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Review of the legislative base for investments in oil and gas sector of the Republic of Kazakhstan

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1. Introduction

Kazakhstan has vast amounts of natural mineral and raw resources, making it a key priority for the Kazakhstani economy. It ranks number two in the world for deposits of uranium, chrome, lead and zinc, number three for manganese, number five for copper and in the top ten for coal, iron and gold. The country also has an advantageous geographical location between East and West, along with a competent labour force, qualified specialists and professionals, and good industrial potential. It is proving attractive to domestic and foreign investment. Attraction to foreign investors is only possible through the development of the necessary legislative framework, and the fact that billions of dollars have been invested, mostly in mineral and raw materials, confirms the existence of this framework.

2. Legislative Framework

Two important legislative acts are the *Decree of the President of the Republic "On Subsoil and Subsoil Use,"* in force from 1996, and the *Decree of the President of the Republic "On Petroleum,"* in force from 1995. One of the main principles of the Law on Subsoil Use is the creation of favourable conditions for foreign investment. In addition to these laws, the tax and custom regimes have also played an important role in investment in the oil and gas sectors. Indeed, the main drivers for changes in the law have related to changes in these regimes.

The first legislative act was the *Code on subsoil and processing of mineral resources.*¹ The Code specifies that the subsoil is the sole property of the Republic of Kazakhstan, and management of natural resources is delegated to the government. The Code envisages the granting of rights over the subsoil for conducting geological studies, producing mineral resources, and building and operating underground construction unrelated to mineral production.

The main provisions of The Code were elaborated in the Law on Petroleum. The definition of petroleum includes crude oil, natural gas, combustible schist and resinous sand. One of the most significant issues that arose in discussion on the draft law was on which body would conclude contracts on behalf of Kazakhstan, the Competent Body. Attempts to define this gave unsatisfactory results; there was a struggle for superiority and a constantly changing structure of state-run public authorities. The result was that the Government, or any state body delegated by the Government, would act as the Competent Body. Currently, this role is assigned to the Ministry of Oil and Gas.

The Code provided rules for two types of contracts for subsoil use: Concession Contracts² and Service Contracts, which are both allowed under the subsequent Law on Petroleum. The former is a lease of the land and subsoil under defined terms. However, these were seen as inexpedient given the developed nature of the petroleum industry. The latter includes service contracts, where the contractor renders services to carry out operations for remuneration, and Production Sharing Agreements (PSAs), where the contractor carries out operations at its own expense and risk, and receives part of the extracted product as payment. Service contracts differ from PSAs only in the source of compensation, and have never been concluded in Kazakhstan. Until recently PSAs were the norm and examples included contracts with Elf-Aquitaine, BG and.

The main distinction between the concessionary system and the service contracts system (commonly referred to as the 'contractual system') concerns property rights over the mineral resources. As a general rule, under the concessionary system the user rents subsoil from the state in return for royalties and taxes. Under the contractual system, the user receives a royalty and a share of the proceeds. Concessions assume mineral resources to be the private property of the user. Under the contractual system, property rights in the minerals only vest after a certain point of sharing³. The PSA does not, generally, require the contractor to pay taxes and other mandatory

1 Adopted by the Supreme Council on May 30, 1992.

2 Defined in the Law on Concessions in the Republic of Kazakhstan (Adopted by the Supreme Council on December 23, 1991).

3 Generally closer to the place of export or transfer

payments (except royalties).

The use of PSAs has evolved historically. The Elf-Aquitaine contract was one of the first contracts for carrying out petroleum operations, as a PSA. This contract was actually concluded in the absence of Kazakhstani legislation. Since 1999, Kazakhstan has refused to license activities under the concessionary system, instead preferring the contractual system.

The law governing subsoil rights is constantly changing and evolving. However, these changes do not necessarily give positive effects. Often the changes are tactical, and can undermine the legal framework. In addition, the law has been through some difficult stages of reform, particularly regarding the transfer of rights, and is still passing through periods of change. Frequent changes, unreasonable declarations, introduction of new subsoil systems, and changes to tax systems can negatively impact the oil and gas investment climate and affect the economy as a whole.

3. New Draft Law On Subsoil and Subsoil Use

A new law on subsoil and subsoil use was drafted in 2008 and is currently being reviewed by the federal Parliament of Kazakhstan. Once the law is put in place, it will replace the legislation currently governing the exploration and production of oil and gas in Kazakhstan, namely the Law on Petroleum, the Subsoil and Subsoil Use Law of 1996, and the Law on Production Sharing Agreements. Production sharing agreements (PSA's) already in effect will remain so, but the production sharing model of investing in oil and gas reserves will no longer be available. The law is expected to come into force at some time in 2010. However, the fact that it was in Committee in Parliament for a very long time and only recently considered by the Senate is evidence that there are a number of complex issues yet to be resolved.

On the surface, the new draft Law on subsoil and subsoil use, along with the new Tax Code, eliminates concession contracts and PSAs, and states that a new kind of contract will be introduced that taxes production instead of imposing a royalty. However, this does not practically differ from royalty payments. Article 2 of the Draft Law provides that, if not specified in the contract, raw minerals belong to the subsoil user. This is more akin to the concessionary system. Therefore, regardless of the taxation conditions, the contract on subsoil use envisaged by the Draft Law could be considered a concession contract unless otherwise provided. However, despite essential differences between the current and proposed systems, the economic rent for both is similar.

As with many recent changes in the regulation of subsoil use in Kazakhstan, this draft law is linked with changes in the tax and customs regimes. As with prior versions of subsoil use laws in Kazakhstan, the draft law describes a general procedure for granting subsoil use rights, including for exploration and production of oil and gas. The law envisions a tender process for granting subsoil use rights, with emphasis put on social development payments and signature bonuses which are then translated to a contract and work programme for the successful bidder. The draft also sets out the types of subsoil use contracts which may be concluded and the parameters to be included in a model contract. Where disputes under this law cannot be resolved through negotiation, they may be referred to a court in accordance with legislative acts of Kazakhstan. It is not clear whether this would include any form of international arbitration. Holders of subsoil use rights have an obligation to ensure the prevention of subsoil contamination and reducing the harmful effect of subsoil use operations on the environment

It was politically important that Kazakhstan, as a petroleum-producing country, had a separate law on petroleum. However, petroleum production is only one of the various productions of mineral resources. The rules in the Law on Subsoil Use are general, and are supplemented by the Law on Petroleum. The question arises, what about other minerals? The main objective of the new Law is to combine the Law on Petroleum and the Law on Subsoil and Subsoil Use. However, it does this very mechanically and there are few new norms.

Of the new norms included, many of these should be excluded. These include norms concerning the contradiction between the Draft and other Laws. In addition, there is confusion over the

concept of pre-emptive and priority rights in the Draft, and the legal nature of contracts is not defined.

4. Administrative and legislative procedures

Kazakhstani legislation provides detailed regulations on administrative procedures. There are positive effects of detailed regulation, because it promotes transparency, but there are still negative sides.

The State has the right and obligation to improve regulation concerning petroleum and other strategic branches of the economy. The market economy of Kazakhstan assumes a clear split between public-legal and private-legal spheres, and equality of entities. However, in recent years there is concern on the increasing retreat from market economy principles. Unreasonable intervention by officials is increasing, and the number of laws growing. Quite often it is not state interests behind these activities, but ministerial or corporate interests of some officials.

One example of where the state earned an unreasonable unilateral advantage in private-legal relations is the amendment to Article 71 of the Law on Subsoil and Subsoil Use. It states:

“For preservation and strengthening of the resource-energy base of the national economy...the state...is granted priority rights versus the other parities to the contract... and before other persons for acquisition of the alienated subsoil rights... and/or share of participation (block of shares) in the legal entity that has the subsoil rights...”

The purchase of shares from their owners and any realisation of priority rights is, in fact, a transfer of the property from private to state ownership. This process of nationalisation is a legitimate right where a state feels unfairly infringed upon by national or foreign investors. However, it is necessary to follow the right procedures, including openly and honestly declaring it and using public law norms without applying them retrospectively. Indeed, the Bill on State Property envisages these norms, and, except in exceptional circumstances, requires full indemnification and compensation for all losses incurred due to nationalisation.

Under the Law on Subsoil and Subsoil Use, rights are ensured in two ways: through conducting bids for rights and contracts, and; through direct negotiations and conclusion of contracts. Subsoil rights are considered transferred only from the moment of contract conclusion.

There are two ways to tender for subsoil rights. The first is through an open competition, which is conducted among an unlimited number of participants. The second is a closed tender, which is conducted among a limited number of participants. In the former, notification is published through mass media. In the latter, notification is given to potential participants. The notification must include information on time and venue, deadline for submission, main conditions, place and description of the site, cost, minimum sizes of the subscription bonus, and the size of payment for participation.

The decision on bids is made by the Tender Commission, whose work and activities are defined in the Rules on the Commission⁴. It is a constantly operating body created to conduct tenders and define winners, and grants rights of subsoil use to the winners according to the legislation. Its functions are to ensure timely and qualitative consideration of bids, evaluate bids and to develop proposals on procedural improvements.

Acceptance and registration of bids is carried out by the Competent Body, who have a right to refuse bids if applications infringe requirements, if the applicant has submitted false or incorrect data, or if there is no documentary evidence that the applicant possesses the necessary technical, organisational, administrative or financial requirements.

The main criteria for determining a winner include: the term and intensity; the prospective sizes of

4 Approved by Governmental Decree of the Republic of Kazakhstan as of February 13, 2003 No. 158

payment; the size of investment, and; observance of legislative requirements for protection of the subsoil and the environment. The winners of open competitions are published in official journals. The winner of a closed competition is informed by the Competent Body.

The Competent Body and the user are considered to be the parties to the contract. The Ministry of Oil and Gas acts as the Competent Body to conclude contracts on exploration and production (E&P), combined E&P of mineral resources, and extraction of minerals from man-made mineral formations. The Committee of Geology and Protection of Subsoil of the Ministry acts as the competent body to conclude contracts on building and/or operating underground construction not supporting E&P. Negotiations are conducted by the Working Group of the Competent Body, and the Draft contract is prepared based on the Model Contract approved by Governmental Decree⁵. The Model Contract has many conditions, including issues of suspension and termination. The Competent Body can suspend a contract in a number of circumstances, including when the contractor is conducting activity not envisaged in the work programme and where the contractor infringes legislation on protection of subsoil, the environment or health. The contract can also be terminated ahead of schedule in a number of situations. These include where the Contractor fails to or cannot rectify the issues that have caused suspension, if the subsoil user will not start operations as established in the contract, or where there is essential infringement of the contractor's obligations.

When defining the economic elements of the project, the Competent Body considers the financial and economic aspects jointly with the Ministry of Economic and Budget Planning. When concluding the contract, it cannot be less favourable to the state compared to the original bid. After the contract is signed, it is subject to mandatory state registration. The contract doesn't give a general right of E&P, only to those minerals it specifies. If new minerals are detected, the Competent Body has the right to define conditions for production of these minerals through amendments or additions to the contract.

Comprehensive and complex rules exist on the protection of the subsoil, and are mandatory for all legal and physical persons, regardless of their ownership arrangements⁶. Rules also exist to provide ways to purchase of goods, works and services, including through tenders⁷.

5. Dispute Settlement relating to oil and gas contracts

Article 9 of the Civil Code⁸ establishes that the protection of civil rights is carried out by the court or the arbitration court. The Civil-Proceedures Code⁹ sets out the regulations for property disputes and establishes the main jurisdiction rules of the courts. As well as domestic cases, the courts consider cases with participation of foreign citizens, organisations and legal entities. Such cases are consignable to regional courts. In addition, specialised inter-district economic courts have been established although they cannot consider cases where one of the parties is an international or foreign organisation.

The Code does not, generally, limit the rights of parties to choose the place for considering their disputes. For example, Article 419 allows for cases to be considered in foreign courts when both parties agree. However, the subsoil is considered real estate, and under Article 417 of the Code, must be considered exclusively in the RK courts. There are, however, arguments against interpreting these provisions in a way which limits the jurisdiction of other courts in subsoil contracts. For example, it can be argued that the subject of the contract is not subsoil, but removable minerals.

5 Governmental Decree of the Republic of Kazakhstan as of July 31, 2001, No. 1015

6 Single Rules on Protection of Subsoil for development of mineral deposits in the Republic of Kazakhstan, approved by RK Governmental Decree as of July 21, 1999 No. 1019.

7 Approved by Governmental Decree of the Republic of Kazakhstan as of November 28, 2007 No. 1139

8 Civil Code of the Republic of Kazakhstan (General part adopted on December 27, 1994, Special part adopted on Jul 1, 1999)

9 The Civil-Proceeds Code of the Republic of Kazakhstan, adopted on July 13, 1999

In addition to RK courts there are arbitration courts. However, these are on the verge of disappearance as a result of targeted action by the State Office of the Public Prosecutor, the Ministry of Justice and the Governmental and Constitutional Council. Also, the norm that decisions by the arbitration court must be executed has disappeared, due to the Civil-Proceedures Code. In addition, the Constitutional Council accepted a decision in 2002, which established that consideration of disputes in the arbitration court does not exclude repeated consideration of the same dispute in the state court. As a result, the system of arbitration courts in Kazakhstan was destroyed.

However, both opponents and supporters of the arbitration courts have come to the common opinion that the only way out of the situation is to adopt the Law on Arbitration Courts. Although there are a number of problems with the law, including that it expressly excludes particular civil disputes and persons, the acceptance of this law and the Law on International Commercial Arbitration is undoubtedly an important stage in the development of arbitration courts in Kazakhstan.

6. Modern Practices

Attraction of foreign investments has been recognised as one of the main conditions for economic development, and, until recently, the country was considered to have a favourable investment climate, due to political stability, no exceptions to the national treatment of foreign investors, no restrictions on property and free exchange of KZT for any currency. In addition, there was a stable tax structure and a number of tax privileges for foreign investors. One of the most important elements was the well-developed investment legislation. In the last 10 years, the inflow of private capital to oil, gas and mining was 87.5 billion US dollars.

Kazakhstan's challenge is now to attract and create favourable conditions for national investment. In 2003, an additional law was adopted, the Law on Investments, which tried to create single rules for national and foreign investors. However, this law has a weakness, in that it excludes all the norms concerning foreign investors, and it has been necessary to apply other legislative acts.

Recent practice has shown increasing state intervention and a refusal to offer guarantees, but the main problems for foreign investors have been the stability of the concluded contract and the status of arbitration. Due to the new Tax Code, new contracts cannot include any provisions on stability of contracts (stabilisation clauses). In addition, the Code only expressly preserves tax stability in PSAs and contracts approved by the RK President, meaning that other contracts made prior to the Code may not be stabilised for tax purposes.

Another development which could prove unattractive to foreign investors is that contract cancellation and unilateral refusal can be made without intervention of the court, and can be made without giving any reasons; the Competent Body need only declare that there is essential infringement of economic interests of Kazakhstan. Although this right has, so far, never been used, the Ministry of Energy and Mineral Resources has recently demanded subsoil users to make changes to their contracts. If they do not then the Ministry has said it has the right to terminate the contract unilaterally.

Although this situation is not preferable for foreign investors, there are legitimate reasons for these developments. Kazakhstan has become economically independent and developed, and the public, businessmen and officials have become more interested in the conditions of the petroleum contracts concluded in the 90s. There were a number of reasons why these contracts were concluded on what were perceived as unfavourable terms to Kazakhstan, including inexperience and the economic crisis. The level of risk associated with these early investments into fields with uncertain reserve played a role in the negotiating position of investors at that time.. Kazakhstan is now striving to pursue policies that induce and force foreign investors to share part of the enormous profits earned from its mineral resources.

Also, despite these problems for foreign investors, the Law on Investment provides a 'grandfather

clause.' Literally interpreted, it means when there are changes in legislation, the Republic guarantees the stability of conditions except where changes are made by mutual agreement.¹⁰ The Article, however, expressly excludes legislative changes as a result of international treaties or changes to ensure national and economic security, public health and morals.

Article 6 of the Law states that, where legislation changes improve an investor's position, changes can be applied by mutual consent to achieve a balance of economic interests. A similar provision is contained in Article 285 of the Tax Code. The Government has recently tried to revise some of the conditions of subsoil contracts based on this although attempts have not yet been successful.

¹⁰ Item 3 or Article 4 of the Law on Investments