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Local Content Policy: Kazakhstan review

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Promotion of 'local content' in the oil and gas sector is a major government policy priority. The new Concept on further Development of Local Content (2009) is already in action. The new Law on Subsurface Use is in the Parliament changing the regulatory context and variety of provisions governing relations between investors and the state. Up until 2010, operators differed in their approaches to assessing local content, relying on various sources including production sharing agreements, the general definitions contained in existing laws, and international practice.

In early April 2010, with new requirements in place, 34 contract termination notices were sent out to the subsurface users based on the incompliance with local content requirements¹. The Ministry of Oil and Gas (MOG) indicated that further 122 incompliance notices will be sent out in the near future. Major operators, such as TCO, KPO and NCOC are excluded from this list, but the Government expects long-term commitments to local content support from these companies.

These trends indicate that the legislative developments of the last few years had really set the stage for changes in the investment climate and emergence of the new state direction for the governance of the natural resources. Local content policy seems to be a good indicator of such trends.

Legislative context

The 1996 Law on Subsurface and Subsurface Use (as amended) required applicants in tender proposals to set out their proposed obligations to engage a certain percentage of goods, work and services of Kazakhstan origin meeting national and/or international standards, and procured on a tender basis, in the total value of goods works and services required. Broadly parallel provisions on engagement of Kazakhstan personnel are also incorporated within the Law. Definitions are given of 'Kazakhstan manufacturer', 'Kazakhstan origin' and 'Kazakhstan content', but these are too general definitively to resolve the issue of what constitutes 'local' content.

The 2005 Law Concerning Production Sharing Agreements (Contracts) when Conducting Offshore Petroleum Operations required for the first time that all new production sharing agreements include at least a fifty percent stake to be held by the national oil company KMG. The Law also contained specific requirements addressing local purchase of goods and services applicable to offshore exploration and production, providing that tender conditions shall provide for Kazakhstan content during the performance of offshore work.

The 1995 Petroleum Law (as amended) stated that contractors have the right to engage subcontractors, but provides that the latter must be largely organisations of the Republic of Kazakhstan.

Detailed rules on tendering procedures are contained in Rules for procurement of goods, works and services when carrying out subsurface operations, adopted in June 2007 (in turn replacing earlier 2002 Rules) and amended in November 2007. These Rules address all subsurface operations, and apply to subsurface users and their subcontractors purchasing goods, works or services for carrying out subsurface operations (save that they do not apply in circumstances where separate law on Public Procurement, highlighted below, are applicable).

The Rules specified methods by which procurement must be undertaken, reserving single-source tenders for defined, limited, circumstances. Detailed procedures for the tender process are specified, and the Rules contain a 'positive discrimination' in favour of Kazakhstan

¹ <http://www.bnews.kz/>

contractors: they provide that comparing bids for the purpose of selecting the winner of a tender an organizer must decrease the price bid by a Kazakhstan provider by 20%.

Changes proposed in the 2008 draft Law on Subsurface and Subsurface Use built on this overall legislative history. Subsoil contracts are to be based on a model contract appended to the draft Law. Mandatory contract terms are to include provisions on % of Kazakhstan personnel and allocations of Kazakhstan goods, works and services. In a new development, the draft provides for provision of equal conditions and remuneration for Kazakhstan personnel *including those engaged in subcontract work*. Provision in contracts is also to be made for fines for failure to meet local content requirements.

Further support for creation of a level playing field for Kazakhstan contractors is provided by public procurement legislation (in the form of the 2007 Public Procurement Law) which required a public tender for supply to state agencies (or state-controlled companies) of certain goods, works and services. Amendments of November 2008 introduced electronic procurement and, additionally, aimed further to strengthen the position of local providers of goods and services. Preference is to be given to local manufacturers where “the quotations presented are equal”. Furthermore, the Law began to address the wider definitional challenge of what constitutes ‘local’ content: a “domestic provider of work and services” is a Kazakhstan resident individual or a legal entity whose workforce is no less than 95% local. For a “domestic entrepreneur” to be recognized as such he/she needs to be a resident of Kazakhstan doing business in the country.

Varying approaches to defining and reporting on local content often led to difficulties in the interpretation of statistics provided by operators. Overall, it was difficult to compare such figures with others produced by different agencies, since their determination was based on different methodologies.

The Concept on further development of local content (2009)

Originally based on the import-substitution analysis for the extractive sector, the Concept, accepted by the Government RK in September 2009, set out a number of goals focusing on enabling conditions for stimulating national and local production of competitive goods and services. The analytical part of the concept indicates that raw resources constitute major part of export, while processed goods and produced products are not competitive enough. Supply of qualified labour resources and their fit to specific industry demand is limited. Other cited reasons for low competitiveness of local products for export and lower local content range from low levels of tariff shelter on internal market and lower investment potential of the processing industry to insufficient application of non-tariff measures, i.e. standards.

The original analysis of the import-substitution potential for the extractive industries (MOG, KCA 2009) included some of the major findings and recommendations that the present concept incorporated:

- Proposal to revise existing contracts in order to include specific local content requirements [even if without the exact percentage]
- Requesting long-term procurement plans from the major operators [KCO/NCOC, KPO, TCO]
- Refurbishment and modernization of the domestic production facilities—a very costly undertaking requiring Government commitment and support with appropriate policies
- Transition to the international standards and requirements, including management systems
- Appropriate customs and tax regulations targeted to promote domestic production and secure commercial advantage
- Ensure demand for new types of domestic products and services and guarantees of special conditions—including financing by development institutions guaranteed by the State holdings and national companies
- E-procurement and tender process transparency—to increase accessibility for domestic producers

Some of these recommendations were further developed in the Concept. Proposed measures for increasing Kazakhstan content include improvement of legislative base, information support, development of unified definitions and fixed requirements for local content in contracts, application of tariff and other stimulating instruments among many others. The prospects for the new concept provided subject for many discussions among experts and practitioners, with skeptics as well as promoters alike agreeing that success will largely depend on clear and consistent economic and legislative mechanisms for implementation.

The Action/Implementation Plan for the Concept states few stages of delivering on the proposed goals by 2012:

- I stage (2009-2010): defining major prospective categories for good and services, minimal local content requirements for subsurface users and developing appropriate legislative provisions

- II stage (2010-2011): availability of state subsidies or credit schemes to promote domestic producers of prospective good and services. Technology transfer, science support and new skills acquisition feature prominently here.
- III stage (2010-onward): state support for domestic entrepreneurs' access to international markets. Government Working Group in collaboration with operators and service companies will target human resource training capacities and coordination of skills base for the industry

In connection with the Concept and other legislative developments, **the Uniform Method of Local Content Calculation** for products and services has been decreed by the Government RK on March 20, 2009, with additional revisions introduced in September 2009. In this formula, some of the indicators caused much debate among the stakeholders. Specifically, inclusion of the salary ratio of the domestic employees across an overall salary base of suppliers and contractors/sub-contractors has been considered very problematic by some companies for the reasons of confidentiality, competitive advantage and other commercial factors. Another requirement concerns obtaining local content certificates, CT-KZ, for every product and service subject to calculation, from the Committee on technical regulation under the Ministry of Industry and New Technologies (MINT). It posed a challenge for mid-size investors, concerned that resources allocated on their part to compliance with and calculation of local content provisions alone are disproportionate vis-à-vis large companies and puts them at a disadvantage. Overall, an increased vulnerability of smaller investor companies has been cited as a major critique of the new approaches.

On December 29th, literally in the last days of 2009, **the Law RK “On introducing changes and amendments into legislative acts RK covering local content provisions”** has been passed by the Parliament [but not yet decreed by the President]. Primary changes introduced by this law include the following:

- Establishing the same terminology across the board on local content issues and differentiating competencies and responsibilities of the state agencies. MEMR—or now the Ministry of Oil and Gas (MOG)—is responsible for development of local content in the procurement by subsurface users. Ministry of Finance—for state procurement. The MINT—for local content data analysis and overall coordination.
- Administrative Code will have provisions covering sanctions for incompliance with regulations on local content (see Appendix on local content calculation)
- Expenses from the contracts made as a result of the tender processes conducted outside of Kazakhstan will not count as contract compliance by the monitoring agencies
- Corresponding amendments into the laws on state procurement, stock companies, and national wealth fund, that reflect preference and prioritization of Kazakhstan products and services

Institutional arrangements

The Ministry of Oil and Gas and the Ministry of Industry and New Technologies have attempted to formalize and unify the definition of 'local content' for all investors and to compile a comprehensive registry of local companies providing specialized services in different regions in the form of "The Unified Register of Domestic Producers and Foreign Investors". A specialised agency KazContract (KCA), with the MOG and MINT as primary shareholders, manages and updates the Register, providing the Government RK with a substantial analytical base for local content issues and policies. The KCA mission concerns facilitation of the local content policy implementation and ensuring transparent procurement for subsurface users.

In January 2010, KCA in coordination with both key Ministries established the Expert Council on local content. The Council includes representatives of the major industry associations and unions of entrepreneurs and suppliers of goods and services, operators, Government and policy experts. The Council will also participate in the assessment of the major projects, developing of working programs in Kashagan, Tengiz and Karachaganak, ensuring interests of domestic suppliers and contractors. These activities are directly monitored by the Ministry of Oil and Gas.

Stakeholder perspectives

Thus, the newly developed legislative system is meant to stimulate subsurface users to search domestic suppliers and contractors and to heavily invest in capacity building and technology transfer. The set target for the level of product procurement from Kazakhstan suppliers is 50% by 2012, for services—up to 90%. The stakeholder perspectives differ on the effectiveness of proposed policy measures and many questions arise regarding realities of reaching such ambitious targets. Cited challenges to compliance with local content requirements from the industry side include:

- Lack of domestic suppliers, who produce specialized products in demand by subsurface users
- Insufficient growth of technological capacity on behalf of domestic suppliers
- Deficit of qualified human resources domestically
- Limited exchange between domestic producers, subsurface users and state bureaucracy
- Long-term nature of investment in human resources training and education, as well as technology transfer and capacity building and short-to-mid-term local content compliance targets stipulated by the Concept and the Law
- Administrative sanctions and termination of subsoil users' contracts due to non-compliance with local content requirements does not induce collaboration between the state and private industry. These measures, intended to boost domestic supplier base, can have an opposite effect, if not coupled with a significant investment into SME development

Additional perspectives and considerations come from the academia and non-governmental institutions. While industry representatives have a wide range of pros and cons on the subject in their dialogue with the Government, NGOs express concerns over transparency and access

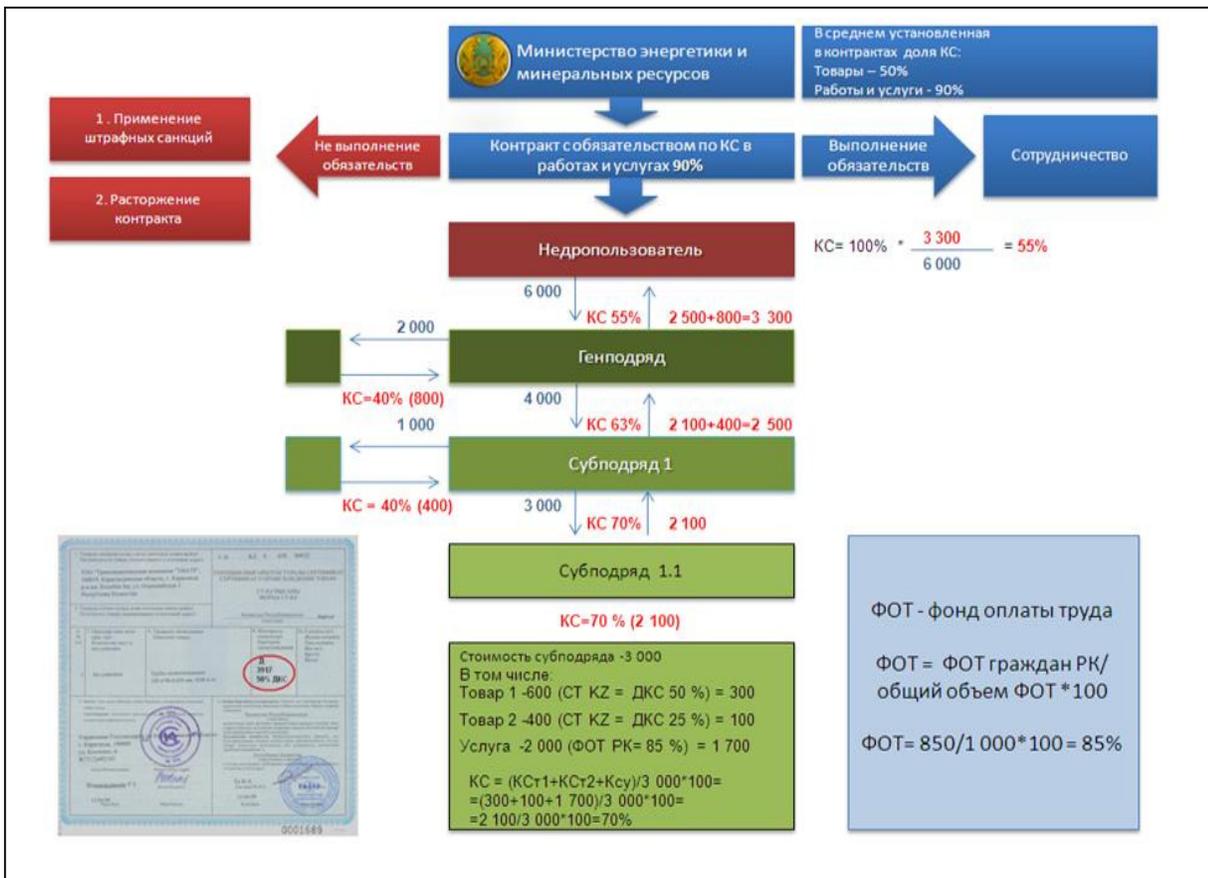
to the tendering process, lacking reporting mechanisms from the government and business side, and overall opaque nature of actual financing in the capacity building schemes and SME development.

One of the highlighted issues in the local content debate concerns complexities surrounding oil and gas contracting chains or supply chains. Real information and access to the contracts governing relationship between the operators and general/major contractors (such as Schlumberger, BakerHughes, Halliburton) and subcontractors are limited and hardly feature in any policy dialogue. Yet, it is here where most E&D activities take place and where local content calculation should take on additional layers of information in order to fully represent actual situation. Realistically, even the authors of the formula admit to complexities involved in the information gathering process and CT-KZ verification for all levels of contracting chains.

The local content policy and active regulatory stance from the MOG side, including recent contract termination notices, clearly point to the high salience of this issue and political will to follow through with the stated objectives, now supported by the recently introduced legislative base. The questions arising in the stakeholder discussions fall somewhere into three major categories:

- **Capacity and commitment of the Government** to coordinate and manage industry, labor, education, environment objectives and needs in the path to compliance with the local content objectives
- **Investment climate impact:** short and long-term implications of the local content policy. Many experts consider short-term prospects rather negative with severed contractual relations and push from the Government side for revisions of local content contractual provisions. Yet long-term outlook is rather positive, provided successful development of product/skills base and reaching stated LC policy objectives.
- **Consistency and fit of the local content policy** with other concurrent legislative initiatives and developments and realities of business-as-usual context. Some experts argue that the net impact of this policy carries more of a political weight, being used as an additional tool in the major push for contract re-negotiations and revisions. Whereas in economic terms, the impacts both potential and present require technical assessment and forecast.

Appendix: Local content calculations and decision-making²



² <http://www.kca.kz/?module=articles&catID=16&item=3&docID=127> KazContract (2009)