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OIL AND GAS REGULATIONS IN PRACTICE: A LAWYER'S REVIEW

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Kazakhstan is a country renowned for its commodities, whose major source of government revenue is the export of minerals, with oil exports holding the largest place. According to statistics, oil exports account for about 60% of all country exports. Consequently, close attention is paid by the local and international community to the state and legislative developments in the field of oil and gas exploration and production. The global economic situation, oil prices, operations of foreign investors, project implementation, and industry social problems of the industry are the main triggers for any initiative in legislation and social response.

Since its independence - and following from the signing of the main PSAs in the early 90s - Kazakhstan's oil and gas industry has witnessed a phased development of legislation, ranging from the establishment of favorable conditions within the framework of coherent and welcome investment legislation in the 90s to a situation where Kazakhstan has mainly recovered, formed its own National Fund, begun to strengthen government control measures, and to increase requirements for investors, some of which are very questionable.

In this article I will try to briefly analyze the main legal issues facing the industry, with conclusions detailing how it is possible to achieve comfort and positive law enforcement for investors, and where legislation still needs to be significantly improved. To discuss this in more detail, I would like to dwell on recent trends in the industry, current red flags for investors in the oil and gas community. Since I am expressing the opinion of a practicing lawyer on the processes that exist today, without a long-term perspective, some issues may be viewed from different perspectives - political, social, or through the lens of long-term development.

Improvements: Achieved KPIs

Given the increasing maturity of the market as well as its players, there is a pressing need to increase liberalization of legislation, decrease government intervention, and change economic conditions to revive the market and make the situation more appealing to investors. What has been done to date, and how do current laws and practices address these needs?

Entry of investors into projects

Current legislation clearly defines and clarifies conditions for tenders regarding the signing of new concession agreements, as well as details regarding the procedure for buying and selling interest in existing projects. Kazakhstan has changed the procedure for obtaining state permits, established a clear and coherent process (documents, deadlines), removed the state's pre-emptive rights of acquisition of small and medium-sized projects (non-strategic projects), making the procedure for acquiring interest in projects more straightforward and faster.

Are PSAs no longer challenged?

Several years ago, previously concluded PSAs were actively challenged by trying to waive their tax stability, by converting them into regular contracts, or by changing their meaning and interpretation. We are now witnessing a more or less established process of their recognition and application.

Taxation

Today, contracts can be conditionally divided into those that have fixed tax stability as of certain date (as a general rule as of the signing date), and contracts that have no tax stability. Under the latter, the investor is subject to current tax legislation. If we analyze the tax burden, we can conditionally say that it is not as high as in many developed countries, however, constant changes in the legislation detract from the stability and clarity of the game's rule.



Reporting. Project Documentation

At present, no major questions arise regarding which project documents are needed and where they are to be submitted, how they should be drawn up, or where to look for experts. The processes for reporting and the preparation and approval of project documents seem to be settled and are comprehensive and straightforward.

R&D Expenses

A formal list of nominated organizations has been established to which oil companies transfer a certain percentage of their working capital budget for research and development to improve exploration and production technology. However, it would make real impact and clarify meaning if the formal transfer of money to entities "authorized to accept money" would entail clarity of the relevant results and outcomes. Kazakhstan could spend this money to acquire technologies, patents or innovations for disruptive businesses other than commodities production to diversify the economy.

Environmental matters

The current Environmental Code establishes processes and environment compliance rules. The rules of the game have become increasingly transparent. However, a number of issues raised by the industry remain in relation to “economics vs ecology”, for instance, compensation for excess emissions or gas flaring.



Local talent training

In the past, there was a shortage of local talent in the field. Subsequently, establishment of contractual obligations for the training of personnel and the replacement of foreign personnel led to an increase in local employment. Active training of local specialists and their promotion to management positions is now visible. This is due to the commitment of oil companies and their corporate culture to train local staff and internal talent development programs.

KPIs to Target

Stabilized vs. Current legislation on concession agreements

PSAs and contracts approved by Kazakhstan's President now have a certain security and stability against legislative changes; however, Kazakhstan's economy is still that of a developing economy with constant revisions to its legislation, yet it is important that investors be assured of a certain stability.

At the same time, stability should not be equated with rigidity; it should not mean refusing to improve legislation, but rather guaranteeing clear and consistent rules to predict long-term results of investment activities. When planning an entry into a project, an investor must be able to predict its economy based on some coherent and calculable initial data. Therefore, Kazakhstan at this present stage, - when there is already relevant experience and knowledge - should consider how to reduce the number of “shocks” to investors, openly announcing longer-term policy planning.

Local content

The contracts now set various thresholds for local content, for example, the percentage of locally- produced materials and equipment in the total budget spent for purchasing goods and equipment for operations. The same normally applies to purchase of services and staff hiring. The goal of the state is obvious - to increase domestic production and national product. However, it is often necessary to adopt an individual approach, for example, for goods and equipment due to the non-diversified economy of Kazakhstan and the limited production and availability of local goods and equipment.

Procurement

Procurement rules are in constant flux. There is currently an innovative online platform that marks the beginning of transparency; however, this system does not allow an accurate determination regarding the compliance of price range qualification requirements. Moreover, competition between potential suppliers at a fixed price cannot be applied to projects with special sensitivity or the need for complex technologies and qualifications.

Oil Export Quota

Currently, most contracts require that a subsoil user supply the local market with a certain percentage of oil produced and then be allowed to export the rest (export quota). However, in practice there is frequent non-compliance with the quota in the contracts. For example, the contract may require supply to the local market of up to 30 percent of the volume of oil produced, allowing over 70 percent to be exported, but in practice government agencies often only permit smaller export volumes. Creation of a transparent mechanism and compliance with guaranteed export volumes is the most important KPI to convert an ambiguous oil sales economy into a transparent, corruption-free system.



Customs Export Duty

Customs export duty was introduced as an instrument of state influence on excess profits of oil companies, as a response to the years of high oil prices. It is directly dependent on world oil prices. However, the government's bureaucratic mechanisms to update the rates often delay a prompt response to the volatile oil prices market, and, therefore, to the economics of the investment projects.



Regional Social Response

Given the general economic situation — the lack of diversification of the economy and the concentration of basic income around oil exports — the negative social response in the 'oil patch', which should be properly managed by the local governments to avoid risks to investors, has instead intensified. Increase of public awareness and the engagement of local communities should also be seen as important KPIs for collaboration between the national governing bodies and investors.

Government Management and Cooperation

Today, the competent authority - the Ministry of Energy - plays a dual role: that of the party to the civil contract (E&P contract), and that of the controlling state body. However, this cannot always work due to the different status and legislation regulating these roles. As the common objective is to ensure the safety of the projects and improve their economics at the same time, the mechanism of state management and regulation of oil operations should be significantly improved, for example, by introducing self-regulatory organizations, agencies, or institutions without the status of a state body into the management structure, following the example of many Western countries representing the state's interests to the investors. This allows the establishment of real cooperation, increases the efficiency of project implementation, takes into account the specifics of projects, and changes the nature of the relationship from "punitive" to "collaborative".

Recent Trends

Litigation: Rule of Law or Rule of State Interests?

When representing the interests of oil companies in court disputes with state bodies, we are faced with a persistent bias by the courts towards the interests of the state. How should courts be guided? By Rule of Law or Rule of State Interests? Without getting into political theory, a solution must be found.

One solution could be the pre-trial (peaceful) settlement of disputes. This is not currently done due to the dual status of the competent authority. Legislation sets out a peremptory norm - public authorities cannot conclude amicable agreements with private companies. This directly contradicts the nature of a civil law contract - a subsoil use contract. Peaceful resolution of disputes, the search for compromises between the parties to civil law contracts, especially in long-term relations, should be the basis of cooperation between investors and the state since it directly proceeds from the essence of contractual legal relations.

An extrajudicial and pre-trial settlement of disputes by analogy with tax disputes can also be a good alternative. There is already a positive example - an appeal commission to hear complaints of tax assessments (decided not only by the relevant government body, but also by the Atameken National Chamber of Entrepreneurs).

Although this option is not ideal, it is definitely a step towards improving the process of dispute settlement. Currently, the claims against the competent authority are appealed directly to the court, in the absence of any alternative. The competent authority may also immediately file a lawsuit against the subsoil user in court. A buffer between the dispute and its consideration by the court is necessary. In terms of judicial review of disputes, a good option is to consider disputes in non-state courts, for example, the AIFC court or arbitration.

Finally, during the hearing itself, a reconciliation between parties is possible. After all, the competent authority's claim to recover the penalty under the contract is not a public law matter. The voluntary agreement by the competent authority and the subsoil user to enter into a mediated negotiation process to resolve the conflict through compromise, helps to maintain a balance of interests between the parties and the possibility of further joint activities.

Breach of Contract

Earlier this year, a number of companies were sued for breach of contract and ordered to pay fines. The violations were:

- *Violations of the deadlines for the start of exploration or production*
- *Failure to fulfill obligations under the work program*
- *Violations of obligations regarding Kazakh personnel, goods, work and services, and maintenance*
- *Failure to train Kazakh specialists and finance social programs, etc.*

For bona fide investors, who are still the majority, the non-fulfillment of contractual obligations arose in most cases for reasons beyond their control, for example, untimely (protracted) signing of documents by the competent authority (permission for additional issue, altering of the contract, affecting the fulfillment of contractual obligations). At the same time, in almost all claims, court decisions were made in favor of the state.

Without analyzing the specifics, in those cases we reviewed, the subsoil user's fault was ambiguous, often directly due to inappropriate action by the competent authority. As a result, due to the improper fulfillment of obligations by the competent authority acting as the state regulatory body, the same authority, but acting as a party to the contract, sued the company for defaulting on its obligations.

Model contracts

As a measure of the unification and "modernization" of subsoil use contracts, the latest Subsoil Code, after exploration, envisages the conclusion of new production contracts in the form of a standard contract. This is a logical step in light of the new regulations in the field of subsoil use.

Despite the fact that this is the right of the subsoil user, the competent authority in most cases insists on concluding a new contract. The first model contracts are already being concluded and a paradox of this process has already arisen. The tax authorities' position is that these are "new contracts" and, accordingly, accumulated exploration expenses under the "old contracts" cannot be counted as costs against future production.



Is this a "cold shower" for the investors? It is nonsense. On the one hand, the state is in favor of creating conditions to attract investment in subsoil use, and, on the other hand, it frightens investors by legal inconsistencies and/or their interpretation, which do not favor subsoil users. An investor may invest in exploration, taking huge risks with the expectation of recovering the investment through production, only to lose this opportunity.

Given the above, we believe there is a real need for negotiations between the State Revenue Committee, on the one hand, and subsoil users, with the assistance of the competent authority, the Ministry of Justice and the bodies regulating investment activity. A transparent and fair approach to the taxation of hydrocarbon exploration and production should be developed. Otherwise, irreparable damage will be caused to the investment climate in Kazakhstan.

Tax Stability vs. Tax Creativity

The state has also found creative ways to increase profitability from projects, even from under-stabilized contracts. In our practice, we observe repeated cases of refusal to return VAT, the amount of which is sizeable as the accumulated VAT is often almost fully refundable.

Companies may not receive VAT refunds due to errors made by their suppliers, such as problems with documents or a supplier reporting of the 4th stage in the total supply chain. Yet the investor cannot influence the actions of this supplier in any way as he does not have a contractual relationship with the supplier. And so the investor is punished. The government aims to create a transparent system for the supply chain and VAT, but why must this be done at the expense of a bona fide investor?

Transfer pricing

In Kazakhstan, control of oil export prices, even in transactions between independent parties, is included in the concept of transfer pricing. Despite regular changes (introduction of price monitoring - submission of regular reporting, establishing an agreement on prices), there are still additional assessments of the oil revenues, yet a clear practice still does not exist for both tax and judicial authorities. There are often cases where companies, with an absolutely transparent mechanism for selecting oil buyers, and all the documents confirming the costs associated with the transportation and sale of oil, accrue millions of dollars through the use of "convenient" sources of information.

Summary

With the development of oil and gas legislation and maturity of the industry, it is necessary to introduce new institutions and mechanisms to cooperate with oil and gas investors so that the state's profit from projects is expressed not only in material benefits, but also in a meaningful balance of economic interests and collaboration with oil companies.

This collaboration should sustain the short-term receivables as well as increase investment into future gains by acquiring new technologies, human and social capital, and overall to improve Kazakhstan's reputation in a challenging and changing global economic arena.