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Enhancing the stability of the oil and gas investment climate in the Republic of Kazakhstan

Project Outcomes and Recommendations

This report is prepared with the technical assistance of the British Embassy to Kazakhstan and Kyrgyzstan. It does not necessarily reflect the official views of the Embassy.

Overview

The core concept of this two-year project is the hypothesis that the policy imperative of 'sustainable development' (i.e. an integrated approach to securing environmental, social and economic benefits) offers a valuable entry point for multi-stakeholder analysis and dialogue on oil and gas investment in Kazakhstan. The aim of the project has been to identify critical issues and develop policy recommendations for enhancing long-term investment stability in the oil and gas sector in Kazakhstan.

The project was designed and coordinated by the International Institute for Environment and Development (IIED), a London-based think tank, in partnership with a range of Kazakhstani experts. Funding for the project was provided by the British Embassy in Astana.

The timeline of the project has coincided with several important legislative changes in Kazakhstan that will impact the future stability of oil and gas investment in the country, including a new Tax Code and most importantly the parliamentary consideration of a new draft Law on Subsurface Use. The re-negotiation of the Kashagan Production Sharing Agreement also occurred during the life of the project.

Key project activities are comprised of the following:

- 1) Preparing analytical research papers by Kazakhstani expert partners - paired with international expertise - across four main themes: legal, economic (especially local content), social (primarily social investment requirements) and environment.
- 2) Facilitating multi-stakeholder dialogue in the form of roundtable discussions and smaller meetings on key issues and options for the future oil and gas investment in Kazakhstan.
- 3) Disseminating project outputs to showcase the process for possible replication in other countries, particularly within the Caspian Region.

The final roundtable discussion of the project is scheduled to take place in Astana in May 2010. The final written output of the initiative will be a set of policy recommendations for enhancing the long-term stability of oil and gas investment within the context of sustainable development.

All outputs are presumed to take into account current government thinking in Kazakhstan, whilst endeavouring to find ways to achieve an optimal acceptable balance across stakeholder concerns.

A range of longer-term impacts has been envisioned and built into the project design:

- A 'next generation' of investment arrangements that makes a visibly enhanced contribution to economic, social and environmental sustainability;
- Greater sensitivity to sustainable development concerns in the implementation of existing operations;
- Local content arrangements and social investment programmes under future oil and gas investment contracts that are grounded in fundamental public policy priorities.

Project Outputs

The analytical component of the project focussed on four major themes pivotal to the subject of oil and gas contracts and sustainability. Based on the thematic reviews and stakeholder engagement process, three workshops covering each of the four themes were conducted—in April and November 2009:

- legal analysis of the changed legislation on subsurface
- local content and economic development
- social investments and
- environment

A number of stakeholder and expert meetings took place in smaller settings to discuss major thematic areas in more detail and to assess the implications of new legislative changes and policy frameworks around hydrocarbon development in Kazakhstan. The significant issues flagged and discussed under each of the thematic areas are as follows.

Legal analysis

Project working paper. *Review of the legislative base for investments in oil and gas sector of the Republic of Kazakhstan*, Maidan K Suleimenov and Yerlan B Osipov

Project working paper. *Oil and gas contract management in Kazakhstan: Investment stability in the energy sector*, Oleg I Yegorov

Project working paper. *Taxation of oil and gas under the new tax code of the Republic of Kazakhstan*, Natalya Yantsen

The revised Law on Subsurface Use states that its purpose is to create favourable conditions for attracting investments to subsoil exploration in the Republic of Kazakhstan. In practice, however, the new legislative regime is perceived to be less favourable for investors. The following issues have been flagged as areas of concern, which may require further clarification and possibly further revision of the law:

- Over-regulation as an increasing trend in the new legislative provisions on subsurface use favouring State intervention over market-driven mechanisms.
- Pre-emptive vs. priority rights of the State and implications for the nationalisation process and the Law on National Security. While considered a ‘natural trend’ under ‘strong State’ conditions, ‘rules of the game’ can be further clarified and decision-making made more transparent.
- Model Contract conditionality: rights of unilateral suspension and termination of contract by the State require explanatory component and clear criteria in line with Constitutional norms. The nature of the contract needs to be specified [concessionary vs. production-sharing]. Contradictions in the applicability of Civil Law to subsurface use contracts may arise.
- Rights and guarantees of subsoil users
- Tendering process criteria: signature bonus and amount of spending allocated for “socio-economic development of the region and infrastructure development”

- Dispute settlement and arbitration procedures: providing an option to choose international arbitration is consistent with the international agreements ratified by Kazakhstan and is part of many existing contracts. Its exclusion from the Law on Subsurface Use presents a challenging contradiction and could lead to accusations of discriminatory practice.
- Stabilisation clause absence due to new Tax Code provisions
- Interpreting when balance of economic interests has been achieved: resource rent calculation and re-assessment of value over time. How might this value be embedded in contracts and reflected in revenue sharing?

Local Content

Project working paper. *Current policy for promoting local content and technology transfer in the Republic of Kazakhstan, Saule Ospanova*

- New legislation on local content: the Concept and the Law: prospects for implementation, short-term vs. long-term projections for viability
- Calculation of local content: pros and cons of different variables and difficulties in assessment and access to data, confidentiality of information, large companies vs. small-medium capacities
- Local content as a contract condition and sufficient reason for contract termination
- Administrative control of financial obligations in contracts: imposing fines for non-compliance with non-taxable contract obligations
- Existing education and training base vis-à-vis new contract conditions on local content: long-term nature of education and training investment and short-term requirement for achieving local content targets
- Precedents of unilateral termination on grounds of local content conditions: more than 30 in the current year
- External factors impacting intended outcomes and goals of the local content policy: Customs Union, WTO accession
- Implications for investment climate: improved labour conditions, human resource base, local supplier development, sustainable supply chains, tighter requirements for investors

Social Investment

Project working paper. *Social investment in Kazakhstan today and prospects for the future, UNDP Kazakhstan and Parliamentary Institute Nur Otan*

- Corporate responsibility and sustainability: challenges in definitions. Wide variability in interpretation of corporate responsibility (CR), corporate social responsibility (CSR) and corporate environmental and social responsibility by different stakeholders

- CSR as a stakeholder engagement tool: reputation management, earning social license to operate, shareholder value
- Financial underpinnings of social investment programs: voluntary spending programmes financed by the operating companies vs. cost recoverable expenses
- Transparency and decision-making: defining priorities and reporting mechanisms, e.g. EITI, GRI guidelines, Sustainability Indices, Voluntary Codes
- Sustainability reporting: shareholder value vis-à-vis State requirements. Harmonisation process for investing companies
- Stakeholder engagement and communications: public disclosure policies, NGOs and communities networking and exchange, access to social investments information
- Prioritisation of social vs. economic vs. environmental—or sustainable development: Social investments portfolios tend to reflect local government preferences, while all stakeholders concerned express preference for systemic approach in decision-making on social investment projects
- Contractual social and environmental obligations and the public domain: public access and participation in decision-making on social investments, public hearings as an insufficient participatory mechanism

Environment

Project working paper. *Analysis of the environmental regulation of oil and gas projects, and balance between local and external regulations of various kinds of contracts, Daulet L Baideldinov and Nazheda Lapteva*

Project working paper. *Environmental impact assessment and the implementation of oil and gas contracts in the context of sustainable development, Yuri Eidinov*

- Environmental impacts from operations: current issues and hot topics - ecosystem degradation, water contamination, biodiversity, sulphur/waste management, off-shore drilling, gas-flaring
- Environmental social and health impact assessment (ESHIA) frameworks validity and baseline identification: defining role of environmental impact assessments (EIAs), preliminary and ex-post, at different stages of contract development
- Environmental payments/fees/fines as a source of bargaining: punitive tool or re-investment mechanism, question of re-distribution and compensation, preventive mechanisms
- Strategic environmental valuation and assessment as a tool for project planning:
- Harmonisation of environmental control requirements: clear reporting and monitoring regulations, standards, EMS, and further interpretation of the environmental legislation
- Environmental governance and stewardship: what this means for the State, companies and public at large

Emerging questions and suggestions:

- If the draft Law on Subsurface Use is accepted, what are its prospects for implementation over the short term and over the long-term?
- What are the implications of these legislative changes on the investment climate in Kazakhstan? What is the Government's policy objective? How will companies presently operating in the oil and gas sector in Kazakhstan be affected? What about potential investors?
- Does the higher degree of administrative control resolve existing problems in socio-economic and environmental terms? What are the prospects and projections?
- Packaging project outputs and possible next steps:
 - Guidelines for different stakeholders on oil and gas contracts and sustainability;
 - Recommendations flexible enough to adapt to ongoing legislative development;
 - Lessons learnt on contract development based on Kazakhstan case study;
 - Practice guide on contracts for non-lawyers.