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**Analysis of the environmental regulation of oil and
gas projects, and balance between local and external
regulations of various kinds of contracts**

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Current situation

Favorable indicators of the oil and gas market give incentives to the authorities of oil countries to strengthen control over the sector. The fact that the oil and gas sector ensures about 30% of the country income is very important for Kazakhstan. Significant increase of oil production is expected in the future in those oil fields which are now developed predominantly by international oil companies.

President Nazarbayev called for strengthening of the role of the state as the major player in the international oil and gas markets therefore early in February the Prime-minister of Kazakhstan declared that the authorities of the country will revoke licenses on development of natural resources from the investors who infringe the terms of their contracts. In the last couple of months some oil and gas companies, including the consortia involved in development of the Karachaganak and Tengiz fields and the Kashagan offshore field, have become targets for close attention of the RK authorities in terms of observation by them of the environmental standards.

Legislative developments

To conduct analysis of the environmental regulation of the existing oil and gas contracts it is necessary to consider the legislation which acts or acted when such enterprises as TCO or Kashagan started their activity in the territory of the Republic of Kazakhstan.

Many companies started their activity when the base legal acts of the Republic of Kazakhstan were in force which by now have lost their effectiveness. Many normative-legal acts that were in force during that period also lost their effectiveness by now.

Tengiz-Chevron Agreement¹

After two years after collapse of the USSR and declaration of independence and sovereignty of Kazakhstan the legal and normative acts which lost their effectiveness as of today allowed the Republic of Kazakhstan to sign crucially important for the national economy investment contracts and contracts on subsoil use with the world-wide known transnational corporations that work in oil and gas including "Chevron". On the basis of these legal acts, the Republic of Kazakhstan initiated signing of the package of acts and documents on the Tengiz project, including the most important ones such as "Project Agreement" that has the status of the investment agreement; "Production License" which in fact is the Production Contract; "License agreement" and "Exploration license" that have the status of the Exploration Contract and a series of other important documents. The signed documents complied to the regulations of the Republic of Kazakhstan that were acting at that time and to the requirements of international practice on conclusion of investment contracts and contracts on subsoil use. The entire package of the Basic documents on the Tengiz Project was approved by the Special Governmental Enactment of the Republic of Kazakhstan and approved by the Special Decree of the President of the RK. Thus, the main Tengiz Project documents obtained a legal status binding all participants of this agreement, in a broad sense of this term, to observe all its terms.

To encourage this investment project the Republic of Kazakhstan granted to TCO as to the subsoil user special preferences and privileges. This decision of the state corresponded to the regulations of the national legislation that was in force at the time of conclusion, signing and approval of the Basic documents on the Tengiz Project. Possibility to grant privileges and preferences to investors, including to those that work in the sphere of subsoil use is envisioned

¹ This section is based on an article by Yelyubaev, Zh. S., Tengizchevron JV, on the analysis of obligatory normative-legal and normative-technical documents.//Presented at the at the 5th Atyrau International Legal Conference, April 2007, Atyrau.//Yelyubaev, Zh. S., Subsurface use and the law in the Republic of Kazakhstan: A collection of scientific articles and reports: Practical science grant. Almaty: Complex, 2009. pp 328, pp 64 – 81.

in the regulations of the legal-normative acts that are in force by now (*Law of the RK "On Subsoil and Subsoil Use", 1996; and Law of the RK "On Oil", 1995*) where it is stated that the terms of the contract on subsoil use are determined based on the mutual consent of the parties.

While the basic documents of TCO, in particular, "Production Licenses", "License Agreement" that provide the right on exploration to TCO have a regulation that (*the corresponding rights and obligations*) resulting from the indicated documents and their "*interpretation and execution are regulated by laws of the Republic of Kazakhstan provided that in the greatest possible extent allowed by these laws the intentions of the parties will be considered*".

Thus, on the one hand the Republic of Kazakhstan granted and warranted to TCO certain rights on unobstructed start of its activity on Oil production and Exploration, and on the other hand it has obliged TCO to observe the existing for subsoil user procedures and rules which are envisioned in the national legislation. Therefore, TCO after having already started to carry out its economic activities immediately proceeded to development, coordination and approval of the normative-legal and normative-technical documents needed for the subsoil user for implementation of its rights on subsoil use, land use and environmental management.

The first "Field development plan for Tengiz" was developed during the Soviet period in 1986 by "Giprovostokneft" Institute and that was long before establishment of TCO. The new "Initial Field Development Plan for Tengiz Field" was developed on the basis of a large volume of work undertaken by TCO since April of 1993 up to 2002.

In 1999, TCO together with the Kazakh Scientific and Research Geological Survey Oil Institute (*further - KazNIGRI*) developed, coordinated and approved "Pilot operation project design for Korolevskoe field". This field was discovered in 1986 and in April of 1993 was transferred to TCO. By that time the field was underexplored and according to the named Design Project it was necessary to carry out the whole complex of exploration works on estimation of oil reserves and on preparation of the Initial Field Development Plan/Reservoir Management Plan.

Last year, TCO together with *KazNIPIneftegaz* finished development and approved (*October 20, 2006*) in the Central Commission on development of oil and gas fields of the Ministry of Energy and Mineral Resources of the RK (*further - CCD*) "Initial Field development plan for Korolevskoe field".

Development, coordination and approval of the obligatory documents granting the rights in the sphere of environmental management and land use take special place in the activity of TCO. These documents are required to practice the rights on subsoil use. In respect to TCO such documents would in particular include: "Draft Standards on the maximum permissible emissions", "Draft Standards on the maximum permissible discharges", "Draft Standards on formation and limits of wastes disposal", "Gas utilization program", "Sulphur utilization program" and annual permits and licenses on special kinds of environmental management.

Subsurface use regulation problems

A more improved legislation can be reached through adoption of new legal acts or through introduction of changes and addendums to the acting legal acts but in this process certain stability must be ensured. A traditional approach to law-making and law revisiting process which is basically limited by constant revisiting of the acting legal acts should be reconsidered. New laws, by-laws and departmental acts, multiple proposals on introduction of changes and addendums to the acting legal acts can be initiated by whomever and whenever: companies-monopolists, central ministries and departments, Akim's offices of all levels, deputies, influential businessmen and politicians, foreign investors, public associations, mass media, political parties and their leaders. Such law-making activity reduces the quality level of legal acts and effectiveness of their impact on regulation of public relations and negatively impacts the formation of lawful, equitable and objective law-enforcement practice.

Issues to be resolved through legislative changes

Basically, the following issues are related to this: procurement of the Kazakhstan goods and services; attraction of the Kazakhstan labour; additional requirements to subsoil users which are intentionally and objectively imposed and are next to impossible to fulfill; strengthening of the role of the state bodies in matters of control of activity of subsoil users; continuous changes concerning interpretation (reading) of these or those terms and concepts.

However, subsoil users as well as other economic entities will procure and use Kazakhstan goods and services only when if these goods and services are really competitive, of good quality and safe and meet other requirements of the market economy. Efforts to solve the given issue (so important for the RK economy) through the law will not facilitate improvement of quality of the RK goods and services. Why shall a Kazakhstani producer or provider of services work on improvement of quality of its products and services if there is an opportunity to "impose" these products to the consumer through the RK law.

However, we need to solve this important problem and it can be solved at conclusion of contracts on subsoil use when a subsoil user undertakes certain obligations on procurement of a part of the goods and services produced in the RK through the tender process and bids. Such approach will facilitate the growing interest and motivation of the RK producers and service providers to improve quality of their goods and services. Attraction of the Kazakhstani labour shall also be solved through contract obligations but not on the legislative level. Many subsoil users have always been interested in increasing the share of the national labour.

We need to mention one more problem: to increase the share of obligatory payments to the state revenues so many frequent changes are made in the laws through various interpretations of one and the same condition or term (concept).

It is necessary to pay attention to the issues related to the authority of various state bodies implementing control of activity of economic entities in the sphere of subsoil use, environmental management and land use. This issue must be solved once and forever even maybe at the legislative level. To the extent possible, it is necessary to determine the exact criteria for state bodies to diminish interference in the economic activities of subsoil users and to avoid official lawlessness. Control and supervision must be executed strictly within the framework of legislative regulations, they must not have a prohibitive nature; they must be directed on rendering of assistance to the economic entity, on increasing reliability and effectiveness of its activity, on encouragement of activity of subsoil users directed on protection of subsoils, environment and health of people, and on ensuring of industrial safety and reliability of industrial objects.

Inspections of any kind must be directed on checks of fulfillment of contractual obligations by subsoil users; on reliability of work of the industrial complex; on observance of technological rules; on ensuring of industrial and occupational safety; on undertaken measures of environmental protection and protection of health of people; and on fulfillment of tax and other financial obligations.

And, finally, it is necessary to understand that subsoil use as well as any anthropogenic activity cannot be exclusively clean and safe for the environment. On the contrary, oil and gas facilities initially are hazardous; production activity and operations to certain degree impact the environment and that is why subsoil users carry out significant activities directed on compliance of the production activity to the established norms, standards, limits and other requirements of safe business. Only the objective approach to evaluation of the subsoil user production activity can stimulate formation of normal relations based on regulations of the legal acts that are in force. In order to exclude disputes and conflicts it is necessary to reach a fair balance of interests of the state, society and a subsoil user.

The oil and gas sphere is a potentially hazardous sphere of anthropogenic activity; however, it stops being hazardous at a high level of management of the production cycle, at implementation of the contractual obligations by a subsoil user, at objective and fair monitoring by the authorized state bodies and at solution of problems (industrial, technological, ecological, social, legal and etc) on the basis of legal regulations. This branch keeps being the "steam locomotive" for the entire economy of Kazakhstan and attitude to it must be as to the loco of the country economy; there must be no conflicts in this sector especially with those subsoil users which show high examples of production activities and business management. Every possible declarations of the senior state officials do not facilitate to creation of the positive image of the country among law-abiding subsoil users; they undermine the authority of the government in the opinion of the public and the business environment and do not facilitate improvement of the situation to ensure the rule of law and order in this sphere of economy of Kazakhstan.

Key problems in the process of control

Environmental management is carried out by the Government of the RK through its central executive bodies such as Ministry of Environmental Protection, Ministry of Economic Development and Trade, Ministry of Oil and Gas, Ministry of Agriculture and Agency of Land Resources Management. The Government and the local government bodies establish the order on protection and use of environmental components, approve the rates of payments for use of resources, regulate activity of subsoil users in accordance with the legislation and carry out activities on rehabilitation of biological resources.

While the oil and gas branch constitute the platform of the economical growth of our country, it can also be seen in some quarters as the source of serious ecological problems. The concept of transition of the Republic of Kazakhstan to sustainable development for 2007-2024, approved by the Decree of the President of the Republic of Kazakhstan as of November 14, 2006 N216 indicates that historical pollutions, waste landfills and increasing emissions of toxic substances from stationary and mobile sources threaten the environmental status and health of the population. In this relation, the Concept envisions the use of economic instruments for environmental protection, including the principle "polluter pays" which means that a subsoil user is responsible for financing of activities on environmental protection and for reimbursement of a possible environmental damage otherwise the polluter must give up its activity.

Special alert is raised by the fact that the problem is related to the activity of oil companies operate in the environmentally sensitive area of the Northern Caspian Sea – which is unique in terms of its nature phenomena and as such it is the most sensitive to negative processes in the area. Drilling activities do not exclude any probability of contingency situations of extreme impact and therefore the issue of uniqueness of the Caspian Sea translates the problem of response to emergency situations to the interstate and global level and therefore the issue of development of response plans and programs becomes not only the national concern but the concern of the international community.

Another important issue: it is related to abandoned flooded oil wells and flowing hydro-geological wells. Currently there are approximately 148 wells under water, but during rise of the sea level the number of overflowed wells will increase up to one and a half thousand. Ministry of Environmental Protection repeatedly raised this issue and during the last years the funds were allocated for these purposes; however the volume of funding is very small; meanwhile pollution of the sea with oil products, water salinization and mire formation still goes on. Creation of a special fund which will undertake abandonment of wells is necessary. All the parties interested in the ecological stability in the Caspian Sea sector could participate in the work of this fund.

Oil production in Kazakhstan frequently becomes the source of formation of environmental pollution hotbeds. The soils polluted by fuel oil, different kinds of oil separators and technological pits – still have not been put in order in our enterprises.

Strengthening of the role of the state in the oil and gas sector of Kazakhstan will make a limited effect on creditworthiness of the companies of the sector. Strengthening of the role of the state could be a positive moment because it can ensure significant stability and certainty for all players in the oil and gas sector of Kazakhstan. More over it can lead to establishment of more clear although of more rigid "game rules"; and contribute to clarification and coordination of regulation in the sector.

The National company KazMunayGaz ("NC KMG", "BBB" / "Negative") has a good standpoint to use close relations with the state and to get more advantages from strengthening of the state control over the oil and gas sector given its right on the first choice to purchase assets in projects of onshore Kazakhstan field developments and also in view of essential state support it enjoys. As for large international oil and gas companies operating in Kazakhstan, the potential strengthening of the state role in the sector can limit the level of their participation in the shareholder equity, but this would hardly make any negative impact on their creditworthiness. Moreover, these companies, tending to replenish their reserves will still keep access to huge reserves of Kazakhstan.

Increase of the state role can lead to reduction of transparency. Nevertheless, NC KMG shows successful management of assets and improvement of quality of corporate management, including introduction of a more rigid financial policy and ensuring of better transparency. As for large international oil and gas companies, the analysis will be conducted of the terms of any potential reacquisition of their assets under the existing projects but this will possibly make limited effect on creditworthiness of these companies because their capital investments in the oil and gas projects in the RK are already considered in ratings.

At the same time, strengthening of uncertainty can negatively impact implementation of the scaled program of the country to increase oil and gas production which will require significant investments and experience. In other words, it is necessary to find a balance between resources' availability and ability to develop them without foreign support.