



Oil and Gas Contracts for Sustainable Development in Kazakhstan

Background Note on Context and Key Issues

Introduction

This is a background paper for a Round Table on 'oil and gas contracts for sustainable development in Kazakhstan'. The Round Table will be held at the Radisson-SAS hotel in Astana on 18th April 2007, with 30 participants drawn from government, parliament, businesses, think-tanks and civil society.

The aims of the day are to identify the links between oil and gas contracts and sustainable development, and to begin a discussion on how future contracts might best be designed from a sustainable development perspective.

The relationship between natural resource contracts and sustainable development is receiving increasing attention around the world. There are many reasons to focus on that relationship in Kazakhstan. They include the significance of the oil and gas sector in Kazakhstan's economy overall and relative to global trends; the country's extensive experience in the negotiation and implementation of a variety of natural resource governance arrangements; the increasing policy interest in corporate social responsibility and sustainable development, and the presence of significant interest in civil society and among expert analysts in the issues.

The terms of foreign investment contracts need to strike a balance between the interests of investors in ensuring an appropriate level of stability for their projects, and the pursuit of sustainable development. How to define the level at which 'sustainable development' takes place and the appropriate mix between local and national costs and benefits of oil and gas development; and how to define the balance between negotiation, the application of general and specific legal requirements, and the market-based innovation of foreign investors - these are among the major challenges of making oil and gas contracts supportive of sustainable development.

Making sure that oil and gas contracts support sustainable development calls for action at four distinct levels:

- the processes through which contracts are negotiated
- the terms of the contracts themselves
- arrangements for resolving disputes between foreign investors and public authorities
- alignment between sustainable development and the wider policy environments in which oil and gas contracts are negotiated

This background paper aims to highlight some issues for discussion at the round table. It does not offer prescriptions on ways forward. Nor does it offer the detailed analysis that can only come from practical experience with the negotiation and implementation of oil and gas contracts. Our hope is that participants at the round table will bring just that to the discussion.

What is sustainable development?

At its simplest, sustainable development is the policy imperative for governments, people and businesses to balance economic, social and environmental considerations.¹

The overall goal of sustainable development is to meet the needs of today's generation without compromising the ability of future generations to meet their own needs. Global Summits in Rio de Janeiro in 1992 and Johannesburg in 2002 affirmed multiple governmental commitments on sustainable development, and helped to extend the reach of the imperative into the worlds of business, local government and civil society.

Today, four key underlying causes of unsustainability remain:

- Dominant economic growth models. Too often it is these models which are considered inviolable, not peoples' rights and welfare, or environmental processes and limits
- Environmental costs and benefits of human activity are 'externalised' (i.e. the environmental impacts of transactions of various kinds are not reflected in market prices, so they tend not to get taken account of in decision-making)
- Poor people are marginalized, and inequities entrenched
- Governance regimes are inadequately designed in terms of internalising environmental factors, ironing out social inequities, and developing better economic models (Bass, 2007).

Rising to these challenges is part of the context for efforts to make oil and gas contracts supportive of sustainable development.

Key Features of Public Policy for Sustainable development in Kazakhstan

Sustainable development is an increasingly visible policy imperative in Kazakhstan, with the adoption of the country's Sustainable Development Concept in November 2006.

The goal of the Sustainable Development Concept is to achieve '*economic, social, environmental and political balance of the development of the Republic of Kazakhstan as a base for improvement of quality of life and provision for the competitiveness of the country in the long-term*'.

¹ In Russian the translation of 'sustainable development' does not easily convey the economic and social dimensions of the concept. The translation runs the risk of implying that 'steady economic development' is enough to deliver 'sustainable development'.

Consistent with globally accepted thinking, the main principles underpinning the transition of the Republic of Kazakhstan to sustainable development are to include “*broad public involvement in the process of transition to sustainable development*” and “*establishment of the political base for sustainable development*”.

As a political base for sustainable development, the Concept notes that “*sustainable development of the internal situation in the Republic of Kazakhstan is based on facilitation of the democratisation process and strengthening of the political system of the country for the sake of all people of Kazakhstan... Sustainable development in internal policy of the Republic of Kazakhstan is ensured by.. improvement of democratic procedures.. formation of the political opponent culture, strengthening of constructive opposition as a basis for competitiveness of the programmes and expressing of the interests of all society groups*”

The Concept notes that Kazakhstan’s significant dependence on the raw materials sector is a potential threat to the sustainable economic development of the country. It stresses:

- the notion of enhancing Kazakhstan’s resource use efficiency (i.e. the efficiency with which product outputs are gained from resource inputs);
- development of science in the field of environmental protection;
- introduction of programmes of sustainable territorial development on the basis of an ‘ecosystem approach’ that considers entire ecosystems, not only administrative units;
- development of economic instruments and tools of environmental protection;
- ‘increase of incentive effect of the emissions payments and administrative penalties for violation of the environmental legislation of the Republic of Kazakhstan’;
- introduction of cleaner and economically efficient technologies;
- prohibition of the inefficient use of resources;
- actions to mitigate poverty
- actions to secure industrial safety and labour protection
- improvement of the business sector in the region in poverty mitigation activities
- measures on formation of civil society

The negotiated terms of oil and gas contracts of various kinds have many implications for the achievement of sustainable development in Kazakhstan. These contracts are an important part of the overall framework for governing direct investment in the oil and gas sector. For this reason alone, they have an important role to play in channelling the sustainable development impacts – positive and negative – of oil and gas companies.

Kazakhstan’s Sustainable Development Concept touches on a number of subject areas that are relevant to discussion on how best to design oil and gas contracts to contribute to sustainable development. For example:

- The balance between voluntary business action, general legislative requirements, and negotiated contractual commitments in areas addressed by the Sustainable Development Concept, including
 - development of new technologies and of the educational and scientific basis for sustainable development in Kazakhstan;
 - provisions on health and safety and labour protection;
 - business engagement in poverty reduction,
 - environmental requirements on oil and gas companies
- The role of parliament, civil society and members of the public in the development and implementation of oil and gas contracts of various kinds

Other areas that are less directly addressed by the Sustainable Development Concept are also of critical importance to the overall way in which oil and gas contracts contribute to sustainable development in Kazakhstan. These include the overall revenue management structure for oil and gas projects, (including structures governing direct and indirect flows of revenues to the regions of Kazakhstan) and the policy commitments and legal frameworks governing 'local content' and efforts to stimulate the development of Kazakhstani enterprises.

Oil and gas contracts in Kazakhstan: a changing context, and evolving frameworks

The context in which oil and gas contracts in Kazakhstan have been negotiated and implemented since independence has evolved during the nation's process of transition. Early contracts – including for example the Tengizchevroil contract – were concluded before detailed legislative provisions for the governance of the oil and gas sector had been put in place, relying essentially on the legal basis provided by the country's Civil Code and the 1992 Subsurface and Mineral Processing Code.

One commentator (Olga Chentsova) suggests that Kazakhstan's legislation on subsurface use has passed through three distinct stages. Phase I, from 1990-1996, reflected the early development of Kazakhstan's legislation on subsurface use. Phase II, from 1996-1999, was marked by the promulgation of the 1995 Petroleum Law, and the 1996 Subsurface and Subsurface Use Law. Phase III, beginning in 1999, was marked by substantial amendments to the two basic laws in light of experience, the development of various Model Contracts for subsurface use, the adoption of the new Law on Investment of 2003, and the inclusion of specific provisions on taxation of production sharing agreements in the Tax Code.

A fourth Phase might now be added with the adoption of the 2005 Law on Production Sharing Agreements (Contracts) When Conducting Offshore Petroleum Operations, which for the first time brings a dedicated legal regime to the development of certain production sharing agreements.

'Hot topics' in Kazakhstan's oil and gas sector include the implications of the new Environmental Code, adopted in 2006; the impact of 2004 changes in the tax regime on investment; the implications for investment stability and the

attraction of Kazakhstan as an investment location of pre-emption rights of the Government of Kazakhstan on transfers of subsurface use rights and of provisions allowing refusal of consent for transfers in certain defined circumstances; provisions granting KazMunaiGas substantial preferences in relation to participation in certain new oil and gas projects; and the implications of Kazakhstan's forthcoming accession to the World Trade Organization for the country's approach to promotion of local content; and the processes for achieving phase-out of gas flaring in the country.

More widely, 'hot topics' include progress in Kazakhstan's participation in the Extractive Industries Transparency Initiative, the implications of oil revenues for socio-economic development of oil-producing regions of Kazakhstan and for macro-economic stability overall, governance of the National Oil Fund, and implications of the new Environmental Code. Each of these 'hot topics' has implications for sustainable development.

Transparency and public participation

In Kazakhstan, oil and gas contracts are not formally publicly available – though significant portions of some contracts can in practice be freely downloaded from the internet, or obtained from www.barrowscompany.com on payment of a fee. One problem with reliance on such sources of information, however, is that there is no guarantee that these documents are up to date, complete, or even (on occasion) genuine. Consequently, these sources are appropriately used simply as a trigger for discussion about how future generations of contracts might optimally be designed from a sustainable development perspective.

Some countries – including Azerbaijan – have developed procedures for the adoption of oil and gas contracts which mean that they are adopted by parliament as legal instruments – and consequently form part of the country's overall legislative frameworks. In Kazakhstan, where the status of oil and gas contracts as administrative or civil law contracts remains subject to debate, they are not publicly available.

Taken literally, the sustainable development principles of transparency, access to information and rights of public participation might suggest that members of the public should have a right to comment on oil and gas contracts, to have access to the information necessary to monitor their implementation, and at the very least to be able to access copies of concluded contracts. However, oil and gas contracts may also contain commercially sensitive information. In Kazakhstan, some incorporate provisions that explicitly specify that no party to the contract should be permitted to disclose the terms and conditions of the contract, save for in limited defined circumstances.

Whether future oil and gas contracts should be made publicly available is one question for discussion at the round table. Significant discussion points would include the optimal extent and timing of any enhanced transparency, and optimal arrangements for public or parliamentary participation in the process of developing and implementing oil and gas contracts. Other possible issues

for discussion include the role of public consultation and local community participation in setting community development-related requirements within contracts.

Revenue management

The revenues generated by oil and gas projects are a very significant source of wealth for the people of Kazakhstan. They also provide the financial basis for the nation to define its path to sustainable development. Oil and gas contracts are an important determinant of the rate at which revenues accrue.

Detailed understanding of the economic basis of individual oil and gas investment projects requires a great deal more data than is afforded by simply reading the contract terms. However, analysis of the Kashagan and contracts by Peter Wells has shown that, with access to contract terms and information on capital and operational expenditure, economic modelling of the revenue implications of production sharing agreements under different oil price scenarios is feasible. In turn, this can help to enhance understanding of the economic choices that are made by the Government of Kazakhstan when agreeing on different kinds of revenue management arrangements, and facilitate analysis of the budgetary effectiveness of different kinds of arrangements.

Since 2005, Kazakhstan has been an active participant in the Extractive Industries Transparency Initiative, which works to encourage extractive industry businesses to publish details of the revenues that they pay over to governments. In early 2007, Kazakhstan became the first participating country *de facto* to require compulsory participation in the EITI by applicants for new subsoil use rights.²

Corporate social investment and corporate social responsibility in oil and gas contracts

“Corporate social responsibility” (CSR) is essentially about the role of business in society. While there is little contention about the broad concept of CSR, there is no consensus definition of CSR at the operational level; that is, *how* business should “give back” to society, what role governments should play in requiring or helping them to do so, and how to measure progress.

Interest in the notion of ‘corporate social responsibility’ has increased rapidly in Kazakhstan – receiving endorsement in President Nazarbayev’s address to the nation in 2006, and in the 2006-2008 government work programme of the Republic of Kazakhstan.

Issues related to the overall governance of companies’ social investment programmes, and to their contributions to skills transfer, community development and education, are also relevant in this context. Some of these programmes are mandated, in a variety of ways, by oil and gas contracts.

Contract provisions mandating spending on educational and training efforts of various kinds are commonplace. Here there is significant debate about the

² Macleod Dixon Kazakhstan Legal Bulletin, 30 January 2007

way in which tax incentives for this kind of spending work for different kinds of oil and gas contracts, and on the kinds of initiatives to which spending is channelled.

Contracts may also contain provisions on community relations (for example requiring oil companies to provide public access to information on environmental and other impacts of petroleum operations). Additionally, contracts often contain requirements for companies to contribute to communities affected by, or located near to, the places where projects take place, or to provide funding for social and infrastructure projects.

The social investment contributions provided for under the terms of oil and gas contracts may be as much as 5-10 million USD per year in the case of Kazakhstan's largest projects – making these payments a significant source of revenue for regional authorities in regions where oil and gas developments takes place.

Who administers the implementation of social investment projects, and the processes through which they are proposed, are significant issues. Without careful governance, there are risks that projects could be proposed and implemented that are not grounded in regional policy processes and priorities, and which make little lasting contribution to the sustainable development of oil and gas-producing regions. Corruption in social investment programmes is also a concern in Kazakhstan, as in many other parts of the world.

Issues of cost recoverability in respect of social and community investment programmes are a significant consideration for oil companies and government. When social investment programmes fall within the scope of contracts' cost recovery provisions, there is a clear basis for bringing reluctant joint venture partners on board. Setting too low a ceiling on cost recoverability of social investment can disincentivise company spending. Too high a ceiling, however, can (depending on the governance structure for the spending) deprive governments of much-needed oil revenues.

Contemporary 'best practice' thinking encourages companies to make the most of their 'core competences' and 'business skills' in the delivery of community and social investment programmes. And it encourages companies to find ways to align their social investment practices with public policy frameworks. These prescriptions are as relevant for 'voluntary' social investment programmes as for those mandated by contracts.

One policy question concerns the balance between mandated social investment, and development of wider public policy measures to stimulate world-class 'voluntary' community and social investment by companies.

At the round table, participants will have an opportunity to discuss optimal governance structures and decision-making processes for the social investment programmes, and education and training initiatives that are mandated by oil and gas contracts.

Local content

The quality of the local economic development benefits brought by oil and gas projects may depend on the kinds of economic opportunities that it brings for local people. One of the ways in which oil and gas companies can bring development benefits is by using their technical skills and their buying power to help to develop local businesses.

The question is, what should be the role of law versus voluntary initiatives in promoting 'local content' and supply chain linkages between foreign companies and local suppliers. A World Bank report cautions that 'oil operators.. have a 'reservation price' for the total required payments they will make for their license to operate.. Clearly, only if the government asks oil operators to carry out economically viable local content developments, they will regard these as outside the 'reservation price'.

State regulation of procurement of goods and services by the oil and gas sector in Kazakhstan is rigorous. The general principle in Kazakhstan's Subsoil Law is that holders of subsoil use contracts should procure goods and services of Kazakhstani origin. Local content requirements may be contained in oil and gas contracts, and in addition, contracts may contain targets for employment of Kazakhstani staff at different levels of the operation. Many practical issues arise out of the challenge of implementing local content commitments.

Commentators have pointed to the importance of investing in provision of high quality vocational training in Kazakhstan and of ensuring that the best possible technologies are applied. Here, too, there is a role for oil and gas companies' education and social investment programmes to contribute to the necessary skills and technology transfer.

2007 amendments to Kazakhstan's Subsoil Law have further tightened Kazakhstan's local content requirements.³ However, Kazakhstan's accession to the World Trade Organization is likely to introduce significant constraints. The result may be a shift from mandated approaches to experimentation with a variety of more 'facilitative' approaches. The implementation of the Memorandum of Understanding on the Development of Local Content in the Services Market of Subsurface Use and on Implementation of Subsurface Users Transparency Initiative in the Republic of Kazakhstan may be precursors of the next generation of approaches.

A question for our round table is what could be the contribution of the next generation of oil and gas contracts to addressing local content and 'vendor development' concerns.

Dispute settlement

Foreign investors generally have a right to compensation from host states if their contractual rights are breached. But this is typically not a benefit that is available to domestic businesses. When disputes arise between foreign

³ Ditto

investors and the countries that host them, foreign investment contracts usually say that they should be resolved through international commercial arbitration, not national courts.

Many external commentators have criticised the use of international arbitration because of its opaque nature, suggesting that this is undesirable in the case of disputes raising major issues of public concern. However, not all national legal processes are transparent and open to public scrutiny, nor are all important domestic judicial judgments published around the world.

A further criticism of international arbitration is that where investment disputes arise out of action taken by a host state to protect a public interest or the rights of citizens, international commercial arbitrators may not be best placed to evaluate those interests or rights.

In Kazakhstan, whilst the general rule is of freedom of contract in relation to governing law, relations “related to the conduct of Petroleum Operations” must be governed by Kazakhstan law. Kazakhstan has adopted a Law on International Commercial Arbitration and a Law on Arbitral Tribunals. International commercial arbitration is not available where both parties are treated as ‘Kazakhstani’.

For the next generation of contracts, a key policy question is whether these provisions represent an optimal balance between domestic courts and international arbitration processes, and between transparent resolution of disputes raising important public policy questions and privately resolved determination of disputes that are effectively viewed as civil matters between contracting parties.

Stabilisation and choice of law

‘Stabilisation clauses’ in oil and gas contracts are legal devices that foreign investors commonly use to manage so-called ‘non-technical risks’. They are typically used in contracts with host countries where there is considerable political, regulatory or institutional uncertainty, or when standards addressing potential impacts of the investment have not been developed in host states.

In effect, stabilisation clauses work by committing the host government not to take action or to alter its legal system in a way that negatively affects the investment project. If a government that is party to a contractual stabilisation clause breaches the commitment, it is likely to be required to pay compensation.

The evolution of Kazakhstan’s oil and gas legislation has gradually seen a shift away from the use of stabilised contractual regimes. For example, tax stabilisation is no longer available for tax/royalty based contracts (as opposed to production sharing agreements). Legislative amendments in the sphere of defence, national security, the environment/environmental safety/ecological security and public health are excluded from the scope of stabilisation guarantees.

For some, the pendulum may have swung too far away from stabilisation to be comfortable for foreign investors – in effect, prioritising wider policy goals over investment stability. For others, the limited availability of stabilisation provisions for new contracts is a welcome manifestation of Kazakhstan's evolution and maturity as an investment location.

The use of stabilisation provisions needs to be addressed alongside other provisions that govern which set of norms and regulations govern the investment project. At their most controversial, provisions in foreign investment contracts may state that the law of the host state is to apply *with the exception of* specified pieces of legislation. Whether Kazakhstan has adopted such provisions in its contracts is a matter of some speculation among some NGOs, since most existing contracts are not available.

At the round table, participants may wish to discuss the pros and cons of different balances between negotiated self-contained and/or stabilised normative regimes within oil and gas contracts, and general application of the country's legislation in key policy areas such as labour and environment.

Environment

Enforcement of environmental requirements is considered to be a priority concern for the government of Kazakhstan by many foreign investors. A new Environmental Code was adopted in 2006, and special provisions apply to offshore development in the Caspian.

Unlike many other countries, Kazakhstan's oil and gas contracts have not sought to extend stabilisation provisions to environmental requirements. Indeed, many NGOs analysing natural resource contracts around the world, have argued that the evolving nature of environmental understanding means that stabilisation provisions should never extend to environmental requirements.

However, some foreign investors in Kazakhstan have on occasion argued that one result of the lack of this environmental carve-out has been uncertainty, and that environmental penalties have become an extra source of revenue for regional and local authorities. Other concerns relate to the way in which environmental fees and charges are set, with considerable uncertainty for investors on likely levels of charges before they are set. Commentators have also raised legal concerns over whether tax stability (for those contracts that benefit from it) ought properly to extend to environmental fees and charges.

From an NGO perspective, there have also been concerns that foreign investors in the oil and gas sector have on occasion been granted exemptions from certain environmental requirements. Whilst this is not a subject for discussion at the round table, one related question concerns whether as a matter of principle it should ever be permissible for oil and gas contracts to contain such provisions.

Environmental impact assessments potentially play a key role in establishing the baseline for subsequent allocation and apportionment of environmental

costs and responsibilities within contracts – including determination of environmental fees and charges.

Other areas for potential discussion at the round table include environmental dimensions monitoring and of ‘abandonment’ provisions in oil and gas contracts; the appropriate role of industry environmental standards and other kinds of ‘best practice’, ‘beyond compliance’ environmental requirements in oil and gas contracts and the implications of the introduction of Kazakhstan’s new Environmental Code.

Corruption

One cannot ignore the challenge of corruption in a discussion of the contribution of oil and gas contracts to sustainable development in Kazakhstan. Well-known corruption scandals have already arisen related to the acquisition by foreign companies of stakes in major oil and gas projects in Kazakhstan. Corruption distorts markets, and undermines sustainable development. Enhanced transparency in the process of contract negotiation and implementation has sometimes been suggested as one response to the challenge.

Conclusion: balancing the overall governance framework for oil and gas in favour of sustainable development

Considering how best to make future oil and gas contracts work for sustainable development calls for examination of the evolving balance between state control and negotiated contractual commitments; between commercial confidentiality and public access to information and participation; and between investor concerns to generate lasting shareholder returns from their investments, and the public policy responsibilities of the government of Kazakhstan.

One focus for future efforts to strengthen the contribution of oil and gas contracts to sustainable development could be revisions of Model Contracts. But this is not the only option by any means. Enhancing the enabling environment for various kinds of socially responsible business behaviour, voluntarily undertaken, could also be part of the mix. Equally, examination of the relationship between oil and gas contracts and sustainable development could lead to a range of suggestions for progressive improvement of the current institutional framework within which contracts are monitored and enforced and foreign direct investment governed more widely.

At the round table, participants are invited to consider whether a process of analysis and engagement in Kazakhstan, involving national and international experts, and focusing on how best to design future oil and gas contracts from a sustainable development perspective, might be of value. This note has highlighted some of the issues that might be addressed in such a process. Round table participants are invited to offer their thoughts on the pros and cons of such an initiative.

Halina Ward, IIED, London, April 2007

Key Sources

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