

New Developments in the Regulatory Framework for Investing in Kazakhstan's Oil and Gas Sector

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Before I begin my section of the program, I would like to take the opportunity to thank the organizers of KIOGE for inviting me to speak at this year's event. The hard work put into this conference provides the petroleum industry with an excellent focal point for the exchange of contacts and ideas.

In this short presentation, I will draw your attention to several key developments in the regulation of the oil and gas sector in Kazakhstan.

The first issue that I would like to address today is the application of the transfer pricing rules. As you know, in January 2001 Kazakhstan implemented the **Transfer Pricing Law**, which was followed by the Implementation Instruction in May of the same year. However, the tax authorities began enforcing these Rules only last year. At that time, the tax authorities did not have the suitable experience in such activities. As a practical matter, the tax authorities did not have the necessary database or price monitoring system, nor did they have the dialogue co-operation with the customs authorities, necessary to implement these rules. Even now many of these difficulties still exist. The general tumult of this process caused, at times, significant misapplications of the law. As a result of this tact, several oil producers companies were forced to defend their rights in court.

Our law firm, SALANS, is very happy to report that one week ago we secured a victory in Kazakh court case on behalf of one of our clients against the Tax Committee dealing with the Transfer Pricing Rules. During the course of litigation, the parties to the dispute analyzed every aspect of the Rules. As a result, the tax authorities appear to have a much better understanding of the Rules, as well as of practical difficulties related to their implementation. To our knowledge, this was the first big transfer pricing case in country. We are glad that other companies can now utilize the principles established by the court in this particular matter.

There are three principles relating to the Transfer Pricing Rules that are particularly important:

The first is that pricing information should be taken from those official sources and publications ag-

reed to by the parties in the relevant sales contracts and that the dates for such pricing information must be strictly the same as provided by the contracts;

The second is that, in the absence of a tax list of the off-shore jurisdictions, the list of such jurisdictions established for banking purposes should be applied;

The third is that the various circumstances of a particular shipment or transaction should also be taken into consideration in determining the "market price".

The case revealed a lot of difficulties in the implementation of the Transfer Pricing Rules, many which were successfully resolved by court. Having invaluable experience in dealing with this issue in Kazakh courts, SALANS is in a unique position to share its experience with other oil companies with similar problems, if needs be.

As a second issue in my address relates to the procedure for amending the subsoil use licences. In observing various petroleum transactions in the past year, there is still a clear need to spell out exactly what is the process for amending licences.

As you know, both the Petroleum Law and Subsoil Law were significantly amended in late 1999 to change the regime used by the Republic to grant rights for the use of the subsoil in conducting oil and gas operations¹.

Prior to the 1999 amendments, subsoil use rights were granted on the basis of both a licence and contract. Under this system, the licence contained the essential terms for the exercise of subsoil use rights, including the name(s) of the subsoil right holder and a basic description of the minimum work program. Generally speaking, these licences were issued by and were subject to the jurisdiction of the Licensing Body, which was the RK Government.

It is an important tenet of the old system that licences are paramount to subsoil use contracts.

¹ Law of the Republic of Kazakhstan, "On the Introduction of Amendments and Changes to Certain Legislative Acts of the Republic of Kazakhstan on Subsoil Use and the Conduct of Petroleum Operations in the Republic of Kazakhstan," dated 11 August 1999 (the "Subsoil Amending Law").

Following the 1999 amendments, the licensing scheme was abolished. Since that time, subsoil use rights are governed by the amended laws and are granted solely on the basis of a subsoil use contract with the designated Competent Body (currently the Ministry of Energy and Mineral Resources). *At the same time, Article 2.3 of the Subsoil Amending Law mandates that all pre-existing licences continue in effect according to their terms.*

Article 2.3 of the Subsoil Amending Law also provides that the issues of suspension, revocation and termination will continue to be governed by the prior text of the Subsoil Law, without taking into account the Subsoil Amending Law. However, there is a difficulty in the application of this provision, since suspension, revocation and termination of licences were within the authority of the Licensing Body.

This body no longer exists as a result of the Subsoil Amending Law. In this case, many lawyers in Kazakhstan believe that the RK Government should continue to perform the functions of the Licensing Body under the old law, as follows from the above-mentioned Article 2.3. However, the RK Government has taken the official stance that further amendments to subsoil use licences are not necessary, except with respect to suspension, revocation and termination³. As such, it now generally refuses to amend such licences with the exception of particular cases where a licence was amended to reflect a change in the identity of the subsoil rights holders.

To this end, it is important to remember that the contract must conform to the terms of the licence, or the terms of the contract will be deemed invalid as explained above⁴. **In light of these factors, it is critical for licence holders to ensure that they properly amend their licences to reflect the current understanding with the Republic, as mere ministerial approval will generally not suffice.**

Our experience during the past year shows that the amendment of existing licenses is becoming more and more troubling, especially since more and more companies are becoming interested in acquiring subsoil use rights in Kazakhstan. The current position and practice of the authorities does not assist the general understanding of the process. On one hand, there is a protocol decision of the Deputy Prime-Minister establishing that there will be no further amendments to licenses by the Government. On the basis of this decision many

assignments were documented solely by amendments to hydrocarbon contracts. On the other hand, at least two Government decrees have in fact been

issued to amend two licenses and one of those decrees was passed on the very day that the Deputy Prime-Minister issued his decree doing away with licence amendments.

It is very important for this issue to be resolved in future amendments to the subsoil legislation. In the meantime, any amendments made to subsoil contracts concluded prior to August 1999 without the corresponding amendments to the respective licenses in the form of a Government Decree remain vulnerable and subject to challenge.

The third issue I would like to address attracted a lot of attention during the last year. This issue centers around whether the New Law on Investments applies to Production Sharing Agreements.

The enactment of the new *Law on Investments* by the Republic may signal a formal change in attitudes surrounding foreign investment in Kazakhstan. Although it will take some time to determine the full impact of the new law on foreign investors, many of our clients in the oil and gas industry have been asking the same question: **Does the new Law on Investments apply to Production Sharing Agreements (PSAs) entered into between foreign investors and the Competent Body?**

Unfortunately, the new *Law on Investments* does not provide investors with a clear answer to this question. Under the new law, "Investments" are defined as all types of property, including leased property: "invested by the investor into the charter capital of a legal entity or an increase of fixed assets, which are used for entrepreneurial activities". The definition of "Investment Activities" echoes these two investment avenues. Arguably, the investment and funding obligations of a foreign energy company under a PSA could be deemed to constitute an 'increase to fixed assets used for entrepreneurial activities'.

However, the new *Law on Investments* confuses matters by stating at Article 2.3 that it is not applicable to: "relations which arise in carrying out investments that pertain to the sphere of effect of other legislative acts of the Republic of Kazakhstan [...] except as provided for by such acts". Regrettably, the new act does not clarify the meaning of the 'sphere of effect' of other legislation. This is vexing, because most sectors of the economy are governed by a multitude of specific laws, ranging from securities to tax to currency exchanges.

Since oil and gas activities are specifically governed by a number of normative acts, including the *Law on the Subsoil* and the *Law on Petroleum*, they would likely be deemed to be under the 'sphere of effect' of those laws. On this basis, PSAs would fall outside the ambit of the new *Law on Investments*. In such circumstances, PSA holders would not have the benefit of any rights that might

² Op. cite, note 4.

³ Protocol/Minutes of the Meeting Convened by RK Deputy Prime Minister K.K. Masimov of May 14, 2002.

⁴ Subsoil Law, Article 22.

be afforded by the stability provisions set out in Article 4 of the new *Law on Investments*. It is noted that the stability provisions of Article 23 of the *Law on Investments* would appear to apply only to investment agreements concluded with the State body authorized to grant investment preferences.

However, such investors would continue to benefit from the more advantageous stability provisions under the *Law on the Subsoil* and the *Law on Petroleum*. In addition, the investors would, in any event, benefit from the stabilization and other protections that might be accorded under applicable investment protection treaties in effect between their home governments and the Republic. Such treaties would supersede Kazakhstan laws of general application.

In light of the foregoing, the foreign business community in Kazakhstan will have to closely monitor the future interpretation and application of the new *Law on Investments* by the courts and other State bodies. As a body of jurisprudence and practice emerges, foreign investors in the energy sector will have a more accurate understanding of the impact, if any, of the new *Law on Investments* on their PSAs.

Finally, I would like to direct your attention to certain amendments to the legislation affecting foreign investors' **choice of a business vehicle for doing business** in Kazakhstan. In particular, with reference to the recently adopted Laws on Investment and on Joint Stock Companies, and to legislation regulating purchases by oil and gas and State companies, I would like to discuss the factors should be taken into account when deciding on a legal form of representation in Kazakhstan.

Prior to 2002, we usually advised our clients to act in Kazakhstan either through a branch of a foreign company or a Kazakhstan subsidiary. The most obvious advantage of using a branch for work in Kazakhstan was the low profile of Kazakhstan legislation in regulating the activities of foreign companies. This allows branches to effectuate payments in Kazakhstan in any currency, to freely transfer capital abroad and to reduce the total tax burden on a company. Previously, if a foreign company intended to create a Kazakhstan subsidiary, we suggested establishing either a closed joint stock company or a limited liability partnership, which were considered less-regulated business vehicles in respect of corporate governance, the registration of shareholdings and the amount of the authorized capital.

At present, the legal situation has changed. As a result, investors should now consider acting through a Kazakhstan subsidiary rather than a branch of a foreign company. Concerning the available forms for a Kazakhstan subsidiary, the legal entity known as a closed joint stock company was eliminated in May 2003, thus shortening the list of possible

options open to foreign companies for a Kazakhstan subsidiary.

In 2002-2003, Kazakhstan adopted legislation that makes carrying on business in Kazakhstan through a branch of a foreign company less attractive in comparison with carrying on business through a Kazakhstan subsidiary.

First of all, a foreign company which intends to provide goods or services to oil and gas companies or State companies needs to take into consideration the "local content" requirements. Requirements to purchase goods and services from local providers, if such goods and services meet applicable standards, were recently strengthened by petroleum legislation, as well as by legislation regulating state purchases.

Strict local content requirements were introduced into the Petroleum Law on 11 August 1999⁵. The Petroleum Law provides that "*amendments and additions to legislation which worsen the position of the Contractor shall not apply to Contracts concluded prior to such amendments and additions*"⁶. Therefore, oil companies that concluded their subsoil use contracts before these amendments took effect in 1999 may argue that they may comply with requirements of the previous legislation, under which oil companies need only "*give preference*" and "*give priority*"⁷ to Kazakhstan companies⁸. However, those oil companies that concluded their subsoil use contracts after these amendments took effect, will have no choice and will be obligated to use Kazakhstan suppliers of goods, and involve Kazakhstan service providers in their operations.

Before 2002, the requirements to purchase goods and services for oil operations from Kazakhstan companies were rarely complied with in practice. However, during the last year, the RK government started a vigorous enforcement of these requirements. For this purpose, the government adopted the Rules for the Acquisition of Goods,

Work and Services for Petroleum Operations in June 2002 (the "Procurement Rules")⁹.

The Procurement Rules state that oil companies may purchase goods and services from foreign suppliers only where Kazakhstan suppliers cannot provide goods and services to the applicable standards and requirements. If the bids of foreign companies are considered, priority is given to those potential suppliers who:

⁵ RK Law "On the Introduction of Changes and Additions into Certain Legislative Acts of the Republic of Kazakhstan on the Issues of Subsoil Use and the Conduct of Petroleum Operations in the Republic of Kazakhstan" dated 11 August 1999, Article 1.

⁶ Petroleum Law", Article 57.

⁷ Id., Article 41, version in force before 11 August 1999.

⁸ Please note, however, that this argument is not decisive and another interpretation of the law is possible.

⁹ Rules for Acquisition of Goods, Work and Services for Petroleum Operations adopted by the RK Government Decree dated 7 June 2002 (the "Procurement Rules").

- ! produce goods and services in Kazakhstan;
- ! attract high technology to Kazakhstan;
- ! use goods and services of Kazakhstan producers; and
- ! offer to use foreign goods and services on the basis of creating a joint venture with a Kazakhstan company in which a share of the Kazakhstan company is not less than fifty (50) percent¹⁰.

In our view, the law requires that subcontractors who acquire goods and services for Petroleum Operations comply with the Procurement Rules.

Another recently adopted law that articulates the priority of Kazakhstan providers of goods and services over foreign providers is the Law on State Purchases.¹¹ The requirements of the Law on State Purchases are mandatory for State bodies, State institutions, State enterprises and joint stock companies controlled by the State, as well as their affiliated legal entities, when they acquire goods and services from the funds which are at their disposal¹². This effectively means that the Law on State Purchases governs, among other things, the purchases of large national companies such as KazMunaiGas. Since KazMunaiGas is an integral part of the Kazakhstan petroleum market, the requirements applicable to State purchases might be of interest to foreign investors.

The Law on State Purchases and related legislation has created a scheme for granting priority to Kazakhstan suppliers, which significantly differs from the one set forth in the petroleum legislation. Unlike the Petroleum Law, the Law on State Purchases does not contain any obligation to use goods and services of Kazakhstan suppliers. It merely states that potential suppliers that are local entities shall have priority when a State purchaser determines a successful bid¹³.

All priority conditions are set forth in the Rules for Organization and Conducting State Purchases of Goods and Services adopted by the RK Government on 31 October 2002 (the "State Purchases Rules")¹⁴. The Rules provide that a potential supplier is recognized as a "local supplier", if it:

- (1) is a resident of the Republic of Kazakhstan;
- (2) produces finished products in Kazakhstan; and if
- (3) eighty-five (85) percent of its employers are local¹⁵.

According to the State Purchases Rules, when determining a successful bid, a tender commission may reduce prices offered by local suppliers by as much as twenty (20) percent¹⁶. Of course, such price reduction represents significant assistance to local providers in securing a State contract.

(1) In addition to the foregoing, Law on Investment adopted in early 2003 also suggests the necessity for creating a Kazakhstan legal entity for business activity in Kazakhstan. The Law on Investment provides for the possibility of obtaining investment incentives, such as the reduction of corporate income tax, land and property tax for the period not exceeding a 5-year term, the exemption from customs duties, and the receipt of in-kind grants from the State¹⁷.

The investment incentives provided for by the Law on Investment are available only to those investors who invest in legal entities established under Kazakhstan laws. Accordingly, those investors who intend to invest in Kazakhstan through a branch office would not be eligible for the investment incentives provided by the Law. The Law on Investment provides that the particular incentives to be granted are decided on a case by case basis between the investor and the RK government represented by its authorized body, and are stipulated in an investment contract¹⁸.

In summary, under Kazakhstan legislation, certain business activities can be only carried out by Kazakhstan legal entities. Although certain types of activity is not the sole purview of local companies, a foreign company which produces goods or services for the Kazakhstan market may encounter problems with selling such goods or services since priority is given to local providers. Furthermore, different legal acts set out the different characteristics required in order to be viewed as a "local provider" and to be eligible for respective benefits. This leads to the conclusion that before commencing any activity in Kazakhstan, a foreign company needs to carefully consider two questions: (a) What particular activities will it carry out? and (b) Who are its potential buyers? On the basis of the answers to these questions, a company would be able to select a suitable business vehicle for work in Kazakhstan.

The constant development of Kazakhstan legislation in different spheres requires a higher degree of attention from companies when selecting a business vehicle for doing business in Kazakhstan. This step will help to ensure that the company is entitled to all benefits and privileges provided for by Kazakhstan legislation.

I would like to thank you all for your kind attention today. If you have any questions about any of the issues raised this morning, please do not hesitate to come and speak to me afterwards.

¹⁰ Id., section 70.

¹¹ RK Law dated 18 May 2002 "On State Purchases" (the "Law on State Purchases").

¹² Id., Article 1.

¹³ Law on State Purchases, Article 26.1.

¹⁴ Rules for Organization and Conducting State Purchases of Goods, Work and Services approved by the RK Government Decree dated 31 October 2002.

¹⁵ Id., section 37.

¹⁶ Id.

¹⁷ RK Law dated 8 January 2003 "On Investment", Article 13.

¹⁸ RK Law on Investment, Article 14.