> (Spain); Elisabetta Iossa and Antellini Russo Federico<sup>15</sup>, Roberto Gallia<sup>16</sup> (Italy); José Luis Coraggio<sup>17</sup>, Marcelo Romero<sup>18</sup> (Argentina); Heather Fussell and Charley Beresford<sup>19</sup>, Allison Padova<sup>20</sup> (Canada), Robert Lonergan<sup>21</sup>, Dieter Katz<sup>22</sup> (New Zealand) and others.

The organizational-economic mechanism for implementation of investment projects under concession agreements in the Russian Federation is formed under the influence of European and American approaches and carried out with regard to the peculiarities of the institutional environment, national legislation, industrial production units, forming the basis of economic systems.

## 2. Problem Statement

Despite the impact of foreign approaches, the Russian Federation has its own potential for the formation and development of the concession mechanism

Historically, the idea of the concession mechanism was formed by the end of the 19<sup>th</sup> century as of a progressive

instrument of economic activity enabling to concentrate huge financial and material resources in terms of the agrarian country, which Russia was at that time, and to give a powerful impetus to the growth of the entire economy, including the development of iron and steel, coal mining and oil industries. Initially, the concession (as a form of PPP) was considered as a right conferred (granted) to an individual to carry out any kind of activity that the state deemed its prerogative, including activities related to the use of state property<sup>23</sup>.

Taking into consideration the results of concession activities in Russia in the late 19<sup>th</sup> and early 20<sup>th</sup> century in a number of material- and energy-intensive industries, the government gave preference to the concession form when implementing New Economic Policy (NEP) to revive the market forces of the economy. As a result, in the legislative and doctrinal respects and from a practical point of view the efficiency of concession policy was so great that a special plan was developed to achieve a balanced development of the various sectors of the economy with its help and to create an economic model for the country development.

Since the late 1920s concession activity in the country started gradually being scaled down because it could not fit into the planned economy both due to the external factors and for ideological reasons.

And only the economic situation in the country in the 90s forced the government to recollect the concessions as an effective tool for stabilizing the economy and attracting investments in the real sector (based on the example of concessions of the NEP period). Legislative acts developed in the early 2000s were intended to give a qualitatively new level to the development of the concession relationship between the state and private business. In connection with the search for new forms of public property management, adequate for the modern stage of social development, attention of scientists to the issue of concession mechanism implementation in the practice of business has increased<sup>24-26</sup>.

A significant contribution to the formation and development of the concession mechanism in Russia at this stage in the legislative and in practical terms was made by A.B. Karass<sup>27</sup>, B.A. Landau<sup>28</sup>, M. Reikhel<sup>29</sup>, I.N. Bernstein<sup>30</sup>, V.N. Schreter<sup>31</sup>, E.N. Nosov<sup>32</sup>, V.G. Varnavsky<sup>33</sup>, S.A. Sosna<sup>34</sup>, M.A. Subbotin<sup>35</sup>, A.A. Konoplyanik<sup>36</sup>, N.G. Doronina<sup>37</sup>, L.K. Linnik<sup>38</sup>, Yu. M. Yumashev<sup>39</sup> and others. The results of the scientists' investigations initiated the revival of the lost private

business forms and methods of economic management when using and operating public property, and creation of a full-fledged concession legislation in Russia.

In Russia, the country with a high level of the economy governmentalization in conditions of acute shortage of investment resources, the establishment of concession legislation and its further development aimed at creating an appropriate institutional environment promoting the operation of the concession companies is essential for the formation of concession mechanism for the effective management of public property in the different sectors of the economy under the state control. Using the presented mechanism at the industry level can be realized in the construction of facilities of the industrial and social infrastructure that is necessary to improve the investment appeal of the integrated structures of the mineral resource specialization.

### 3. Methodology

The existing in Western countries mechanism of partnership between the state and private business in the form of concession agreements reflects a new level of the government regulation of the economy, based on:

- the postulates of the liberal theory of economic development;<sup>40-56</sup>

- the provisions of the stakeholder concept;<sup>57-60</sup>

- the principles of the public-private partnership.<sup>3,5-19,21,22</sup>

According to the neo-liberal concepts of economic development, new institutional structure of the economy is formed in many countries by the introduction of concession mechanisms either into the existing institutions in the context of the declared new economic policy of the government regulation (United Kingdom, New Zealand, Argentina and other Latin American countries), or as part of additions to the existing system of the government regulation (the developed countries of Europe and America: USA, Canada, Japan, the EU countries, etc.)<sup>33</sup>.

Implementation of concession mechanisms in the above countries is supported by an appropriate legal basis regulating the relationship of the parties to the concession process and acting either within the limits of special rules of public law (France, Italy, Spain, Germany, Austria, Switzerland and other countries belonging to the continental legal family) or under common law (Great Britain, Northern Ireland, USA, Canada, Australia and

other countries of Anglo-Saxon and Anglo-American legal family type), providing legal protection of property and property rights of the state and municipalities<sup>33,61</sup>. Despite differences in the legal approaches, the general principles of the organizational-legal nature of the concession mechanism are as follows<sup>33</sup>: contractual basis of a partnership with the long-term nature of the interaction; realization of public interests; common interests of the participants in the partnership and the freedom of choice of action; implementation of partner relations in a competitive environment; recovery of concession facility; specific forms of liability distribution between the partners in performance of the agreement; the transparency of concession activities and provision of information disclosure to the public.

The regulation of the main provisions of the organizational-legal nature, the disclosure of the provided provisions and principles occur as a result of the development of a specific organizational scheme, implemented on the basis of the national legal model formed. Organizational chart (model) is a comprehensive mechanism of cooperation of the public authority (state or local government) with a private investor in the public interest to delineate responsibilities and projected costs and revenues during the joint implementation of project on creation (reconstruction), operation of infrastructure facilities, as well as in provision of public services, traditionally administered by the public authority.

### 4. Discussion

In global practice different types of PPP organizational charts carried out under the concession agreements are known. They are differentiated depending on the amount of property rights transmitted to the private partner, investment obligations of the parts and the principles of the division of responsibility between the parts for carrying out various types of work (including construction, operation, management, etc.)<sup>33,3,61,34</sup>. The most complete classification reflected both common features of concession charts (within the group) and their significant differences and peculiarities manifested in the economic nature and essence of the prevailing relations, as well as specific provisions of the contract (subject, part of emerging relations, scope and limits of responsibility sides) are shown in Table 1.

**Table 1.** Organizational Schemes of Projects Realization under Concession Agreements

Concession scheme	Characteristics
<i>1. Concessions providing infrastructure construction “from scratch” (Greenfield Projects).</i>	
Schemes, in which the private sector carries out construction and operation of a new infrastructure object during the period of agreement, upon the expiry of which the object can be returned to the state. The government usually provides guarantee to a private company of the minimum income through the purchase of infrastructure services for a longer period or the minimum payment traffic.	
- <i>Build, Own, and Operate - BOO Scheme</i>	Scheme, in which the private investor is carrying out a building of the object at its own risk. The state, which gave the necessary rights and land allocation to the private investor, determines operating conditions in virtue of completed contract – regulates the access to the object, price, agrees development plans.
- <i>Scheme “Build, Own, Operate, and Transfer – BOOT”</i>	Scheme, in which the private investor is carrying out building, ownership and operation of a new infrastructure object to meet the requirements of agreement, completed with the state customer; ownership for the facility is transferred to the latter after this agreement is terminated.
- <i>Scheme “Build, Operate, and Transfer – BOT”</i>	Scheme, in which the private investor is carrying out building and operation of a new infrastructure object taking risks, then sends it to the state at the end of the term of the agreement. A private investor may have the right to ownership of the objects created during the contract period.
- <i>Scheme “Build, Lease, and Transfer – BLT”</i>	Scheme, in which the private investor is carrying out building of a new infrastructure object betraying the finished object to the ownership of the state, then leases and operates it assuming all the risks before the end of the lease term taking risks.
- <i>Scheme “Build, Transfer, and Operate – BTO”</i>	Scheme, in which the private investor is carrying out building and operation of a new infrastructure object taking risks; while the object is received by the grantor in the property upon completion of the construction phase.
<i>2. Concessions providing restoration of infrastructure object (“concessions for expansion”).</i>	
Schemes, in which the private sector carries out restoration (reconstruction) of infrastructure facility taking over himself the management of state-owned property (infrastructure object) and the significant investment risks for a certain period.	
- <i>Scheme “Rehabilitate, Operate, and Transfer – ROT”</i>	Scheme, in which a private investor restores (reconstructs) an existing object, operates it for a specified term of the contract taking risks involved, then returns it to the state.
- <i>Scheme “Rehabilitate, Lease or Rent, and Transfer – RLT”</i>	Scheme, in which a private investor restores (reconstructs) an existing object, then rents or borrows it from the state’s ownership to leasing for a specified term of the contract, taking all the risks, then returns it to the state.
- <i>Scheme “Build, Rehabilitate, Operate, and Transfer – BROT”</i>	Scheme, in which a private investor provides a new construction (reconstruction) of infrastructure facility, and then operates it for a term specified by the contract, taking all the risks involved, then returns it to the state.
<i>3. Concessions providing infrastructure object engineering.</i>	
Schemes, in which the private sector is engaged in the engineering, construction, operation and financing of infrastructure facility without necessarily returning it to the state.	
- <i>Scheme “Design, and Build – DB”</i>	Scheme of the project realization of in which a private investor (in the form of a company, consortium, joint venture or other organizations gathered for a specific project) undertakes executing a contract for a fixed amount for both services: engineering and construction.

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- Scheme “Design, and Build, and Operate/Maintain – DBO/DBM” Comprehensive partnership scheme that combines contractual obligations of the private partner in the model DB – engineering and construction with operation/maintenance. The liability of Public funding of the project is imposed on the private sector provided by a unified contract.
  - Scheme “Design, Bid, and Build – DBB” Scheme of the project realization where the public sector concludes separate contracts for the engineering, construction and operation of infrastructure objects with contractors with full public financing of the project and applying all kinds of risks related to its implementation by the state.
  - Scheme “Design, Build, Finance and Operate – DBFO” Scheme, in which the private partner designs infrastructure facilities in accordance with the requirements of government agencies, funded its construction, operates income-generating infrastructure in exchange for the right to collect income over the term of the contract. At the end of the latter assets may be returned to the state, if it covers the terms of the contract.
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#### 4. Contracts for management and provision of services.

*Concession scheme, in which a private company takes over the management of public infrastructure facility for a fixed period of time; besides that, the right and obligation to finance the property remain with the state.*

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- “Management Contract – MC” In this model the government defrays costs to a private company for managing infrastructure facilities; the state is attributable for operational risks.
  - “Operation and Management Contract – OMC” Agreement between the government and a private company whereby the responsibility for the management and operation of the infrastructure facility is transferred to the private sector. Remuneration to the private sector are paid on a fixed or differentiated basis, taking into account premiums related to the achievement of specific targets.
  - “Service Contract – SC” Agreement between the government and a private company about transferring public assets (infrastructure) of a private company in short-term operation. Management, control and investment commitments remain at the state retaining the financial risks.
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The analysis of the presented organizational charts allows concluding that in terms of the ownership regime concession schemes are allocated for the operated object, which includes physical property complexes (BOO, BOT, BOOT, ROT schemes, etc.) and schemes, the object of which is the implementation of certain activities: management contracts, operation and management contract, service contracts.

The first group includes concession schemes providing infrastructure construction “from scratch” (Greenfield Projects), the restoration of the infrastructure facility (“concessions for the expansion”) and concessions schemes associated with designing infrastructure.

In addition to the above-mentioned mechanisms involving different ratios of the powers and obligations of both sides of the partnership, there are several types of typical specialized concession-type contracts (Management Contract, Operation and Management Contract, Service Contract), the peculiarity of which

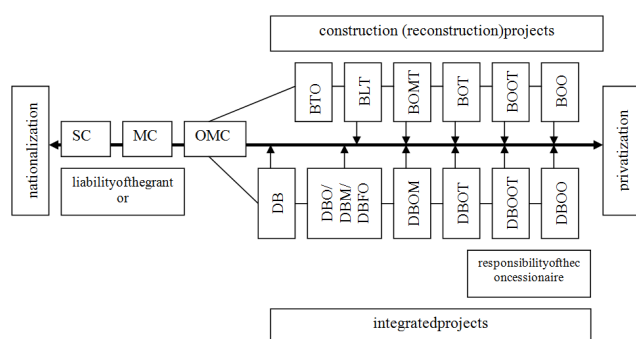
is an assignation of full or partial responsibility to the private partner for the provision of maintenance and infrastructure services.

The analysis of foreign practice of concession mechanism implementation of organizational schemes suggests that at their formation there is no significant invasion in property relations; created as a result of partnership the infrastructure projects do not become either privatized or nationalized, in most cases they remain the property of the state. As a part of the established partnership there are significant institutional changes allowing realization of the private initiative potential that enables greater participation of the private sector in the implementation of the organizational, economic, administrative and other functions, retaining a certain degree of economic activity with the state.

From the following schemes the increasing (or decreasing) extent of the possible participation of the private enterprise in joint with the state projects depending



on the chosen organizational scheme and the extent of the transfer of property rights to private business can be seen (Figure 1). Extreme types are simple contractual relationships (contracts for works and services) with full saving property powers of each partner, on the one hand, and complete privatization, i.e. the transfer of ownership from the state to the private entrepreneur, on the other. Between the outermost schemes many possible forms of public-private relations based on varying degrees of transfer of any particular proprietary powers from the state to the private entrepreneur on the terms and conditions stipulated by the relevant partnership agreement are arranged.



**Figure 1.** Basic organizational schemes of interaction between the government and the private sector in the framework of concession agreements.

Concession schemes and their adaptations to their unique features discussed above are widely used in the countries of America and the European Union. Such a variety of concession schemes and their subtypes provides the necessary flexibility in accordance with the expectations of the state, with broad coverage of the actual conditions of implementation of investment projects of federal and regional significance.

The Russian economy and society are institutionally poorly prepared for the use of concession mechanisms: there is a lack of concept and strategy for transition to the concession mechanism of management, instruments of state regulation of concession companies are unclear, there is a lack of comprehensive research of concession mechanism as a whole and in separate industries in particular. Specificity of modern and largely pre-stage character of the state property reform through the introduction of concession relations in Russia lies in the fact that, along with the creation of the legislative

framework the real mechanism exercise in certain sectors is taking place<sup>34</sup>.

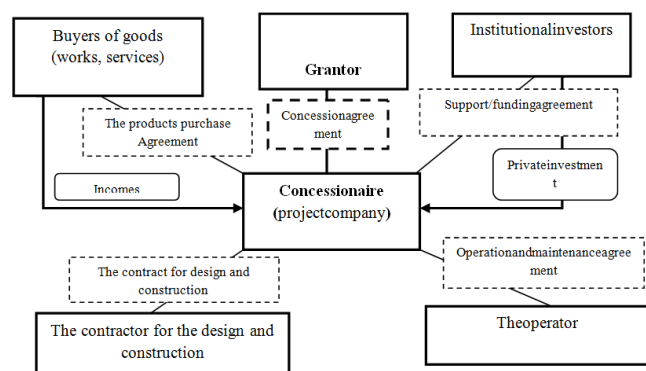
The formation of the legislative base of concession relations in Russia exists under the influence of European and American concession mechanism. In the modern Russian law there are no concepts of public law and private law property of the state and municipalities common to most of the advanced Western countries. Therefore, provided by the Russian legal system a statutory model of concession agreement is most closely approximate to the model of a civil contract, in contrast to the advanced Western countries. It has a dual legal nature: in addition to the provisions of private law it contains a number of publicly-legal elements beyond civil law. All the basic features of the legal and administrative model used in the legislation of the European countries are inherent to concession agreement, but the model is characterized by minimizing the public prerogatives of the grantor, granting him only the administrative and supervisory powers<sup>24</sup>.

According to the Russian legislation only the BTO (RTO) and DBO schemes from all of the above basic schemes (SBI BOT, BOOT) fully comply with the concepts and requirements of federal law and can be applied in the framework of the law. The main difference of this abovementioned schemes from each other is the fact and the transition time of the object of concession agreement to the property of the grantor. According to the Federal Law the object is owned by the grantor at the time of conclusion of the contract, if the content of agreement implies its modernization and maintenance, and it becomes the property of the grantor after maintaining, if the content of the agreement implies the new construction and operation (RF FZ-38 revised as of 25.04.2012)<sup>61</sup>. The first scheme (BTO) means that the subject of concession agreement is the construction of a new facility, its maintaining and subsequent maintaining for a certain period (sufficient for return on investment); used for the implementation of large investment projects (construction of bridges, roads, tunnels, etc.). The second scenario of concession (RTO scheme) foreseeing the improvement (expansion, reconstruction, conversion) of an existing and functioning object is more often used in the energy, utilities and social services.

The use of introduced concession schemes in sectoral layer is possible through the development of

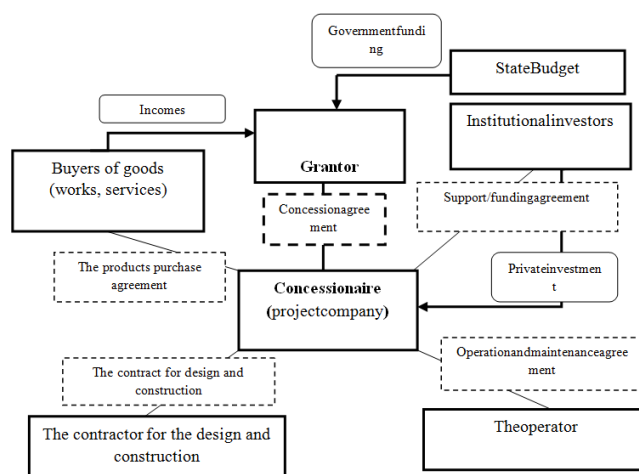
a typical concession agreement (pro forma), which allows developing and implementing investments projects in the engineering, construction, maintaining of infrastructure. In particular, in order to develop and reconstruct the infrastructure required for the development of the specialization branches of economic systems and the mining industry enterprises forming the basis of industrial agglomerations a DBFO scheme can be suggested (Design, Build, Finance and Operate).

DBFO scheme is the most complex model, which includes the need for a private part to provide both construction and operational efficiency, it makes possible to stimulate the private sector to develop an integrated solution for the management of infrastructure project based on the optimization of costs at all stages of the project (including operation and maintenance). The possibility of private funding will depend on the terms of concession agreement in relation to schemes acquisition of income, the use of an infrastructure facility, as well on the risk level of demand. If the demand risks are fully borne by the private sector, so the volume of refinancing for the project will be limited by the value of the estimated revenues from the operation of the infrastructure facility, without additional revenues of public funds. In order to refine the proposed schemes an expected revenue from the operation of infrastructure facility should be provided, i.e. reliable and sufficient to cover all costs of the action (including contingency reserves)<sup>61</sup> (Figure 2).



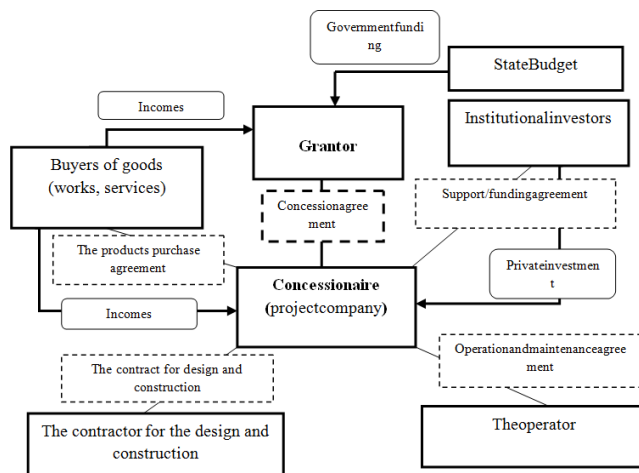
**Figure 2.** Design, Construction, Financing and Operation (DBFO) Scheme; (the concessionaire bears most of the risks).

If the demand risks are borne by the state, so the volume of private financing will depend on the amount of public funds allocated to the project (for example, a combination of subsidies for the construction and compensation payments) (Figure 3).



**Figure 3.** Design, Construction, Financing and Operation (DBFO) Scheme; (the grantor bears most of the risks).

In that case, if the public and private sectors bear the risks of demand together, so the refinancing of the project is provided by income from the operation of the infrastructure facility and compensation payments (Figure 4).



**Figure 4.** Design, Construction, Financing and Operation (DBFO) Scheme; (for joint settlement risk during operation of infrastructure projects).

Since DBFO is an integrated model, in the base of which there is either the BTO scheme involving the transfer of ownership to the state after the end of the maintaining term of the subject or the RTO scheme, providing reconstruction of infrastructure object, so the present model can be implemented in a variety of scenarios. In order to create the infrastructure necessary

for the development of agglomerations of mineral resources and specialization of the Eastern Zone of the European area (northern regions), the DBFO model (with a basis of BTO) can be used. The application of this scheme in the main resource bases (East, North and North-East of the country) is due to the need of a large amount of infrastructure works in the preparation of the IIP for the use in underdeveloped and remote areas complicated by the influence of climatic factors. Capital coefficient, labor intensity and materials-output ratio of the mining industry due to the constant job shifts in the process of excavation of mineral resources predetermine the high cost of designing and building infrastructure facilities ensuring the process of extraction and processing of minerals. In order to improve investment attractiveness of industrial agglomerations of the Western area (except for the regions of the Northern Region), for which the self-development is largely determined by the intensive production factors owing to increase in labor productivity at a relative reduction in the consumption of fuel and energy resources, the DBFO model (with a basis of the RTO) can be offered to provide the reconstruction of infrastructure of industrial and social facilities.

At present, within the first direction (with a basis of the BTO) federal projects for the construction of infrastructure facilities to develop the mineral resource potential of Siberia and the Far East are implemented. The largest among them are the following ones: Creating Transport Infrastructure for the Development of Mineral Resources of the South-east of the Chita Region Project (investment costs are RUB 169107.18 million); Integrated Development of the Lower Angara Region Project (RUB 213.915 million); Construction of the Kyzyl-Kuragino Railway Line in Connection with the Development of Mineral Resources Base of the Republic of Tyva Project (RUB 131.6221 million). Implementation of the submitted projects contributes to the creation of industrial agglomerations – integrated structures based on large polymetallic deposits, advancing the represented territories to the major industrial regions of Russia, the flow of financial resources in the budgets of different levels. The second direction (based on the RTO) in a greater extent determines the implementation of regional projects to build infrastructure capacity areas of the European North to address the problems of ecology, energy efficiency, security of transport, engineering and social infrastructure sites for the complex development of affordable housing, information and improving the

quality of the state and municipal management and the social development<sup>62</sup>.

## 5. Conclusion

Thus, the analysis of the global experience in implementing socially significant investment projects under concession agreements and its usage in the innovative development of the economic systems of the mineral resource specialization of Russia allows us to conclude the following:

- the concession providing the necessary volume, concentration and effective use of financial resources of participants' concession process stands as an effective economic mechanism for increasing investment appeal of economic systems through the implementation of socially significant federal and regional projects based on PPPs;
- the formation of the organizational and economic mechanism of investment projects realization under concession agreements in the Russian Federation is under the influence of European and American approaches and is carried out with regard to the characteristics of the institutional environment, the relevant market approaches of state regulation of the economy; the state legislation providing the concession relations and industrial production which form the basis of economic systems;
- the disclosure of the organizational and economic mechanism for realization of investment projects in the form of concession agreements implemented through concession schemes, taking into account the economic nature, the essence of established relations, specific provisions of an agreement (the subject, structure of emerging relations, scope and limits of parties' liability);
- the usage of the provided concession schemes across industries while creating infrastructure (in the East, North, North-East of the country) or their reconstruction (within the economic systems of the West Zone) is possible through the development of the integrated scheme, which takes into account industry-specific features and is built on the basis of sustainable module of known Western schemes.

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