

New Rules for the Purchase of Goods, Work and Services in the Performance of Petroleum Operations in Kazakhstan

Dr. Olga I. Chentsova, Managing Partner, and Natalia V. Brainina, Partner, Aequitas (Kazakhstan)

1. Introduction

In July 2002 *Rules for the Purchase of Goods, Work and Services in the Performance of Petroleum Operations* were adopted and entered into effect in Kazakhstan ("the Rules")¹. The content of the Rules is a striking example of the clear tendency of excessive tightening of state control over the business activity of entities of entrepreneurship that is taking shape in the national economy.

The Rules apply to the activity of contractors under contracts for the performance of petroleum operations in Kazakhstan, when they purchase goods, work and services (collectively – the Goods), as well as to similar activity of third parties (agents) for benefit of contractors. (Hereinafter contractors and their agents are collectively referred to as Contractors).

The Rules have been adopted for the implementation of requirements of the Edict On Petroleum², specifically, of Article 41 (6, 7) that obligates a Contractor to use Kazakhstani materials and products and engage Kazakhstani contractors during the "process of the contract's implementation"³.

The Edict On the Subsoil⁴ contains essentially similar provisions, and, furthermore, a rule that "in the event of absence of some, services in the Republic of Kazakhstan, a subsoil user shall to use the services of foreign organizations pursuant to permission of the state agency" (Article 63 (8-1)).

In this paper we just briefly review the procedure for the purchase of Goods in accordance with the Rules, and also focus on certain issues of concern that arise in connection with the adoption of the Rules and their application.

2. Procedure for the Purchase of Goods as Established by the Rules

Under the Rules, the main ways of the acquisition of goods in the performance of petroleum opera-

tions are as follows:

1) a tender; 2) the purchase without holding of a tender.

2.1. A Tender is the Main Method for the Purchase of Goods.

The Rules define the following terms as general requirements to its holding:

! a tender should be held in Kazakhstan;

! in order to recognize a tender as held participation of not less than two participants is required, provided the tender organizer considers their bids as meeting the requirements of the tender;

! the basic language of the tender holding is the state or the Russian language. All tender documentation, including competitive bids shall be submitted in the Russian language, which is given the status of the prevailing language;

The Rules admit the possibility of holding both a closed and open tender and also the use of two-stage procedures for its holding⁵.

¹ Approved by Decree No. 612 of the Government of the Republic of Kazakhstan, On the Approval of the Rules for the Purchase of Goods, Work and Services in the Performance of Petroleum Operations, dated June 7, 2002 ("Decree No. 612").

The Rules relate only to petroleum operations, however, Decree No. 612 prescribe to the Ministry of Energy and Mineral Resources of the Republic of Kazakhstan (the "RK MEMR") within six months from the moment of its adoption to submit to the Government of the Republic of Kazakhstan proposals on the regulation of the purchase of goods, work and services in the performance of other operations related to the subsoil use. The same Ministry is designated as an authorized state agency for the regulation of the purchase of goods in the performance of petroleum operations.

² Edict No. 2350 of the President of the Republic of Kazakhstan Having the Force of Law, On Petroleum, dated June 28, 1995, in the wording as of August 11, 1999 (the "Petroleum Edict");

³ Literally, Article 41 establishes that a contractor shall: "obligatorily use the materials and finished products made in the Republic of Kazakhstan provided they comply with the standards and other requirements, with holding of tenders in the Republic of Kazakhstan in the procedure as established by the Government of the Republic of Kazakhstan" (clause 6);

"obligatorily engage Kazakhstani enterprises and organizations for the performance of work and rendering of services in the conducting of Petroleum Operations, including the use of air; railway, water and other types of transport, provided these services comply with the standards and other requirements, with holding of tenders in the Republic of Kazakhstan in the procedure as established by the Government of the Republic of Kazakhstan" (clause 7).

⁴ The Edict of the President of the Republic of Kazakhstan Having the Force of Law, On the Subsoil and Its Use, dated January 27, 1996, in the wording as of August 11, 1999 (the "Subsoil Edict").

⁵ A tender with the use of two-stage procedures shall be carried out only in cases explicitly defined by the Rules, for example, when: it is difficult to formulate detailed specifications of Goods and to determine their technical and other characteristics, and the organizer of the tender needs to request competitive bids from potential participants or conduct negotiations with them; scientific research, experiments or development need to be conducted; the one-stage tender did not result in the establishment of a winner of the tender.

On the whole, it may be asserted that the Rules, while defining the terms and procedure for tender holding, establish a vast number of requirements to be met by a Contractor before it succeeds in the purchase of required Goods.

These requirements are subdivided into those which a Contractor needs to meet before holding a tender for it to take place, and those which should be complied with in the course of the tender holding.

Prior to the holding of a Tender a Contractor shall, firstly, take a decision on the purchase of Goods which content is determined by the Rules (clauses 8, 23); secondly, approve at the authorized state agency the terms of the tender holding which list is also determined in detail by clauses 24-33 of the Rules.

The authorized agency shall deny approving the terms of the tender holding if inaccurate information is contained in the documents submitted for the approval or certain provisions of the terms of the tender holding (and also of the submitted documents) are inconsistent with the requirements set forth by the Rules or other regulatory legal acts of the Republic of Kazakhstan.

The Rules in great detail regulate procedures subject to be implemented in the tender holding, including the determination of the deadlines for informing its potential participants and for submission of competitive bids; the procedure for consideration of these bids; criteria for the determination of the winning competitive bid; the procedure for taking a decision upon the results of the tender and the content of that decision; approval of a protocol on the results of the tender at the authorized state agency (clauses 43-89).

2.2. Procurement without holding tenders (clause 90 of the Rules) is applied in cases when:

- ! required Goods are available only at particular Kazakhstani or foreign enterprise or the latter have exclusive rights to those Goods;
- ! a customer, having purchased Goods from some seller, should purchase from the same seller other goods, work and services consequential to, and owing to, the considerations of unification, standardization or owing to the need to provide compatibility with already available goods, equipment, technology or services.
- ! a tender is recognized as not held.

In order to purchase Goods without holding a tender it shall be necessary to obtain a relevant per-

mission and for that the customer should apply to the authorized state agency. The application should be attached with various documents which sufficiently long list is provided in the Rules.

The authorized state agency shall take a decision on the issue or refusal to issue permission within 10 days; the refusal to issue it or non-receipt of the motivated response may be appealed in the court.

3. Certain Issues of Concern Arising in Connection with Adoption and Application of the Rules

Contractors negatively reacted to the adoption of the Rules, which is quite understandable. The greatest problems are related with the tightening of state control over the activity of Contractors, verging on the violation of their rights to the freedom of business activity and also with general inconsistency of a number of the basic provisions of the Rules with the current legislation of the Republic of Kazakhstan. Other important problems relate to poor legal technique of the Rules regarding the key issues, including the absence of the clear-cut definitions of Goods to be purchased in accordance with the Rules, the absence of a price threshold for purchased Goods, vagueness of interrelation of the Rules and the Law of the Republic of Kazakhstan On State Procurement.

3.1. Excessive Tightening of State Control

In our view, the basic idea and the objective of the new Rules is the establishment of the strict control from the state represented by the authorized agency over business activities of Contractors that perform petroleum operations through direct interference in the process of acquisition by them of Goods. The above is confirmed by the following arguments.

The Rules endow the authorized agency with very broad powers, the most effective instrument of its influence being (1) obligatory participation of a representative of the authorized agency in the tender commission, and (2) the possibility to purchase Goods with the consent of the authorized agency.

The Rules expressly state that *“Prior to the approval of the protocol on the results of the tender at the authorized state agency the Organizer of the tender may not enter into a contract with the winner of the tender upon its results”* (clause 81).

We believe that there is no objective need for the authorized agency to approve the outcome of

the tender, especially, in the light of the presence of its authorized representative in the tender commission. The approval of the tender outcome just tightens and duplicates control over, and interference of the authorized agency with, business activity of the Contractor.

The Rules are abundant in requirements and conditions to be met by Contractors when they purchase Goods. Incompliance with them results in the refusal of the authorized agency to approve the protocol on the results of the tender, with subsequent invalidation of the tender (clause 81).

3.2. Incompliance of the Rules with the Current Legislation of the Republic of Kazakhstan

We believe that the requirements stated in the Rules, in the aggregate, may be considered as violation of the constitutional right to the freedom of business activity stated in part 4 of Article 26 of the 1995 Constitution of the Republic of Kazakhstan⁶, which establishes that *"Each individual enjoys a right to the freedom of business activity, free use of his/her property for any legitimate business activity"*.

The requirements of the Rules may also be evaluated as the violation of the basic provisions of the civil legislation on the protection of the freedom of business activity, specifically, Article 2 of the RK CC⁷ "The Fundamentals of the Civil Legislation"⁸ and Article 10 of the RK CC "Protection of the Rights of Entrepreneurs and Consumers"⁹.

Additionally, there may be raised the issue of contradiction of the Rules to the Petroleum Edict and the Subsoil Edict for the implementation of which the Rules were adopted. Though both these regulatory acts set forth that the Goods should be purchased with the holding of a tender (Article 41 (6,7) of the Petroleum Edict, Article 63 (7,8) of the Subsoil Edict) neither of them contain a rule that tenders should be carried out with direct participation of the state and with its interference in the process of the tender winner determination.

Furthermore, Article 63 (8-1) of the Subsoil Edict expressly define the only case when the consent of the authorized agency on the purchase of Goods is sought – in the absence of some type of services in Kazakhstan and when Contractors uses services of foreign organizations.

The Rules automatically violate the right to the freedom of business activity not only of Contractors but also of their potential partners who cannot now freely, without interference of the state, enter

into civil legal relations (enter into contracts) with organizations that perform petroleum operations.

In the connection with the foregoing, we believe that serious legal grounds exist to appeal against the Rules as not conforming to the Constitution of the Republic of Kazakhstan and the RK CC, and other legislation, for example, by the bodies of the Prosecutor's Office¹⁰.

3.3. The Absence of Clear-cut Definition of Goods to be Purchased According to the Rules

With regard to many material aspects the Rules do not altogether contain or contain rather vague definitions.

For example, in accordance with the Rules (clause 4) "goods", "work" and "services" which should be purchased in the procedure established by the Rules mean the following:

"goods" – equipment, finished products and other materials required for the performance of petroleum operations;

"work" – payable implementation pursuant to the assignment of a customer of the work on the creation (production) of goods, assembly of equipment, construction of structures and other work required for the performance of petroleum operations;

"services" – payable implementation pursuant to the assignment of a customer of certain actions or performance of certain activity as a result of which no goods are produced or the object of which are not material items, but which are required for the performance of petroleum operations.

It is absolutely unclear from the provided definitions what particu-

⁶ The Constitution of the Republic of Kazakhstan, adopted at the referendum on August 30, 1995.

⁷ The Civil Code of the Republic of Kazakhstan (General Part) dated December 27, 1994, as amended (the "RK CC").

⁸ According to the rules of Article 2 of the RK CC "Civil legislation is based on the recognition of the equality of the participants of the relations regulated thereby, inviolability of property, freedom of agreement, inadmissibility of arbitrary interference in somebody's private affairs, indispensability of the free exercise of civil rights, and provision for the restitution of violated rights and their defense in the court (clause 1).

Citizens and legal entities shall acquire and exercise their civil rights by their will and in their interests. They shall be free in establishing their rights and obligations on the basis of agreements and in specifying any conditions in their agreements, which do not contradict legislation" (clause 2).

⁹ According to the rules of Article 10 of the RK CC "Entrepreneurship is the activity of citizens and legal entities, taken on the initiative, irrespective of the form of ownership, which is aimed at the earning of net income by way of satisfying the demand for goods (work, services) which is based on the private property (private entrepreneurship) or under the right to business authority of a state-owned enterprise (state entrepreneurship)" (clause 1).

The rights of entrepreneurs who carry out the activities which are not prohibited by legislation shall be protected as follows:

1) by the possibility to carry out entrepreneurial activities without obtaining anyone's permission, except for the types of activity which are subject to licensing..." (subclause 1 of clause 3) In particular, each consumer shall have the right: to freely enter into agreements to purchase goods and to use work and services..." (clause 6).

¹⁰ The provisions of the Law of the Republic of Kazakhstan, On the Prosecutor's Office, dated December 21, 1995, as amended, including Articles 19 and 23(2) of this Law may constitute the legal basis for the actions of the Prosecutor's Office.

lar goods, work, and services from those required to the Contractor should be considered as needed specifically for the performance of petroleum operations.

We admit the possibility of the narrow and broad interpretation of this issue.

In the broad interpretation, in the procedure as established by the Rules there shall be acquired all and any goods, work, services which are purchased by the Contractor, irrespective of how, directly or indirectly, they relate to petroleum operations. It is quite possible that the authorized agency would adhere to such interpretation.

In the narrow interpretation, in the procedure as established by the Rules there shall be purchased only those goods, work, services which are directly related to some specific petroleum operation and are exactly required for its performance.

For example, rendering services on the representation in the court of interests of the Contractor under its claim to the tax authorities on the recognition as invalid of an Act of checking the fullness of assessment and payment of taxes by the Contractor is not directly needed to the Contractor for the performance of petroleum operations, though it relates to the fact that the Contractor performed these operations. Accordingly, this service may be purchased without application of the Rules. However, the purchase of drilling equipment for prospecting and production should, accordingly, be carried out in the procedure established by the Rules.

We believe that the terminology of the Rules should be interpreted narrowly, which is permitted in the formal legal sense and is expedient from the point of view of the development of the Kazakhstan economy as a market economy.

3.4. The Absence of Price Threshold for Goods Purchased in Accordance with the Rules

The Rules are silent with respect to a question: for what volume of Goods to be purchased (by the cost and/or assortment) the holding of a tender is required?

As stated above, the Rules envisage the possibility of very broad interpretation of the concept of "Goods", which application may practically *paralyze* the business activity of Contractors (which is already occurring to a certain extent) since

the most insignificant purchases made by the Contractor in the process of its business ac-

tivity may fall under the requirement of the tender holding.

Proceeding from the absurdity of the assumption on the need to hold a tender, for example, for the purchase of stationery in a small amount and considering that the former draft Rules contained a provision on the maximum price threshold which exceeding required the holding of a tender, we believe that the grounds for holding of the required tenders (considering the cost or assortment of goods) could be provided in *Instructions on the Procedure for Consideration of Customer's Applications and Issue of Permission to Purchase Goods Without Holding a Tender, on the Procedure for the Approval of Terms of the Tender Holding...*[etc.], which should be developed by the authorized agency in accordance with clause 6 of the Rules.

However, it would be more expedient to establish price criteria (at least in terms of MCI¹¹) in the Rules since this issue is one of the fundamental ones in the establishment of the legal regime for the purchase of Goods, and, accordingly, this issue should be resolved by the Government of the Republic of Kazakhstan in its Decree, but not in the Instructions to be issued by the authorized agency. Furthermore, the Petroleum Edict and the Subsoil Edict explicitly state that it is the Government of the Republic of Kazakhstan that should establish the procedure for the purchase of Goods.

3.5. Correlation of the Rules with the Law of the Republic of Kazakhstan On State Procurement

The Law of the Republic of Kazakhstan, On State Procurement, was adopted on May 16, 2002 (the Law). It follows from the Law that the purchase by state agencies, state establishments, state enterprises and joint stock companies, which controlling shareholding belongs to the state, as well as by legal entities affiliated with them, of goods, work and services at the expense of funds in their disposal is the state procurement and it should be carried out in the procedure as established by the Law On State Procurement (Articles 1 and 9).

A number of enterprises that carry out petroleum operations, including, for example, the National Company Kazmunaigas closed joint stock company and its affiliated companies fall now under the effect of the Law that establishes its own requirements and terms which are to be complied with in the purchase of goods, work and services. The requirements established by the Law differ from those set forth by the Rules.

¹¹ MCI is: a monthly calculation index which amount is established by the Law of the Republic of Kazakhstan, On the State Budget, for the relevant year.

Neither the Law nor the Rules establish which of these two regulatory legal acts should be applied in the acquisition of goods, work and services by an entity that simultaneously falls under the regime of state procurement and the effect of the Rules.

If this issue is not legislatively resolved in the near future, enterprises – “lucky entities” that comply with the concept of “Customer” both under the Law and the Rules, probably would be forced to hold two tenders simultaneously, to deal with two authorized agencies, to coordinate potential suppliers that they should not forget to participate in both tenders. Otherwise, they run the risk that the most unfavorable legal implications would arise, right up to invalidation of the concluded transactions.

4. Possibility of Application of the Rules on the Protection from Changes in Legislation

It is of special interest to consider the issue of the possibility of non-application of the Rules to the Contractors that obtained licenses for the performance of petroleum operations and/or concluded relevant contracts prior to the adoption of the Rules, on the basis of the mechanisms of protection from the changes in legislation set forth by the RK CC¹², Law On Foreign Investment¹³ and the Subsoil Edict and the Petroleum Edict¹⁴.

4.1. The Possibility of Application of the Rules to Contracts Entered into After Amendment of Subsoil Use Legislation on August 11, 1999

The Rules have been adopted for the purpose of implementation of the Petroleum Edict in the wording as of August 11, 1999¹⁵. That is, the requirement to hold tenders in the purchase of Goods needed for the performance of petroleum operations was established as early as September 1999, and the Rules just established the procedures for their holding. Therefore, the application to Contractors that entered into contracts for the performance of petroleum operations after August 31, 1999 of guarantees on the non-worsening of their position in the change in legislation is hardly possible.

It is even more improbable that such guarantees would be applied to contracts that had been entered into after that date and which contain a term on the obligatory holding of the tender in the purchase of goods. Therefore, following the requirements of the Rules becomes mandatory for

the Contractors not only because of the legislation but also because of the provisions of the contract.

However, it should be unwise to completely abandon the possibility of consideration of the protection mechanisms for such legal relations since, as we noted above, the adopted Rules conceptually contradict the Petroleum Edict and the Subsoil Edict, allowing to the authorized body to interfere in the tender holding and issue permission for entering into contract with the winner, while nothing of the kind is stipulated by the Edicts. Therefore, the Rules contradict both the Petroleum Edict and the Subsoil Edict and worsen the position of the Contractor, if compared even with the regulation established on August 11, 1999.

4.2. The Possibility of Application of the Rules to Contracts Entered into Prior to Amendment of Subsoil Use Legislation on August 11, 1999

As regards contracts concluded prior to entering into effect of the August 1999 amendments in legislation on the subsoil use, we, being based on the below, believe that certain legal possibility exists to prove that the Rules should not be applied to them.

The Petroleum Law (Article 41 (6-7)) and the Subsoil Edict (Article 63 (7, 8, 8-1)) prior to their amending in August 1999 had not established the requirements on the obligatory holding of tenders in the purchase of goods, work and services required for the performance of petroleum operations. In our view, the introduction of the new regulation worsened the position of Contractors because it restricted their entrepreneurial freedom, entailed the bureaucratization of their business activity, allowed to the state in many respect to groundlessly interfere into their activities. The new regulation entails additional costs for the Contractors (for example, for holding of tenders, for work remuneration of new employees who should prepare the vast number of documents stipulated by the Rules; costs related to the suspension of work that could not be continued without supply of some goods, and the last, lost profit which may arise in connection with the disruption of already formed business ties between the Contractors and their suppliers).

It should be noted that the current legislation does not contain any legislative criteria of worsening of the position of investors, including subsoil users (Contractors). State structures apparently

¹² Article 383 “Agreements and Legislation” of the RK CC.

¹³ Article 6 “Guarantees from Changes in Legislation” of the Law of the Republic of Kazakhstan, On Foreign Investment, dated December 27, 1994, as amended.

¹⁴ Article 57 “Guarantees of Contractors’ Rights” of the Petroleum Edict; Article 71 “Guarantees of Subsoil Users Rights” of the Subsoil Edict.

¹⁵ Article 383 “Agreements and Legislation” of the RK CC.

tend to think that the worsening of the position means just worsening of the financial nature, that is, unforeseen additional financial costs. We believe that such attitude is not based on the legislation, and any worsening of the legal regime of the subsoil use should be deemed worsening of the position of the Contractor.

Most contracts concluded prior to September 1999 expressly stipulate that the Contractor has a right to free purchase of work, services and goods, including from foreign manufacturers. Thus, the terms of the freedom of the relevant contracts contained in the then effective legislation simultaneously became contractual provisions.

Under a general rule explicitly set forth in Article 383 of the RK CC *"when after the conclusion of an agreement, legislation establishes for the parties the rules which are different from those which were current at the moment of the conclusion of the agreement, the terms of the concluded agreement shall retain force, except for the cases where legislation establishes that its effect shall cover the relations which arose from the agreements concluded earlier"*.

The Petroleum Edict and the Subsoil Edict in the wording as of August 11, 1999 do not contain a special provision stipulating that amendments in the subsoil legislation apply to the terms of earlier concluded contracts. Therefore, the terms related

to the purchase of Goods contained in the earlier concluded contracts should be implemented. Otherwise, the requirement to the implementation of the Rules may be evaluated as violation by the state of contractual terms with all ensuing implications.

We assume that for the lawful refusal to obey the Rules and to use mechanisms of the protection from the changes in legislation because the new regulation worsens the position of Contractors, an investor (Contractor) would be forced to prove that the application of the Rules worsens its position, including from the point of view of the economics of the project. But they may and should prove it impartially and, if required, in the court and in the arbitration tribunal (depending on how this is defined by contracts and the applicable legislation).

5. Conclusions

We believe that Contractors should exert all reasonable efforts for bringing their negative attitude to the Rules to notice of the Government of the Republic of Kazakhstan and the State on the whole, right up to the application to the relevant agencies for the recognition of the Rules as illegal and even unconstitutional with respect to some provisions contained therein, with presentation of the required legal substantiation of that attitude.